TRANSFER OF BUSINESS CONTRACTS – I.R.S. DISAGREES WITH GREENTEAM, NO CAPITAL GAINS WITHOUT A FIGHT

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Tags
Capital Gains
Code §1253
Franchise
Nonacquiescence

INTRODUCTION

In an Action on Decision ("A.O.D.") published in late 2019, the I.R.S. announced its nonacquiescence to the Tax Court's decision in *Greenteam Materials Recovery Facility v. Commr*.[1] In *Greenteam*, the Tax Court analyzed Code §1253, the provision that standardizes the rules under which payments that are incident to the transfer of a franchise, trademark, or trade name may or many not be treated as capital gains. For individuals, capital gains treatment is favorable because the rate of tax is capped at 20%, rather than 37%. The court concluded that the sale of service contracts as part of the complete sale of a business is covered by Code §1253. The I.R.S.'s nonacquiescence in *Greenteam* indicates that it does not agree with the holding and will not follow the decision in examinations of other taxpayers.

CODE §1253

Code §1253 attempts to distinguish payments that are properly considered royalties from payments representing consideration received in connection with the sale of a capital asset. Code §1253(a) provides as follows:

> A transfer of a franchise, trademark, or trade name shall not be 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 transferred property.[2]

Code §1253(b)(2) defines the circumstances when a significant power, right, or continuing interest exists. It provides as follows:

> The term 'significant power, right, or continuing interest' includes, but is not limited to, the following rights with respect to the interest transferred:
>
> (A) A right to disapprove any assignment of such interest, or any part thereof.
>
> (B) A right to terminate at will.
>
> (C) 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.

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1 *Greenteam Materials Recovery Facility v. Commr.*, T.C. Memo 2017-122.

2 Code §1251(a).

(D) A right to require that the transferee sell or advertise only products or services of the transferor.

(E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.

(F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

FACTS IN GREENTEAM

Three related California partnerships were in the business of providing waste and recycling services for several municipalities in California. In all cases, the municipalities awarded exclusive contracts to handle various waste management and recycling tasks on an exclusive basis. In each instance, the award of an exclusive contract was the last step in a complex procedure that began with a detailed request for proposal, published by the municipality and responded to by potential bidders. The exclusive contracts from the municipalities each ran for several years and a provision existed in each contract for renewal at the completion of the initial term.

At some point during the periods covered by the contracts, the three partnerships sold their businesses to an unrelated party. The transactions were set up as asset purchases that, in the aggregate, covered non-compete rights, tangible assets, land, and buildings. The total price was $46.0 million, of which approximately $28.8 million was allocated to goodwill and going concern value.

The I.R.S. examined the partnership tax returns and asserted that the amounts allocated to goodwill represented ordinary income. The partnerships filed petitions with the Tax Court. Ultimately, the amount in issue was reduced to approximately $18.25 million.

LEGAL ARGUMENTS OF TAXPAYER AND I.R.S.

Code §1253(b)(1) defines the term "franchise" in a straightforward manner:

> The term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

The taxpayers in *Greenteam* argued that, under the above definition, the contracts with the municipalities were franchises granted to the taxpayers to perform services and facilities within a specific area for a specific number of years.

In comparison, the I.R.S. argued that Code §1253 simply defines payments that are not entitled to capital gains treatment; it does not, by itself, define when a contractual right is a capital asset. Consequently, case law controls, in particular *Foy v. Commr*.[3] There, the court applied a six-factor standard to determine whether a payment to acquire a contract is a capital asset or merely a substitute for ordinary income:

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[3] 84 T.C. 50 (1985).

- How were the contract rights originated?
- How were the contract rights acquired?
- Do the contract rights represent an equitable interest in property that itself constitutes a capital asset?
- Does the transfer of contract rights merely substitute the payor of what would be ordinary income?
- Were significant investment risks associated with the contract rights and, if so, were they included in the transfer?
- Did the contract rights primarily represent compensation for personal services?

In addition, the I.R.S. argued that, since Code §1253 was not applicable to the payments, industry usage in California should apply. In the municipal waste disposal industry in California, a contract must be automatically renewable at the end of the term unless specifically terminated for the contract to be a franchise. If the contract is granted for a period of years it is a "municipal contract," rather than a franchise.

HOLDING IN GREENTEAM

The court held that the carting contracts that were sold met the definition of a franchise within the meaning of Code §1253(b)(1). The contracts collectively meet the definition of franchises under Code §1253(b)(1) since the agreements provided each facility the right to offer services in a designated area as required under the relevant contract. Industry terms used in California were not relevant in the application of Code §1253.

Once the court determined that the contracts were franchises, it looked to decided cases[4] to conclude that capital gains treatment should apply so long as the payment is not knocked out under Code §1253(a) and the contract is a capital asset.

The court then looked to the treatment of payments by the transferee. Under Code §1253(d)(1), certain payments are deductible. These are payments that are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name that are paid as part of a series of payments made not less frequently than annually throughout the entire term of the agreement that are substantially equal in amount (or payable under a fixed formula). Under Code §1253(d)(2), all other payments are chargeable to capital account, meaning the cost of acquiring an asset.

The Tax Court then cited previous decisions supporting the sale of a franchise under Code §1253 and determined that the legislative history of Code §1253 supported their interpretation.[5] As the three partnerships did not retain any significant or

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4 *McIngvale v. Commr.*, 936 F.2d 833, 839 (5th Cir. 1991), *affd.*, T.C. Memo. 1990-340; *Jackson v. Commr.*, 86 T.C. 492 (1986), *affd.*, 864 F.2d 1521 (10th Cir. 1989).

5 *Tele-Commc'ns, Inc. v Commr.*, 12 F.3d 1005 (10th Cir. 1993); and *Jefferson-Pilot Corp. & Subs. v. Commr.*, 995 F.2d 530 (4th Cir. 1993) (where the court consistently upheld capital gains treatment under Code §1253 on the sale of a franchise).

continuing interests in the assigned agreements, Code §1253 applied and capital gains treatment was proper.

A.O.D. AND I.R.S. NONACQUIESCENCE

An A.O.D. is a formal memorandum prepared by the Office of Chief Counsel announcing the future litigation position the I.R.S. and whether it will follow or continue to challenge issues notwithstanding a judicial decision on point. In its A.O.D., the I.R.S. published its nonacquiescence position with regards to the *Greenteam* decision, arguing that the plain language of Code §1253 does not support the Tax Court's reasoning.[6]

The I.R.S. announced its view that the Tax Court erred in three aspects of its holding:

- Code §1253(a) was not applicable to the facts in *Greenteam* because it does not specify when a sale or exchange of a franchise is eligible for capital gains treatment. It provides only that ordinary income treatment is required when a taxpayer retains certain powers, rights, and interests. Code §1253 does not state under what circumstances gain from the transfer of a franchise is eligible for capital gains treatment.
- Justifying the decision by looking at the tax treatment of the transferee is flawed. Code §1253(d) addresses only the tax treatment of a transferee's payments. The treatment of the transferee has no bearing on the treatment of the transferor.
- The court's reliance on its earlier cases, did not support its holding in *Greenteam*.[7] Those cases state that a transfer of a contract gives right to capital gains treatment only when the sale is a capital asset in the transferor's hands. In *Greenteam*, the Tax Court did not analyze whether the contracts were capital assets in the transferor's hand.

CONCLUSION

In looking at the I.R.S.'s nonacquiescence in the *Greenteam* decision, perhaps the aspect it found was most troublesome was the fact that the contracts were limited-term contracts to provide services under fixed-term arrangements. Aside from the fixed assets, the only item of value to sell was the future stream of income.

Law school professors lecturing on tax often illustrate the difference between capital gains and ordinary income by reference to a tree and its fruit. The tree is a capital asset, and the owner of the land has property rights for as long as the tree lives. When the land is sold, the portion of the gain attributable to the tree is given capital treatment. In comparison, the fruit grows each year and can be easily sold at a profit. In the view of the I.R.S., merely because a transferor does not retain a significant interest in a service contract that has been sold does not, by itself, mean that the sales proceeds should be viewed as gain from the sale of a capital asset. Nonetheless, the decision in *Greenteam* can provide solace to a taxpayer that has the financial wherewithal to challenge the I.R.S. position in the U.S. Tax Court.

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[6] I.R.B. 2019-42.

[7] *Jackson v Commr.*, 86 T.C. 492 (1986).