Office of Chief Counsel
Internal Revenue Service
Memorandum

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CC:LB&I:
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date: November 2, 2017

to:
Supervisory Internal Revenue Agent
Large Business and International (LB&I)
Internal Revenue Service

from: Associate Area Counsel
(Large Business & International)

Legend:

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Brand 1 =

Brand 2 =

Brand 3 =

Clause Omitted =

Date 1 =

Date 2 =

Date 3 =

Domestic A =

Domestic Parent =

Draft Memorandum =

Foreign =

Foreign Country =

Foreign Subsidiary =

Foreign Parent =

Omitted =

Service 1 =

Service 2 =

Service 3 =

Assigned Attorney =

UIL: 197.00-00. Amortization of Goodwill & Certain Other Intangibles

Subject: Application of anti-churning rules of I.R.C. § 197(f)(9).

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

You asked for our legal opinion on whether the anti-churning provisions in I.R.C. § 197(f)(9) prohibit Domestic Parent from amortizing the Brand 2.

All references in this memorandum to I.R.C. § 1253(d)(2) and (3) refer to I.R.C. § 1253(d)(2) and (3) in effect prior to amendment by § 13261(c) of Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, 107 Stat. 312 (August 10, 1993) (the “1993

OBRA"). The 1993 OBRA did not amend I.R.C. § 1253(a), (b), (c), and (d)(1).

Based on the facts and analysis below, we have concluded that the anti-churning rules of I.R.C. § 197(f)(9) and Treas. Reg. § 1.197-2(h) apply to the Brand 2. Accordingly, Domestic Parent cannot amortize the Amount 2 lump-sum payment to Foreign Subsidiary for the Brand 2 under I.R.C. § 197(a).

FACTS:

Domestic Parent created the Brand 1 but did not amortize amounts capitalized to the brand because it was a self-created intangible.

On Date 1, Domestic Parent sold the Brand 1 for Amount 1 to its Foreign Subsidiary, a company organized under the laws of Foreign Country. Domestic Parent and Foreign Subsidiary are related persons as defined in I.R.C. § 197(f)(9)(C).

On Date 2, Foreign Parent completed a separation transaction pursuant to which the Brand 1 was separated into the Brand 2 and the Brand 3, with Foreign Subsidiary retaining the Brand 3.

Also on Date 2, Domestic Parent purchased the Brand 2 from Foreign Subsidiary for Amount 2 lump-sum payment. Domestic Parent took a cost basis of Amount 2 in the Brand 2 and began amortizing the Brand 2 under I.R.C. § 197(a) ratably over a 15-year amortization period, beginning with its taxable year ended Date 2. For Foreign tax purposes, Foreign Subsidiary reported the sale of the Brand 2 as a sale of a capital asset, resulting in Amount 3 in capital gain. Foreign Subsidiary is not required to pay U.S. federal income tax.

On Date 2, relevant domestic and foreign parties entered into a agreement ("the Agreement") that set forth the parties' respective rights and obligations with respect to the Brand 2 and the Brand 3. Foreign Subsidiary retained the rights to the Brand 3.

LAW & ANALYSIS:

I.R.C. § 197(a) provides that a taxpayer is entitled to an amortization deduction for any amortizable § 197 intangible and the amount of such deduction is determined by amortizing the adjusted basis, for purposes of determining gain, of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

I.R.C. § 197(c)(1) provides that the term “amortizable § 197 intangible” generally means any “§ 197 intangible” that is acquired by the taxpayer after August 10, 1993, and that is held in connection with the conduct of a trade or business or an activity described in § 212. Pursuant to I.R.C. § 197(d)(1), a “§ 197 intangible” includes, among other things, any trademark or trade name.

I.R.C. § 197(f)(9) and Treas. Reg. § 1.197-2(h) provide the anti-churning rules for purposes of I.R.C. § 197.

For purposes of I.R.C. § 197, I.R.C. § 197(f)(9)(A) provides that the term “amortizable

§ 197 intangible" generally shall not include any § 197 intangible described in I.R.C. § 197(d)(1)(A) or (B) (goodwill or going concern value), or for which depreciation or amortization would not have been allowable but for I.R.C. § 197, and which is acquired by the taxpayer after August 10, 1993, if: (i) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993, by the taxpayer or a related person; (ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before August 10, 1993, and, as part of the transaction, the user of such intangible does not change; or (iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before August 10, 1993. For purposes of I.R.C. § 197(f)(9)(A), it also provides that deductions allowable under I.R.C. § 1253(d) shall be treated as deductions allowable for amortization.

Treas. Reg. § 1.197-2(h)(1)(i) provides that the term "amortizable § 197 intangible" shall not include goodwill and going concern value that was held or used at any time during the period beginning on July 25, 1991, and ending on August 10, 1993 (the "transition period") and any other § 197 intangible that was held or used at any time during the transition period, and was not depreciable or amortizable under prior law.

Treas. Reg. § 1.197-2(h)(3) provides that for purposes of Treas. Reg. § 1.197-2(h), deductions allowable under I.R.C. § 1253(d)(2) or pursuant to an election under I.R.C. § 1253(d)(3) are treated as deductions allowable for amortization under prior law.

I.R.C. § 1253(a) provides that a transfer of a franchise, trademark, or trade name is not treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

I.R.C. § 1253(b)(2) provides a nonexclusive list of rights that constitute a "significant power, right, or continuing interest" for purposes of I.R.C. § 1253(a). I.R.C. § 1253(b)(2)(A) provides that one such right is a right to disapprove any assignment of such interest, or any part thereof. I.R.C. § 1253(b)(2)(C) provides that another such right includes a right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.

I.R.C. § 1253(d)(1)(A) provides that any amount described in I.R.C. § 1253(d)(1)(B) that is paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name shall be allowed as a deduction under I.R.C. § 162(a) (relating to trade or business expenses). I.R.C. § 1253(d)(1)(B) provides that an amount is described in I.R.C. § 1253(d)(1)(B) if it: (i) is contingent on the productivity, use, or disposition of the franchise, trademark, or trade name; and (ii) is paid as part of a series of payments (I) that are payable not less frequently than annually throughout the entire term of the transfer agreement, and (II) that are substantially equal in amount (or payable under a fixed formula).

I.R.C. § 1253(d)(2)(A) provided that if a transfer of a franchise, trademark, or trade name is not (by reason of the application of I.R.C. § 1253(a)) treated as a sale or exchange of a capital asset, any payment not described in I.R.C. § 1253(d)(1) that is made in discharge of a principal sum agreed upon in the transfer agreement shall be allowed as a deduction: (i) in the case of a single payment made in discharge of such principal sum, ratably over the taxable years in the period beginning with the taxable year in which the payment is made and ending with the ninth succeeding taxable year or ending with the last taxable year beginning in the period of the transfer agreement, whichever period is shorter; (ii) in the case of a payment which is one of a series of approximately equal payments made in discharge of such principal sum, which are payable over (I) the period of the transfer agreement, or (II) a period of more than 10 taxable years, whether ending before or after the end of the period of the transfer agreement, in the taxable year in which the payment is made; and (iii) in the case of any other payment, in the taxable year or years specified in regulations prescribed by the Secretary, consistently with the preceding provisions of I.R.C. § 1253(d)(2)(A).

I.R.C. § 1253(d)(2)(B) provided that I.R.C. § 1253(d)(2)(A) does not apply if the principal sum referred to in I.R.C. § 1253(d)(2)(A) exceeds $ 100,000.

I.R.C. § 1253(d)(3)(A) provided that any amount paid or incurred on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name to which I.R.C. § 1253(d)(1) or (2) does not apply shall be treated as an amount chargeable to capital account.

I.R.C. § 1253(d)(3)(B)(i) provided that if the taxpayer elects the application of I.R.C. § 1253(d)(3)(B)(i), an amount chargeable to capital account (I) to which I.R.C. § 1253(d)(1) would apply but for I.R.C. § 1253(d)(1)(B)(ii), or (II) to which I.R.C. § 1253(d)(2) would apply but for I.R.C. § 1253(d)(2)(B), shall be allowed as a deduction ratably over the 25-year period beginning with the taxable year in which the transfer occurs.

In Stokely USA Inc. v. Comm'r, 100 T.C. 439, 449 (1993), the Tax Court concluded that once a right falls within one of the specifically enumerated rights in I.R.C. § 1253(b)(2), Congress intended that there should be no further inquiry into its significance.

Domestic Parent does not dispute that the anti-churning rules in I.R.C. § 197(f)(9) and Treas. Reg. § 1.197-2(h) apply to the Brand 2 unless the Brand 2 was amortizable under prior law. In this regard, Domestic Parent contends that the anti-churning rules in I.R.C. § 197(f)(9) and Treas. Reg. § 1.197-2(h) are inapplicable because Domestic Parent would have been eligible to elect to amortize the purchase price of the Brand 2 over 25 years under I.R.C. § 1253(d)(3). Specifically, Domestic Parent argues that the reciprocal quality control provisions contained in (and to a lesser extent,) of the Agreement and the reciprocal assignment provision in of the Agreement constitute significant rights retained by Foreign Subsidiary with respect to the subject matter of the Brand 2 as provided in I.R.C. § 1253(a). Specifically, Domestic Parent argues that:

> The quality control rights gave [Foreign Subsidiary] quality control rights not only over the use of the Brand 2 and the services provided thereunder, but also over the systems and equipment used by Domestic Parent in providing such services. The quality control rights retained by [Foreign Subsidiary] will endure for the life of the Brand 2. The Agreement is perpetual and the quality control rights retained by [Foreign Subsidiary] will survive any transfer of the Brand 2.

Draft Memorandum.

APPLICATION OF I.R.C. § 1253(d)

I.R.C. § 1253(d)(1) does not apply to Domestic Parent because it purchased the Brand 2 from Foreign Subsidiary for Amount 2 lump-sum payment, and Domestic Parent was not required to make contingent payments as described in I.R.C. § 1253(d)(1)(B)(i). Because I.R.C. § 1253(d)(1)(B)(i) is the reason for I.R.C. § 1253(d)(1) not applying in this case, I.R.C. § 1253(d)(1) does not need to be further analyzed for purposes of applying I.R.C. § 1253(d)(3)(B)(i).

Further, the principal sum of the Amount 2 lump-sum payment agreed upon in the transfer agreement between Domestic Parent and Foreign Subsidiary exceeds $100,000. Therefore, pursuant to I.R.C. § 1253(d)(2)(B), I.R.C. § 1253(d)(2) does not apply to the Brand 2.

Because neither I.R.C. § 1253(d)(1) nor (2) applies to the Brand 2, Domestic Parent must treat the Amount 2 lump-sum payment to Foreign Subsidiary in exchange for the Brand 2 as an amount chargeable to capital account pursuant to I.R.C. § 1253(d)(3)(A). Thus, under I.R.C. § 1253(d)(3)(B)(i)(II), the issue is whether I.R.C. § 1253(d)(2) would have applied but for I.R.C. § 1253(d)(2)(B). If Foreign Subsidiary (the transferor) retains any significant power, right, or continuing interest in the subject matter of the Brand 2, then the transfer of the Brand 2 is not treated as the sale or exchange of a capital asset under I.R.C. § 1253(a). If the transfer of the Brand 2 is not treated as the sale or exchange of a capital asset, then Domestic Parent would have been eligible to make the election provided in I.R.C. § 1253(d)(3)(B)(i)(II) to amortize the Amount 2 lump-sum payment over 25 years and the anti-churning rules of I.R.C. § 197(f)(9) and Treas. Reg. § 1.197-2(h) do not apply to the Brand 2. If not, then Domestic Parent would not have been eligible to make such election and the anti-churning rules of I.R.C. § 197(f)(9) and Treas. Reg. § 1.197-2(h) apply to the Brand 2.

QUALITY CONTROL RIGHT

Domestic Parent argues that Foreign Subsidiary retained the right to prescribe the standards of services furnished, consistent with I.R.C. § 1253(b)(2)(C). Our interpretation of of the Agreement is that Domestic Parent and Foreign Subsidiary shared mutual quality control rights over the products and services associated with Brand 1. First, each party agreed to use Brand 1 in good faith, in a dignified manner and in accordance with good trademark practices. Second, each party agreed to use Brand 1 in a manner that does not harm or jeopardize the values of the Brand or its associated goodwill. Third, each party agreed to use Brand 1 in connection with activities, products, and services that maintain at all times the high levels of quality associated with Foreign Subsidiary's and its Affiliates' use of the Brand 1 prior to the date the trademark was sold. Fourth, each party agreed not to take any action that materially harms or jeopardizes the value, validity, reputation or goodwill of the Brand 1.

Domestic Parent may argue that of the Agreement does allow Foreign Subsidiary some control over setting the quality standards regarding the activities, products, and services associated with the Brand 2 as it requires both parties to maintain at all times the high levels of quality associated with Foreign Subsidiary's and its Affiliates' use of Brand 1 prior to the date Foreign Subsidiary sold Brand 2 to Domestic Parent.

However, in our view, of the Agreement does not qualify as "the right to prescribe the standards of quality … of services furnished" pursuant to I.R.C. § 1253(b)(2)(C) for two reasons.

First, the obligations in the Agreement do not meet the plain language of I.R.C. § 1253(b)(2)(C), which provides that the term significant power, right, or continuing interest includes the "right to <u>**prescribe**</u> the standards of quality of…services furnished." (emphasis added.) The word "prescribe" means "to dictate, ordain, or direct; to establish authoritatively (as a rule of guideline)." BLACK'S LAW DICTIONARY (10th ed. 2014). Under the clear language of the statute, to retain a significant power, right or continuing interest, Foreign Subsidiary must essentially have retained the right to dictate, ordain, or direct the standard of quality, as it pertains to the Brand 2, after transferring the Brand 2 to Domestic Parent. Clearly, this was not the function of of the Agreement. Foreign Subsidiary did not retain the right to dictate any differing standard of quality than what had been established in the Agreement. As a result, of the Agreement does not meet the plain language of I.R.C. § 1253(b)(2)(C).

Furthermore, a reciprocal or mutually shared right does not qualify as a power, right, or continuing interest under I.R.C. § 1253(a).[1] Here, of the

[1] <u>See</u> 1998 FSA LEXIS 467 at *18 ("[A] reciprocal right is not granted to [TEXT REDACTED]. Thus, [TEXT REDACTED]'s characterization of [TEXT REDACTED]'s rights is not consistent with the above

Agreement states that it applies to each party and, therefore, this is a reciprocal or mutually shared right/obligation.

That a retained right is not listed in I.R.C. § 1253(b)(2) is not dispositive as to whether the transferor retained a significant right for purposes of I.R.C. § 1253(a). Stokely, 100 T.C. at 453. The list in I.R.C. § 1253(b)(2) is nonexclusive; therefore, retained rights not included in I.R.C. § 1253(b)(2) may qualify for purposes of I.R.C. § 1253(a). Whether a retained right not specifically enumerated in I.R.C. § 1253(b)(2) is "significant" for purposes of I.R.C. § 1253(a) must be determined in light of all the facts and circumstances at the time of the transfer. Id.

Thus, even if we conclude that the quality control provision in of the Agreement is not the equivalent of the right listed in I.R.C. § 1253(b)(2)(C), Domestic Parent could argue that the quality control provision was significant under all the facts and circumstances of the transfer.[2] For instance, Domestic Parent could argue that the provisions in of the Agreement provide Foreign Subsidiary with other quality control rights over the use of the Brand 2 because these provisions require Domestic Parent to adhere to high quality standards and provide remedies for Foreign Subsidiary to ensure compliance. In our opinion, however, such arguments are unpersuasive for the same reasons discussed above regarding our analysis of of the Agreement. Specifically, these provisions are also reciprocal or mutually shared rights/obligations and, therefore, do not provide Foreign Subsidiary the right to prescribe quality control standards.

Domestic Parent also argues that because the quality control provision lasts in perpetuity (for the duration of the Agreement), this fact supports a finding that the quality control provision is a significant right. In Stokely, 100 T.C. at 451, the Court found that the 5-year right to disapprove assignment of the trademarks was not significant because it was not exercisable for the period of time coextensive with the transferred right. The Court stated that unless the rights listed in I.R.C. § 1253(b)(2) were coextensive in duration with the interest transferred, a court would be faced with making a case-by-case determination of the actual significance of whatever temporary limits had been placed on the retained right. Although we agree that the fact the quality control provision lasts in perpetuity could support a finding that the quality control

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referenced Article 4.5(a)(ii) and 4.9(b) of the Transfer Agreement. We conclude that the right retained by [TEXT EDACTED] is a power, right, or continuing interest.").

[2] See Id. at *19-*20 ([TEXT REDACTED] asserts that the quality control right is a mutual right and thus, [TEXT REDACTED] does not prescribe the standards of quality, even though the language of the Transfer Agreement is contrary. However, if [TEXT REDACTED] successfully argued that the quality control right in the Transfer Agreement was not the equivalent of that right listed in section 1253(b)(2)(C), the Service might still be able to establish that the quality control right was significant under all the facts and circumstances of the transfer.).

provision is a significant right, we believe that this fact alone does not establish that the quality control provision is a significant right held by Foreign Subsidiary.

ASSIGNMENT OF RIGHT

I.R.C. § 1253(b)(2)(A) lists the “right to disapprove the assignment of such interest or any part thereof” as a significant right.

In our view, the right to consent to an assignment is similar to the right to disapprove an assignment. After all, if a person does not consent to an assignment request, the person is in effect disapproving the assignment request. Further, of the Agreement provides measures to protect each party in the event that the assignment provision is violated. The consent provision also lasts in perpetuity.

Most importantly, however, of the Agreement, like of the Agreement is a reciprocal or mutually shared right/obligation. Neither party can assign Brand 1 without the prior written consent of the other party. Accordingly, it is our opinion that the assignment provisions in the Agreement do not qualify as a power, right, or continuing interest under I.R.C. § 1253(a).

SUMMARY

In sum, it is our opinion that the quality control provisions in of the Agreement and the assignment provisions in of the Agreement do not constitute the retention of a significant power, right, or continuing interest by Foreign Subsidiary in the subject matter of the Brand 2. Accordingly, I.R.C. § 1253(a) does not apply to the transfer of the Brand 2 from Foreign Subsidiary to Domestic Parent. Further, because neither I.R.C. § 1253(d)(1) nor (2) applies to the Brand 2, Domestic Parent must treat the Amount 2 lump-sum payment to Foreign Subsidiary in exchange for the Brand 2 as an amount chargeable to a capital account pursuant to I.R.C. § 1253(d)(3)(A). Also, I.R.C. § 1253(d)(3)(B)(i)(II) is not applicable because I.R.C. § 1253(d)(2) does not apply regardless of I.R.C. § 1253(d)(2)(B). Because I.R.C. § 1253(d)(3)(B)(i)(I) and (II) are not applicable, Domestic Parent would not have been eligible to make the election provided in I.R.C. § 1253(d)(3)(B)(i) to amortize such lump-sum payment over 25 years.

<u>APPLICATION OF I.R.C. § 197(f)(9)</u>

For the reasons stated above, I.R.C. § 1253(a) does not apply to the transfer of Brand 2 from Foreign Subsidiary to Domestic Parent; I.R.C. § 1253(d)(1) and (2) do not apply to Brand 2; and Domestic Parent would not have been eligible to make the election provided in I.R.C. § 1253(d)(3)(B)(i) to amortize the Amount 2 lump-sum payment over 25 years. As Domestic Parent and Foreign Subsidiary are related persons as defined in I.R.C. § 197(f)(9)(C), the anti-churning rules of I.R.C. § 197(f)(9) and Treas. Reg.

§ 1.197-2(h) apply to Brand 2. Consequently, Domestic Parent cannot amortize the Amount 2 lump-sum payment to Foreign Subsidiary under I.R.C. § 197(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

Please do not hesitate to call me if you have any questions at .

Associate Area Counsel
(Large Business & International)

By: ________________________________
Assigned Attorney
(Large Business & International)