plants and music services (such as Muzak). A franchisor seeking to sell a unit to a franchisee needs to determine which of these executory service contracts exist and which can, or should, be transferred to the franchisee. While these contracts are generally terminable following a short notice period, they also usually provide for liquidated damages in the event of breach. Accordingly, attention to these contracts can avoid franchisor/franchisee disputes following the sale.

A final concern relates to the disposition of the employees at the unit, including management. The franchisor and franchisee should, prior to execution of any agreements, decide which, if any, employees will be retained by the franchisee and the benefits package such employees will receive. Advance planning, and early communication to the employees, can avoid unintended financial burdens on either party as well as a mass exodus of employees that may hinder, if not prevent, the uninterrupted operation of the unit.

### *Conclusion*

Consideration of these issues prior to actual discussion of unit sales and the drafting of form sale agreements will allow for a better focused sales program. The result will likely be a smoother transition at the units and a decreased risk of post-sale problems and friction between the franchisor and franchisee.

FOOTNOTES

1. New UFOC Item 19 provides that disclosure of operating results of a unit need not comply with the strictures of earnings claims if such information is only provided to prospective purchasers of the unit and the franchisor provides the name and last known address of each owner of the unit during the past three years.
2. Where such a unit is subleased to the franchisee, the franchisor can structure the rental payments to minimize the loss potential to the franchise if the unit's performance fails to improve, and to permit the franchisor, in exchange for protecting the franchisee's downside risk, to participate in the increased sales (through percentage rent) if the franchisee succeeds in increasing unit sales.
3. While a franchisor can always attempt to obtain a landlord's consent to release it from this contingent liability, landlords are generally unwilling to grant such a release unless the assignee has adequate assets.
4. Although the same goal may be achieved, where the lease has been assigned, through a franchise agreement provision granting the franchisor an option to purchase the premises following termination, enforcement of such a provision will likely be more time-consuming. If the franchisee refuses to abide by such a provision, the franchisor will be required to seek enforcement in a court of general jurisdiction where the franchisee is entitled to assert counterclaims relating to the franchisor's contractual performance. Where the franchisee has defaulted under a sublease, however, the franchisor may seek summary dispossession in landlord-tenant court. Such proceedings are designed to provide a prompt resolution (although they do not always function as designed) and, particularly for commercial leases, the issues are generally limited to whether or not the tenant has complied with its lease obligations.
5. While the lease will also likely restrict the use made of the premises by the terminated franchisee, that is not a control mechanism available to the franchisor since it lacks standing to enforce the lease terms.
6. While a sublease can be drafted to require the franchisee/sublessee to look directly to the landlord for satisfaction of the landlord's obligations, the franchisee will likely still expect its franchisor to assist in ensuring that the landlord meets its obligations.
7. Depending on the state, capital gains may still receive preferential tax treatment for state tax purposes. Additionally, if President Bush's proposal to again provide preferential treatment for capital gains is passed, this consideration will have renewed value at the federal level.

## New Tax Treatment and Reporting Requirements for Franchise Transfers— IRC Section 1060

By John L. Allbery and Bruce S. Schaeffer*

A new provision added to the Internal Revenue Code in 1986, IRC Section 1060 entitled "Special Allocation Rules for Certain Asset Acquisitions," has received little attention since its adoption. Congress added the section primarily for the protection of the IRS; there is nothing in its legislative history to suggest that it was intended to change the tax treatment with respect to transfer of franchises. Nevertheless, under a literal reading, new Section 1060 would appear to apply to franchise transfers and require fundamental changes in the way franchisors and franchisees account for such transfers for financial and tax reporting purposes.

If Section 1060 applies to franchise transfers, then there is a question as to whether or not it conflicts with Section 1253 (sometimes referred to as the Dairy Queen section) which specifically *does* apply to the franchise transfers. If the new section applies to franchise transfers (particularly the initial transfer of a franchise from the franchisor), there is also a question as to whether it applies to a franchise retransfer situation falling under the parameters of Revenue Ruling 88-24. Furthermore, if Section 1060 applies

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*FOOTNOTES appear at end of article.*

to franchise transfers, there is a question as to whether it requires breaking down an initial franchise fee into its specific components and somehow incorporating the prohibition against deducting trademark costs under new Section 167(r) as added by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). If this is so, it would effectively deny franchisees the right to deduct a certain portion of their initial franchise fee.

A review of the legislative history of Section 1253 and new Section 1060 shows nothing to suggest that a potential conflict within the two sections was considered. In addition, there does not appear to be any suggestion that Section 1060 should prevail where it is in conflict with Section 1253 or interpretations thereto.

### *Residual Method for Allocation of Consideration Among Assets*

Under the new rules, consideration is first to be allocated to Class I assets. Under Temporary Regulation Section 1.1060-1T(d)(i), Class I assets are basically cash and cash equivalents. These are rarely involved in an initial franchise transfer but may be involved in a franchise retransfer. Consideration is next to be allocated to Class II assets which are certificates of deposit and other federally tradeable securities and currencies.

Class III assets "are all assets (other than Class I, II, and IV assets), both tangible and intangible (whether or not depreciable, depletable, or amortizable), including furniture and fixtures, land, buildings, equipment, accounts receivable and covenants not to compete" under Temporary Regulation Section 1.1060-1T(d)(2)(ii). After allocating consideration to Classes I, II, and III to the extent of their fair market value, the residue is then allocated to Class IV assets which are "intangible assets in the nature of goodwill and going concern value" under Temporary Regulation Section 1.1060-1T(d)(2)(iii).

Accordingly, a defendable position can be developed in the context of a normal initial franchise transfer for a new location to be opened by an original franchisee to allocate nearly all of the consideration to Class III assets or to specific services performed. It appears logical not to allocate any of the consideration to Class IV in an initial franchise transfer, since the franchise business has not commenced at the time of the transfer and accordingly, has not established any "going concern" value at that point in time.

In a franchise retransfer situation, there is also judicial precedent, and even some internal IRS documents that could provide sufficient documentation to contend that there is no goodwill or "going concern" value present in many franchise rights assignment situations. Thus, it may be possible to not allocate any value to Class IV in these arrangements.

The IRS has designed a new form to be used by taxpayers in order to comply with new Section 1060. Form 8594, "Asset Acquisition Statement Under Section 1060," as published in July 1988, has four parts. Part I requires that the buyer and seller provide their addresses and taxpayer identification numbers, as well as the date of the sale and the total sales price. Part II of the form requires both buyer and seller to provide the aggregate fair market value and the allocation of the sales price to each of Classes I thorugh IV, (i.e., contracts, bills of sale, etc.), and asks if the allocation is in conformity with the allocation found in the sales contract. The third question under Part II reads as follows: "To be completed by buyer only: In connection with the purchase of the group of assets, did you also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners or employees of the seller)? Yes ______ No ______.

If 'Yes,' specify (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. (Attach additional sheets if more space is needed.)"

In the context of the standard initial purchase of a franchise by a franchisee from the franchisor, if Section 1060 applies to such a transaction at all, it would seem clear that the franchisee is "purchasing" a license (i.e., to use the franchisor's trademark, trade name, etc.). But how does a franchisee compute the maximum amount of consideration to be paid under such an agreement? Does the franchisee include all potential royalty payments to be made over the anticipated life of the franchise? How does he or she guess at the amount? How does the information provided fit in with the purpose of Section 1060?

In the case of such an initial franchise transfer, there is no possibility of the IRS being "whipsawed." IRC Section 1253, which represents a well thought-out congressional decision, mandates the treatment to be given the transaction by both the franchisor and the franchisee. It must be emphasized under Section 1253, the treatment provided for the franchisor and that accorded to the franchisee do not comport. There is nothing nefarious in this; it is the specific language of the Code. The franchisor is required to treat the funds as ordinary income properly includable in income generally upon receipt. The franchisee, on the other hand, is allowed to deduct the franchise fee in full, but only ratably over a ten-year period or less if the franchise agreement is for a lesser term. Royalties paid by the franchisee are includable by the franchisor and

deductible by the franchisee in accordance with their respective methods of accounting for tax purposes.

With regard to franchise retransfers, differing treatment may result, depending on the facts and circumstances of each situation. However, since capital gain and ordinary income are now taxed at the same rate, generally this issue is not as important as it was in the past.

### *Required Reporting and Compliance*

As mentioned above, if there is a requirement to comply with Section 1060 on the initial sale of a franchise, then there is a question as to whether or not there is a further requirement to specifically allocate the franchise fee to its specific components and somehow become partially nondeductible to the franchisee with regard to the element relating to trademark costs. The first question is whether Section 1060 applies to an initial franchise sale at all. The statutory language of Section 1060(c) states that the term "applicable asset acquisition" means any transfer (whether directly or indirectly) of assets which constitute a trade or business, and with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets. Temporary Regulation Section 1.1060-1T(b), attempts to define "applicable asset acquisition" and illustrates its principles with three examples.

In all of the examples, the applicable asset acquisitions involved the transfer of a trade or business which was in operation. An initial transfer of franchise is not the transfer of an active trade or business; it has no goodwill and no "going concern" value at the time of the initial transfer, since the location has not yet been opened at that point in time. The Regulation sections also state that a transfer is an applicable transition if the "assets transferred constitute a trade or business in the hands of either the seller or the purchaser." It is arguable that at the point in time at which there is an initial franchise transfer, there is no trade or business in the hands of either the seller or the purchaser because the franchise transferred is in the "pre-opening" phase and does not yet rise to this status of "trade or business." The IRS has frequently used this argument to deny deductions for ordinary and necessary business expenses to a trade or business in similar situations.

In situations where a franchisor is selling an operating company-owned store, or where a franchise owner has acquired an operating franchisee location from another franchisee, or where a franchisor is re-acquiring an operating franchisee location, this argument may not be available. Therefore, these transactions will probably fall within the definition of the term "applicable asset acquisition" and the required reporting and compliance procedures should be followed. However, a defendable position could again be developed in many factual situations to allocate any premiums paid in such a transaction in excess of the underlying fair market value of the fixed assets acquired to an intangible asset for the cost of acquiring franchise rights, and amortizable over the lesser of ten years or the remaining term of the franchise agreement.

Assuming Section 1060 does apply and all of the parties are required to file Form 8594's, the next question is whether the franchise fee must be broken down into its separate components, or if it is acceptable to simply reply on the form that the buyer bought a franchise for an initial franchise fee plus an ongoing royalty stream. If this is an adequate reply (and there is no evidence to suggest that it is not), then the franchise community is merely being subjected to another layer of government-mandated compliance. On the other hand, if there is a requirement to break down all of the fees into tangible and the intangible components, then there will be an unintended possibility that the tax treatment of the franchise fees could be effected by Section 167(r) denying deductions with respect to trademark expenditures.

There does not appear to be any apparent reason to presume that Section 167(r) was meant to apply to franchise transfers; however, there is also no specific reason to presume that Section 1060 is meant to apply to such transfers either. Since the franchisor generally bears all of the trademark, trade name, and other associated intangible costs, and usually sells many franchises in a similar manner, there is no reason to believe that any material amount of these costs would be passed on to a franchisee. Likewise, there should be minimal or no costs associated with these intangible expenses in franchisee transfer situations.

### *Conclusion*

It is clear that there are many new and unanswered questions related to the new tax treatment and reporting requirements under IRC Section 1060. Although it does not appear that there was congressional intent to change the tax treatment for transfers of franchises, a literal reading of the new section appears to bring franchise transfers within the section. The effective date of Section 1060 was May 6, 1986. The franchise community has the need to know whether the rules have changes, and if they have, what the new rules are with respect for initial franchise transfers or franchise retransfers.