Success Problems and The Closely-Held Franchisor— The Personal Holding Company Tax

by Bruce S. Schaeffer*

[This article is the first in a series of articles which will examine certain select tax problems which may confront successful, closely-held franchisors.]

I. INTRODUCTION—A Case Study

Roman Lobe, Inc. is a Texas corporation wholly owned by Ralph & Edna Stuckey. Seven years ago, in their home town of Laredo, they opened and operated their first Roman Lobe ear piercing salon using their new select STAAB process for painless piercing. They developed and refined a very distinctive business format. Five years ago, when Ralph & Edna's operation had grown to 4 stores, they decided that their best opportunity for growth would be to franchise their know-how, concept, trademark and distinct format. By 1983, in addition to Ralph & Edna's company-owned and operated centers, there were 46 franchised Roman Lobe outlets.

Under the Roman Lobe Franchise Agreement, a Franchisee is obligated to pay an initial franchise fee of $25,000 plus an ongoing royalty equal to 6% of gross revenues from piercing. For its 1983 fiscal year Roman Lobe filed a Federal tax return showing:

(i) Income from Operations [4 stores @ 250,000 per store]	$ 1,000,000
(ii) Franchise Fees [10 new stores @ 25,000 each]	250,000
(iii) Royalties [46 stores which average $1,667,000 per site @ 6% yield approximately $100,000 per store]	4,600,000
TOTAL	$ 5,850,000

Roman Lobe paid Ralph and Edna $250,000 each for fiscal year 1983. Roman Lobe spent another $1,350,000 on other operating overhead. Accordingly Roman Lobe showed taxable income equal to $4,000,000 [$5,850,000 Gross less $500,000 Ralph and Edna salaries, plus $1,350,000 other overhead]. Roman Lobe paid $1,819,750 as the tax due in accordance with the tax rates in Internal Revenue Code Section 11 (all Section references herein are to the Internal Revenue Code of 1954, as amended, and the Treasury Regulations thereunder, unless otherwise noted). Roman Lobe paid no dividends for fiscal year 1983. To promote their business and national recognition, Roman Lobe reinvested the entire $2,180,250 remaining after taxes in the company.

This past March Roman Lobe was selected for audit by the Internal Revenue Service. After careful inspection the revenue agents determined that Roman Lobe was entitled to every deduction they took. However, after reviewing Roman Lobe's operations and revenue sources, the Service determined that Roman Lobe was a Personal Holding Company (hereinafter "PHC") and therefore issued a Notice of Deficiency to Roman Lobe stating that Roman Lobe was liable for the Personal Holding Company Tax for its fiscal year 1983 operations. The Tax allegedly due was $1,090,125 plus interest and penalties. In parting, the revenue agents requested that Ralph and Edna put together all their records for the past 6 years so that when they came back they could determine whether Roman Lobe was a Personal Holding Company (and therefore liable for the Personal Holding Company Tax) in any of the other 6 years which they said were still open to audit.

"Don't you understand," Ralph said to Edna as the revenue agents left, "they are saying that on the $4,000,000 we made for fiscal year 1983 we are supposed to pay $2,909,875 plus some interest and penalties. That's about a 75% effective tax rate. Are they serious? What is the Personal Holding Tax?"

II. STATUTORY REQUIREMENTS

Section 541 of the Code is entitled *"Imposition of Personal Holding Company Tax"*, and states: "In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 50 percent of the undistributed personal holding company income".

Section 542 defines a Personal Holding Company as a corporation which meets two tests: (1) an income test, if at least 60% of the corporation's Adjusted Ordinary Gross Income for the taxable year is Personal Holding Company Income, and (2) a stock ownership test, if at any time during the last half of the taxable year greater than 50% of the corporation's stock is owned by five (5) or fewer individuals (with certain attribution rules).

Section 543 defines Personal Holding Company Income as income from eight specific categories. The category relevant for this discussion is listed in §543(a)(1) "Dividends, etc.—dividends, interest, *royalties* (other than mineral, oil

*Mr. Schaeffer is a partner of the New York firm of Kaufmann, Rosenblum, Gildin & Schaeffer, P.C.

or gas royalties or copyright royalties), and annuities." [emphasis added]

Treasury Regulation §1.543—1(b)(3) reads in pertinent part "The term 'royalties' (other than mineral, oil or gas royalties, or certain copyright royalties) includes amounts received for the privileges of using patents, copyright; secret processes and formulas, good will, trade marks, trade brands, *franchises*, and other like properties" [emphasis added].

On our facts, it would appear that Roman Lobe is liable for the Personal Holding Company Tax. Ralph and Edna own all of Roman Lobe's shares, so the stock ownership test is met, and the 'royalties' of $4,600,000 reported on the return constituted 78% of the income of $5,850,000, so that it would appear that greater than 60% of Adjusted Ordinary Gross Income was Personal Holding Company Income.

How may a franchisor successfully contend with this possible predicament?

III. LEGISLATIVE PURPOSE AND HISTORY

In order to evolve a strategy for dealing with the PHC tax, it is useful to first analyze the legislative purpose and history underlying its present provisions.

In terms of understanding the legislative policy aspects, one must enter this arena and be prepared to deal with at least two levels of what purports to be a logical bifurcation but actually borders on confused schizophrenia. The first level to confront is the general tax law issue of "characterization" between "active" business income, on the one hand, and "passive" investment income, on the other. The second level of focus turns on the difficulty which courts have in characterizing the franchisor—franchisee relationship.

The purpose of the PHC Tax, originally enacted in 1934 and significantly strengthened in 1937 and again in 1964, was quite simple. It was enacted as a drastic penalty tax, focused primarily at the perceived evil referred to as the "incorporated pocket book." When the PHC Tax was first passed in 1934 the maximum individual tax bracket was 63%; the maximum corporate tax rate was 13.75%—49.25% less. In 1936-1937 the maximum individual rates were 79% while the maximum corporate rate was 15%—64% less! Accordingly, it became clear to many wealthy taxpayers that the thing to do was to incorporate their investment assets rather than hold them individually, subjecting the income earned to the much lower corporate tax rates and permitting accumulation.

The PHC Tax was enacted to impose mechanically a stiff penalty tax on such "incorporated pocketbooks," and to combat certain other abuses, including "incorporated yachts" and "incorporated talents."

It should be noted that presently the maximum individual tax rate is 50% and the current maximum corporate rate is 46%. It no longer pays to incorporate a pocketbook. However, even though the tax abuse which the PHC tax was enacted to combat no longer exists, the penalty lingers on as a trap for the unwary.

Congress did not intend to interfere with active income from legitimate operating businesses when it enacted the PHC tax. However, it adopted such mechanical PHC income tests that interference was inevitable, precluded over the years only by Congressional response to industry-specific "persuasion."

An eminent authority has traced the history of this issue:

"From the inception of the personal holding company tax, banks, life insurance companies and surety companies were . . . recognized as active businesses, and were excluded from the personal holding company provisions. Thereafter, a steady procession of supplicants has been granted relief by Congress for comparable reasons: holders of mineral, oil or gas royalties (in 1937), licensed personal finance companies (in 1938), affiliated groups of railroad corporations (in 1938), industrial banks and Morris Plan companies (in 1942), other small loan companies and finance companies (in 1950), corporations renting property to shareholders for use in an active commercial, industrial or mining enterprise (in 1950, retroactive to 1945), domestic building and loan associations (in 1951), shipping enterprises depositing amounts in Merchant Marine Act reserves (in 1954), corporate affiliated groups generally (in 1954), corporations renting property to shareholders but not having other significant personal holding company income (in 1954), small business investment companies (in 1959), music publishers (in 1960), movie producers (in 1964 and again in 1976), securities dealers handling U.S. government bonds (in 1964), manufacturers leasing their products and also realizing related royalty income (1964, and again in 1966), corporate affiliated groups with life insurance subsidiaries (in 1974), and franchisors leasing the franchise and other property to shareholders for use in an active business (in 1976).[1] Congress, in aiding those afflicted, has repeatedly expressed the intention to keep active businesses out of personal holding company entanglements."[2]

And the same authority has concluded:

". . . Nonetheless, there must surely be some message from this seemingly endless parade. There is: The personal holding company tax, despite the intent of Congress, is fundamentally defective in failing adequately to shield active businesses from its impact."[3]

1. Cf. discussion of *Hugh Smith, Inc.*, below.

2. Morgan, Edward A., "The Domestic Technology Base Company: The Dilemma of an Operating Company Which Might Be a Personal Holding Company," 33 Tax Law Review 241-244 (footnotes omitted).

3. *Ibid.* at p. 244.

The 1934 Treasury Regulation including franchise royalties in the definition of PHC taxable income (§1-543-1 (b)(3), quoted earlier) has remained virtually intact since its enactment.[4] If blind adherence to the Regulation was in order, then the standard payments, contingent on productivity, received by franchisors and denominated "royalties" or "license fees" under most franchise agreements would clearly be PHC income. A Treasury Regulation is generally accorded a very strong presumption of correctness. Even greater weight is accorded such a Regulation which remains undisturbed in the midst of change elsewhere; Congressional reapproval is inferred. However, as noted above, Congress has repeatedly gone on record as being opposed to subjecting active businesses to the personal holding company tax.

It is clear from a review of the legislative history that in spite of the language of Regulation 1.543-1(b)(3), it was *not* Congress' intent to have active business format franchisors subjected to the personal holding company tax on the franchisee-related revenues they receive, even though such revenues are characterized as "royalties." However, the risk of accidental inclusion is very real, and the stakes are substantial.

IV. CASE LAW—FRANCHISING

Part of the risk described is engendered by the many difficulties which courts interpreting the Tax Code encounter in resolving certain characterization issues with respect to the revenues earned by franchisors.

Initially, the courts wrestled with the characterization issue of whether a franchise agreement constituted a sale or a license. This issue was determinative of the characterization of the income received from such transactions—if it was a sale, the income was capital gain; if it was a license, the income was ordinary royalty income.

The best anthology of the courts' confusion on this issue is that series of judicial decisions referred to as the "Dairy Queen Decisions."

The first decision was *Dairy Queen of Oklahoma, Inc.*[5] In that case, the owner of a Dairy Queen master franchise covering Oklahoma entered into sub-franchise agreements pursuant to which the franchisor retained the ownership of the Dairy Queen machines, provided training and furnished the formula. It also retained the rights to approve the sources from which Dairy Queen's mix was to be purchased; the locations of stores, standards of construction, supplies, and sanitary conditions; and to audit the records of sub-franchisees. Only Dairy Queen products could be sold. The contract could not be assigned without the franchisor's consent and could be terminated if any material contract provisions were violated. Lump sum and gallonage payments were received.

The Tax Court held that the powers retained precluded characterization of the franchise agreement as a sale since there was no transfer of all substantial rights. The Tenth Circuit, reversing the Tax Court, concluded that there was a sale, stressing that no time limit was placed on the use of the machine, mix, or trademark.

Each succeeding "Dairy Queen" case involved different contractual terms. Perhaps this offers some measure of explanation of the conflicts in the various Federal Circuit Court decisions. The Tax Court consistently held, irrespective of the variations in contract terms, that all payments—lump sum or contingent—constituted licensing (ordinary) income. The Circuit Courts variously held as follows:

The Fourth Circuit held that capital gain treatment was appropriate for the lump sum payments, but not for the contingent payments.[6]

The Fifth Circuit held that a sale had been effected, but remanded the case to the lower court to determine whether the periodic payments were part of the sale price.[7]

The Eighth Circuit, in its decision, looked behind the "cold contracts" to the non-obligatory activities of the franchisor and held that the franchise contracts under consideration yielded only ordinary income.[8]

The Ninth Circuit (on facts identical to those considered by the Fifth Circuit) determined that there was no transfer of sufficient rights to constitute a sale, and that all payments received were ordinary income.[9]

The Tenth Circuit concluded that all payments, lump sum and contingent, were taxable as capital gain.[10]

To overcome this remarkable confusion, Congress, in the Tax Reform Act of 1969, enacted Section 1253, which has come to be known as the "Dairy Queen Section." What §1253 did (and quite effectively) was characterize the payments received by a franchisor in practically all situations

4. Regulation 86, Article 351-2(1) (1935).

5. *Dairy Queen of Oklahoma, Inc. v. Comm'r*, 26 TC 61, rev'd, 250 F.2d 503, 52 AFTR 1092, 58-1 USTC Paragraph 9255 (10th Cir. 1958).

6. *Est. of Gowdey*, 307 F.2d 816, 10 AFTR2d 5106, 62-2 USTC Paragraph 9603 (4th Cir. 1962).

7. *V.H. Mober*, 305 F.2d 800, 10 AFTR2d 5348, 62-2 USTC Paragraph 9662 (5th Cir. 1962).

8. *U.S. v. Wernentin*, 354 F.2d 757, 17 AFTR2d 013, 66-1 USTC Paragraph 9140 (8th Cir. 1966).

9. *T.E. Moberg*, 320 F.2d 782, 10 AFTR2d 5974, 62-2 USTC Paragraph 9824 (9th Cir. 1962).

10. *Dairy Queen of Oklahoma, Inc.*; see note 5.

where there are retained rights as income from "other than the sale of a capital asset," i.e. ordinary income. However, in enacting §1253, Congress gave no consideration to the PHC issue, to wit: whether its characterization of franchise fees as ordinary income (rather than capital gain) should have any effect on the characterization of such fees for PHC purposes.

V. CASE LAW—"COMPENSATION FOR SERVICES" V. "ROYALTY INCOME"

The case law in this area, though at first blush not favoring franchisors, nonetheless, yields the strongest argument available on behalf of the average successful closely-held franchisor that license fees and royalties paid to franchisors are not PHC income.

Some commentators have taken the position that, regardless of denomination, any payment for the licensing of trade names, patents, secret processes or formula, goodwill, trade mark, or format, will be held to be a royalty.[11] The support usually cited for this position is *Hugh Smith, Inc.*[12] In *Smith*, the Tax Court had under consideration a license agreement to "use and vend on bottled Coca-Cola, the trademark name of Coca-Cola, and all labels and designs pertaining thereto." The licensee was required to order syrup from the taxpayer. The Tax Court held that the price for the syrup did not reflect the true value, and that the major portion of the gallonage charges was attributable to the right to use the trademark and other labels. The Court held that since there was no allocation, the entire amount received represented royalties and thereby constituted personal holding company income. In *Dairy Queen of Oklahoma, Inc.*,[13] the Tax Court again held that lump sum and gallonage payments from licensing agreements were personal holding company income.

As part of its argument, the taxpayer in *Smith* specifically contended that the definition of "royalty" in the Regulations [the predecessor to the current Treas. Reg. §1.543-1(b)(3)] was without foundation. However, the Tax Court rejected the taxpayer's contention, specifically stating that it was their understanding that Congress had, in effect, registered its approval of the subject Regulation by re-enactment of a practically identical provision of law without change.

At first appearance, a franchisor taxpayer is stymied. However, let us look closely at the facts in *Smith* to see if extrication is possible. Hugh Smith, Inc. was a corporation wholly-owned by an individual named Hugh Smith. Hugh Smith, Inc. (the corporate taxpayer in the case) entered into a franchise agreement with Coca-Cola which, in essence, allowed the corporation to use Coca-Cola's trademark on condition that Smith, Inc. purchased its syrup from Coca-Cola. Hugh Smith, Inc. was required to pay Coke $1.30 per gallon of syrup. The taxpayer/corporation then entered into a sub-contract arrangement with Hugh Smith individually which gave Smith all of the same rights to use the trademark that the corporation had and required that Smith buy the syrup from Hugh Smith, Inc. at $1.50 per gallon. The actual active conduct of the business of selling the bottled beverage was conducted by Hugh Smith individually. All Hugh Smith, Inc. did was collect its $.20 per gallon profit on the syrup.

This was not a case of royalties received by an "active business format franchisor. On those facts, the Tax Court held that a payment, however denominated, which is exclusively for the use of a trademark (as the court specifically found the payment in *Smith* to be) is a "royalty" for purposes of the PHC tax.

To properly understand the precedential value of *Smith* the reader must note the Court's specific finding that other than receiving the $.20 per gallon profit, *the taxpayer corporation did nothing else*. It was a purely passive entity in *Smith* which was held to be a PHC.

In this commentator's opinion, the more relevant aspect of the *Smith* case, with respect to its applicability to the Roman Lobe situation or the situation of the usual business format franchisor, was the Court's statement that: "the cases, among which are *Kiesaw Petroleum Corp.* 42 B.T.A. 69; and *US Universal Joints Co.* 46 B.T.A. 111, cited by Petitioner in support of its contention that the income involved was not from 'royalties', are so clearly distinguishable on their facts as to require no further comment."[14]

It is thus critical to observe that although the Court felt the taxpayer in *Smith* was not within the facts or holding of *Universal Joint*, it by no means rejected or overturned its holding in that case. Therefore, it seems clear that *Universal Joint* is still good law. The IRS has acquiesced in the case,[15] and accordingly it is ripe for our attention.

The issue for decision in *Universal Joint* turned on payments denominated "royalties" in a written contract for the use of a patented invention. Although not specifically referring to "franchise" royalties, it is this writer's opinion that the Court's reasoning—that such "royalties" were, at least in substantial part, "compensation for services" as op-

11. See e.g. Campbell, Leonard W. "Income from franchising: Capital gain, ordinary income, or personal holding company income" 1 The Tax Advisor 540, at page 547.

12. 8 TC 660, aff'd 173 F.2d 224, *Cert. den.* 337 U.S. 918.

13. See Note 5 *supra*.

14. *Hugh Smith*, op.cit. at p. 674.

15. 1942-1 CB 17.

posed to a purely "passive" patent royalty, and that therefore the corporation was not a PHC—is, and should be, good law today.

In *Universal Joint,* two automotive engineers invented and patented—what else?—a "universal joint." They contributed the patent to their corporation. The corporation, in turn, as the holder of the rights under the patent, entered into various license agreements with certain manufacturers allowing the licensees to manufacture and use under the patent. The invention, however, was of such potentially widespread application that the various licensees all needed—and obtained—the time, advice and engineering services of Murton & Guy, the individual inventors and controlling shareholders of the corporation.

The Court, in *Universal Joint,* made certain specific findings of fact, to wit:

"The licensees agreed to pay the petitioner a fixed percentage of the selling price of the licensed article. *The entire payment required under each written agreement was designated a 'royalty' in the license*" [emphasis added].

"At the time the license contracts were executed the parties orally agreed that petitioners would furnish the licensees whatever engineering services were necessary in connection with the manufacturing and sale of the joint. It was understood by all the parties that such services would be substantial because of the special engineering knowledge required to adapt the joint to varied uses.

The parties were unable to reduce the agreement with regard to petitioner's services to writing because it was impossible to determine precisely how long or at what time petitioner's services would be required. When the contracts were executed it was also understood by the parties that petitioner was to be compensated for the services it would render to the licensees. *The 'royalties' provided for in the contracts were intended by the contracting parties to be, in part, payment for the right to manufacture and use the patented joint and, in part, payment for the services to be rendered by the petitioner.*" [emphasis added][16]

The Court went on to make a specific finding with respect to how much the passive patent rights alone would bring, and then held the rest of the "royalty" to be "compensation for services" and, therefore, to such extent, not PHC income, regardless of the characterization in the contract solely as "royalty".[17]

16. At p. 112-113.

17. "Because of competitive products it would not have been possible for the Licensees to pay greater than 4 percent of net selling price for the use of the patented joint service. The excess of the required payments over 4% of net selling price was intended to be the compensation for petitioners advice and services." at p. 113.

In terms of applying the reasoning of *Universal Joint* to the typical franchise agreement, however, it must be understood that such franchise arrangement usually contemplates not merely the passive receipt of licensing fees, but generally contemplates supervision and management services, expert guidance in the selection of lease sites, training or management and other personnel, guidance in efficient purchasing techniques and in the installation and maintenance of effective accounting records, and other related services.

If the franchise agreement specifically allocates a portion of the fees as compensation for such services, and if such allocation is reasonable, the franchisor can escape personal holding company income classification for such fees. It is not uncommon for such fees to be based upon a percentage of sales or of supplies purchased; the method of determination should not alter the result if the total amounts received represent reasonable compensation.

VI. RECOMMENDATIONS

So, let us return to Edna & Ralph Stuckey, the "Roman Lobe, Inc." people. What is the solution to their IRS dilemmas?

Clearly, the first line of defense is to fight the characterization of their franchise royalty fee as a "royalty" for PHC purposes. Accordingly, special care should be given to the language of the franchise agreement. For a case of how *not* to do so one should review *John C. O'Connor.*[18] In *O'Connor,* the taxpayer corporation, whcih derived all of its income from patent licenses, contended that such income, though denominated as unallocated "royalties" in the license agreement, actually contained a substantial element of compensation for engineering services rendered to licensees by the corporation's controlling shareholders.

Take careful note of the fact that the taxpayer in *Universal Joint* sustained its burden (and the taxpayer always bears the burden of proof in civil tax cases) that there was an express oral agreement, entered into at the same time as the contract, and that substantial, though not at the time quantifiable, services would also be rendered by the staff of the contracting licensor in exchange for a total payment denominated a "royalty".

In *O'Connor,* however, the taxpayer did not sustain its burden of proof. The Court noted the following in its findings of fact:

"...The agreement contained no provision respecting the Patent Company [taxpayer] furnishing any engineering or other services to corporations."[19]

18. 16 T.C.M. 213, Tax Ct. Mem. Dec. 1957-50.

19. at p. 217.

Then the Court, after careful review of the documents, sounded the death-knell to the taxpayer's attempt to avoid PHC status:

"The agreement contained no provisions respecting the Patent Company furnishing any engineering or other personal services to General Mills. However, the Agreement contained the following provisions:

> *'No Other Understandings*
> It is understood and agreed that this written agreement cancels all previous proposals heretofore received by the respective parties prior to the execution thereof and constitutes the entire understanding and agreement between the parties hereto relating or pertaining to the subject matter hereof'"

The Court, in finding the taxpayer in *O'Connor* to be a PHC, stood by the decision in *Universal Joint*, citing it as the case which defines a royalty for purposes of the PHC tax, "as a payment or interest reserved by an owner in return for permission to use the property loaned and usually payable in proportion to use."[20]

So, Edna and Ralph, the moral is that you had better be careful with respect to whom you select to draft your franchise documents, lest those documents themselves bar you from escaping PHC tax liability.

If a loss is suffered on the characterization issue of "compensation for services", is there anything else one can do?

There are several possible remedies, which may or may not be available depending on the particular facts and circumstances of the taxpayer. (Of course, there are the deficiency dividend procedures, however, a discussion of that topic is beyond the scope of this article.) The general avenues of attacking potential PHC tax liability focus on neutralizing the computation which determines whether PHC income constitutes more than 60% of Adjusted Ordinary Gross Income. This can sometimes be accomplished by generating or purchasing another source of high gross (though not necessarily high net) income which is not from any of the eight PHC sources. Or the franchisor can increase the number of company-owned outlets. The operating income from company-owned sites should not ordinarily be PHC income. However, it would not be the gross sales of the company-owned sites which would enter the computation but rather, sales less cost-of-goods-sold, because of the definition of Adjusted Ordinary Gross Income.

Another possible remedy might be to elect "S" status ("S" corporations are specifically exempted from the PHC tax). Care must be exercised, however, as this might be a very nettlesome operation for franchisors which operated prior to the Subchapter S Revision Act of 1982 as ordinary "C" corporations.

Perhaps dealing directly with the Internal Revenue Service would be in order. A franchisor with a good set of facts and a strong constitution could request a Private Letter Ruling. Perhaps the IRS (National Office) could be convinced to issue a Revenue Ruling, preferably holding that 'royalties' received by franchisors do not constitute 'royalties' for PHC purposes when the franchisor is required to perform substantial services as part of the consideration for the fees it receives.

The degree of services necessary to be considered substantial cannot, of course, be quantified or predicted with certainty. Obviously, the more service the franchisor provides to the franchisee, the stronger the taxpayer's position. Examples of such services are advertising campaigns, research and development services, supplying and supplementing operating manuals, supervision and inspection, arrangement of volume purchasing of merchandise, materials and supplies, joint advertising programs and the like.

Some cautions must be sounded with respect to certain of the possible remedies. For one thing, a specific allocation in the franchise agreement of certain payments as compensation for certain specific services should usually exempt such amounts from being characterized as PHC income. However, the flip-side exposure of too strong an allocation is that it could possibly be used by state and local authorities to yield a finding that an out-of-state franchisor is "doing business" within their borders. This could make the franchisor liable to either jurisdiction, and/or taxation, and/or regulation by that state or locality.

Furthermore, too much precision in an allocation formula might give franchisors problems in establishing damages with respect to "breakaway franchisees", who may contend that they are not liable for payment for the "services" not received. It might leave the franchisor open to being sued by franchisees for failure to perform or provide such services adequately.

VII. CONCLUSION

The PHC problem for closely-held successful franchisors is a potential nightmare—it should not and must not be ignored.

However, most actively conducted business format franchisors that provide substantial services should be able to avoid the penalty of the Personal Holding Company tax with proper planning, care and professional diligence.

20. *O'Connor* at p. 222