convinced that there is a genuine desire by the Commission representatives to learn more about a subject on which they have had little data; that U.S. franchisors have a vital stake in the consequences of the process now underway within the Commission; and that it is essential that IFA represent its members' interests in that effort. Formal steps were taken to initiate that representation before IFA's representatives left Brussels, and member companies will be hearing more of this effort—and learning what they can do to assist in coming weeks.

• A recent exploration by the Commission of the interests of consumers in franchising is of special concern. The European Bureau of Consumer Unions, the major consumer voice at the European level, is more than 20 years old and groups 13 national organizations from the member states. There is no precise parallel in the United States for either the role of such an organization or the statutorily-mandated role of the consumer interest in competition policy. It is clear, however, that a study for the Commission by this group, now being contemplated, could have considerable significance for the future of franchising in Europe.

• It has become increasingly clear that a form of block exemption for franchising should be a principal objective of this undertaking. While it is likely to be the product only of a protracted and perhaps tortuous process of negotiation, and should not be expected to solve all the problems which franchisors can expect to face under the Treaty, it is an essential goal. We were encouraged by the statement released during our visit by the Commission in charge of Competition:

> The Commission will further develop its policy regarding possible *future group exemptions*...The Commission will pay special attention...to franchising in this context.

We were reminded of the length and difficulty of the process we are entering:

> It has, however, to be recalled that the Commission needs to gain some experience through the decision of individual cases or adoption of guidelines before further block exemptions can be envisaged.

That final comment is perhaps the appropriate point at which to close this brief overview of current developments in the EEC affecting franchising, for it underscores the reality which franchisors must be prepared to confront: The climate for franchising in Europe is changing, and perhaps more rapidly than most observers would have predicted only a year ago; those changes can be enormously painful, or quite tolerable, for franchisors; and which is to be the case is likely to be, at least in part, the product of how knowledgably, intelligently and resourcefully IFA and its member companies conduct themselves in the era we are now entering.

Franchise Fee Collection: Reaping the Benefit of Franchisee Tax Deductions

by Bruce S. Schaeffer*

Introduction

Franchisors take into account a multitude of factors in calculating the initial franchise fee to be imposed in consideration for the grant of a single franchise, a multiple unit franchise, an area franchise, a master franchise or a subfranchise. Projected value of the franchise, expected franchisee profits, competitive demands, trademark and goodwill valuations and *pro forma* financial statement analyses, among other factors, are all considered in computing the initial franchise fee to be charged.

What is often overlooked, however, is the ability a mature franchisor has to increase the value of its franchise —and, in turn, to increase the franchise fee—by adjusting its franchise fee payment schedule in a fashion which gives rise to substantial tax benefits to its franchisees, the economic value of which will be added to that initial franchise fee. For mature franchisors capable of protracting the initial franchise fee collection period, the dual benefits of significant franchisee tax deductions and higher initial franchise fees may result.

The benefits discussed in this article assume that the franchisor is capable of receiving its franchise fees in installments over time, rather than in a lump sum fashion at the time of execution of the franchise agreement. From a practical point of view, a start-up franchisor cannot usually afford the luxury of such installment franchise fee payments. Too often such franchisors require every penny of the initial fee immediately to cover the costs of promised training, services and advice to be provided to franchisees and to recoup presale administrative expenditures.

However, for the mature franchisor selling a multiple franchise, area franchise, subfranchise, master franchise or even a single franchised unit of great economic value—and receiving a substantial fee in return—the tax benefits generated through the use of installment payments give rise to significant tax advantages to both parties which, in turn, provide a bargaining chip for obtaining an even higher initial franchise fee.

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*Bruce S. Schaeffer, (LL.M. in Taxation) is a partner in the New York, New York firm of Kaufman, Rosenblum, Gildin & Schaeffer, P.C.

Effect on Franchisee

Any consideration of the tax effects accorded to franchise fee payments must focus on Section 1253 of the Internal Revenue Code of 1954, as amended, and regulations issued thereunder.

Section 1253 is often referred to as the "Dairy Queen" section. Since its passage in 1969, it has been virtually impossible for a franchisor to receive capital gains treatment with respect to franchise fees received. However, the benefits of the deferral of taxes may still be available. To understand this we must start by examining the tax aspects of the usual franchise fee collection pattern.

Assume that a successful franchisor is offering a valuable unit franchise, multiple franchise, subfranchise, area franchise or master franchise in return for an initial franchise fee of $500,000.00. (We shall not focus in this article on continuing royalties, which are not germane to the subject at hand.) Usually, the franchisor arranges for payment of the initial franchise fee in full upon execution of the franchise agreement. If the franchisee makes such a lump sum franchise fee payment and the term of the franchise is ten (10) years or longer, Section 1253(d)(2)(A) of the Code requires that such payment be amortized by the franchisee over ten (10) years. If we assume both franchisor and franchisee are paying the current maximum federal corporate rate of forty six percent (46%) and use 10.5 percent (the current prime rate) as the discount and interest factor, then the tax and economic effects on the two parties to the transaction are as follows:

Franchisor

Current Receipts	$500,000
Less: Taxes Due	$230,000
Net	$270,000

Franchisee

Current Cost	$500,000
Less: Present Discounted Value of right to deduct $50,000/year for each of next 10 years	$150,251.44
Net Cost	$349,748.56

The fact that this transaction costs the franchisee more than it benefits the franchisor reflects the tax factor of deferral—a two-edged sword. In this instance, because the transaction involves a deferral of a tax benefit (i.e., the deduction) rather than a tax liability (i.e., the obligation to pay taxes), it puts the franchisee in the situation of having the effective rate of its tax deductions reduced to approximately 30% even though it is in the 46% bracket [$150,251.44 (Present Discounted Value of Tax Deductions) divided by $500,000 (Current Cost) equals 30%].

From the franchisee's point of view, if the initial franchise fee payment was currently deductable, the current value of the tax deduction would be $230,000, thus reducing the net cost to the franchisee to $270,000. This represents approximately a 30% reduction in the real (i.e. after-tax) cost to the franchisee.

Payment Schedule Quirk

One way for a franchisor to give its franchisees the beneficial effects of current deductibility is to accept a payment schedule for the fixed amount of ten equal annual installments keyed to the deduction schedule.

Another method to yield current deductibility is available by selecting a payment schedule which comes within what Proposed Regulation Section 1.253-1(c)(3)(iv) refers to as a "Series of unequal payments payable over the period of the transfer agreement or more than 10 years". In this case, the franchisee's payments will be deductable in the years when made if (1) no payment exceeds 20% of the principal sum, and (2) not more than 75% of the required payments are made in the first half of the term of the agreement or over the ten year period beginning with the year of the first payment, whichever is shorter.

Optimizing such a payment schedule from the point of view of the franchisor (i.e. yielding the franchisor as much of the face amount as quickly as possible) gives rise to a payment schedule for a $500,000 fixed franchise fee as follows:

*Year**	*Amount*
1	$100,000
2	$100,000
3	$100,000
4	$ 75,000
6	$100,000
10	$ 25,000

*Note no payments are received in years 5, 7, 8 and 9.

If we add to this chart the current discounted cost (using the same 10.5% factor) of such installment payments to the franchisee and the current discounted value of the tax deductions when available, we generate the following computations:

Year	*Current Discounted Cost*	*Current Discounted Value of Deductions for 46%*
1	$100,000	$46,000
2	$ 90,073.58	$41,433.85
3	$ 81,132.50	$37,320.95
4	$ 54,809.21	$25,212.24
6	$ 59,290.78	$27,273.76
10	$ 9,757.01	$ 4,488.23

In this example, the cumulative discounted cost in current dollars to the franchisee is $395,063.08; the present discounted value of the deductions is $181,729.03. This would yield a net current cost to the franchisee of $213,334.05; the value of the deductions would be at the 46% rate ($181.729.03 divided by $395,063.08 equals 46%).

Effect on Franchisor

Now let us look at the economics from the franchisor's perspective. One can see that by adopting the optimum installment payment schedule set forth above, the franchisor has reduced the current value of its fixed franchise fee as well as the net cost to the franchisee. This must be rectified to take account of the time value of money. A 25% increase in the amounts gives us a present discounted value approximately equal to our $500,000. Thus the payments and values would be as follows:

Year	Amount	Current Discounted Value
1	$125,000	$125,000
2	$125,000	$112,591.98
3	$125,000	$101,415.62
4	$ 93,750	$ 68,511.51
6	$125,000	$ 74,113.47
10	$ 31,250	$ 12,196.27

Total Present Discounted Value = $493,828.25

This would seem to give rise the best of both worlds, that is, to give the franchisor the same present discounted value as it would have from a $500,000 current payment while affording the franchisee the same tax benefit as current deductibility (i.e. 46% as the value of deductions), all with the same current net cost of approximately $270,000.

But that is not all. It also gives the franchisor some tax benefits of deferral. It allows the interest portion of the franchisor's installments to compound on a pre-tax basis, at least in part. To illustrate, let us follow our two comparable economic situations from the franchisor's point of view over the ten year cycle. Assuming the franchisor can invest all of its receipts after payment of taxes at the same 10.5% rate, subject to the same 46% tax rate, this would yield an after tax interest factor of 5.67% to use for purposes of compounding.

If the franchisor receives a single payment of $500,000 in lump sum upon execution of the franchise agreement (see above), then the $270,000 remaining after taxes compounded at 5.67% over 9 years (i.e. until the first day of Year 10 when the last payment would be due under the installment example) would yield a total future after-tax value of $449,223.33.

If, on the other hand, the franchisor took the net after-tax proceeds of the installment payments and put each such payment out at a compound effective after-tax yield of the same 5.67%, from the time of receipt until the same first day of Year 10 the total future after-tax value would be:

Year	Future Value of After Tax Payment	Compounded from Receipt to End of Term
1	$67,500	$112,305.83
2	$67,500	$106,129.42
3	$67,500	$100,292.70
4	$50,625	$ 71,082.72
6	$67,500	$ 84,638.86
10	$16,875	$ 16,875

The net after-tax value of the installments comes to $491,324.53. Thus, the earnings on installments come to $221,324.53 (on $270,000 of present discounted after tax value) as opposed to $179.223.33 (on $270,000 of present discounted after tax value). This is a 24% increase in the total yield—from 66% to 82% of principal.

Another point should be made. Using a 10½% discount factor, if the franchisor demands a lump sum payment from a franchisee upon execution of the franchise agreement, then the franchisee's benefit from the resulting tax deductions is limited to 30% (as opposed to 46% effective rate). If, however, we assume a 15% discount factor, then the franchisee's benefit from the tax deductions of the fixed amounts of the franchise fee is limited to a 26% factor. Therefore, from the franchisor's point of view, the ability to make the franchisee's tax deduction 15–20% more valuable is clearly a potent bargaining chip in further increasing the franchise fee to be paid by the franchisee.

Conclusion

While franchisors take into account many salient factors when calculating initial franchise fees, one factor often overlooked is the value of franchisee tax benefits generated by structured initial franchise fees. As we have seen, a properly structured initial franchise fee can generate significant tax advantages for franchisees, the value of which can be added to the initial franchise fee—resulting in a greater such fee paid over time to franchisors. While only mature franchisors can now afford the luxury of structuring fees in such a beneficial fashion, all franchisors should be aware of the tax implications of their franchise fees when engaged in planning the future amounts and structure of such fees.