[¶ 10,090] Tax Consequences of Franchise Acquisition Costs Analyzed

Back reference: ¶ 120.

Following is a commentary on the federal income tax ramifications of franchise acquisition costs on purchasing franchises in light of the U.S. Tax Court decision in *Canterbury v. Commissioner* (BUSINESS FRANCHISE GUIDE ¶ 10,089). The article is by Bruce S. Schaeffer, co-author of the franchising volume of the CCH Tax Transactions Library and counsel to Robinson Brog Leinwand Reich Genovese & Gluck P.C., of New York City. The article is reproduced with the generous permission of the author.

The Cost of Acquisition of Franchises—*Canterbury v. Commissioner*

Introduction

On August 17, 1992, the Tax Court, by Judge Ruwe, decided the case of *Canterbury v. Commissioner.* The Canterburys (and several other taxpayers whose cases were consolidated) purchased operating McDonald's restaurants at a price which exceeded the price of the tangible assets.

The taxpayers allocated the portion of the purchase price which exceeded the value of the tangible assets to the franchise and amortized that amount pursuant to Internal Revenue Code Section 1253(d)(2)(A) which basically provided during the time at issue for the amortization of such costs over a period of 10 years.[1] The restaurants at issue in *Canterbury* were acquired in the years between 1972 and 1984 (this gives some idea of the length of time it takes to resolve a tax dispute with the IRS).

The Internal Revenue Service's position in *Canterbury* was that the taxpayers had allocated too much to the "franchise fee" and that such amounts should be allocated to unamortizable assets such as good will and going concern value. The IRS argued at trial that the amount the taxpayers could deduct as the "franchise fee" for purposes of Section 1253, was limited to the amount which the franchisor charged the original franchisee.

Judge Ruwe's decision ripped through the IRS. position. The Court held that with the exception of a relatively small allocation to going-concern value, the remainder of the purchase price (over the cost of the tangible assets) was properly allocable to the "franchise fee" and therefore amortizable under Section 1253.

What was at stake was whether the purchaser of a going franchise can deduct the entire intangible cost as opposed to the purchaser of a normal going business operation who is obligated to allocate a portion of such cost to non-amortizable "good will" and like assets. In other words, whether a business can be paid for with pre-tax or after-tax dollars.

The Service's position and evidence at trial was poor at best. Their arguments bordered from weak to desperate and conflicted with their own published Revenue Rulings.

But perhaps the franchise community should not take undue comfort from the decision. McDonald's in general, and the stipulated facts in particular, make for an almost unique fact pattern which purchasers of other franchises may not be able to duplicate.

In light of the new restrictions on amortizing franchise fees in excess of $100,000 and the new amortization schedules under proposed Section 197 (generally to be put at 14-16 years) it is possible that the *Canterbury* decision will not be decisive prospectively; although with respect to audits still open it should be very helpful. However, with the anticipated coming of the new amortization proposals perhaps current selling franchisees should consider taking part or all of their selling price in the form of an "overriding royalty"—a concept which can be borrowed from the oil industry.

I. Present Cost of Acquisitions—Amortizable Franchise Fee vs. Unamortizable Good Will

The economic motive in the *Canterbury* case, the real guts of the issue, was whether a large portion of the cost of a going operation (an operating McDonald's franchise) was to be paid for with pre-tax dollars or after tax dollars. A subsidiary issue in the same context is the issue of whether payment can be currently deductible, amortizable or not deductible at all.

[1] Since that time Congress has amended Section 1253 to provide ten year amortization is only available to the extent of franchise fees up to $100,000. Under current law, if the fee is more than $100,000 the taxpayer acquiring the franchise can elect to amortize the fee over 25 years.

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Of course, the most valuable characterization to a purchaser is to have payment deductible in full at the time it is made. This is very similar to the treatment of a cash basis taxpayer expensing an item. The IRS is opposed to this treatment on the grounds that the asset actually has a useful life which should be extended over many years and that, therefore, the cost should be recaptured over such extended period of time. The worst possible event is having the characterization of unamortizable "going concern value" or "goodwill"; because, in that context the purchaser's cost can never be recovered until a subsequent disposition. If the business is not disposed of the cost can never be recovered.

A. *Present Discounted Value of Right to Deduct Cost of Acquisition vs. Cost of Unamortizable Acquisition.*

The table below shows the present discounted value of the after-tax cost of the acquisition of an operating franchise of each $100,000 of cost in five situations: (1) where the $100,000 is deductible in full when paid, (2) where the $100,000 is deductible over ten years as a franchise fee (as in current § 1253), (3) where the $100,000 is deductible over a sixteen year period (as in the new proposed Section 197), (4) where the $100,000 is deductible over twenty-five years (as in current § 1253 for "franchise fees" greater than $100,000), and (5) where the $100,000 is all unamortizable goodwill and/or going concern value.

B.

	Currently Deductible (1)	*Deductible over 10 years* (2)	*Deductible over 16 years* (3)	*Deductible over 25 years* (4)	*Not Deductible* (5)
Cash Outlay	100,000	100,000	100,000	100,000	100,000
Less: Present Discounted Value of Tax Deduction @ 8% - 34% tax rate	<34,000>	<22,814>	<18,809>	<14,517>	<0>
Net Cost	66,000	77,186	81,191	85,483	100,000

The table addresses the many ways that a purchasing franchisee may use to recoup its cost. However, this should be understood in connection with a further complication: the purchasing franchisee's treatment of the cost of acquisition for tax purposes is substantially different from the treatment of the selling franchisor (or a reselling franchisee).

Code Sec. 1253 often mandates different treatment for the two sides of the same transaction. This can be illustrated as follows:

Example: Assume that a successful franchisor (or selling franchisee) is offering a franchise in return for an initial franchise fee of $100,000. 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 10 years or longer, the Code requires that the payment be amortized by the franchisee over a 10-year period. If we assume that both franchisor and franchisee are paying the current maximum federal corporate rate of 34% and that both are using the 8% discount and interest factors, then the tax and economic effects on the two parties to the transaction are as follows:

Franchisor	
Current Receipts	$100,000
Less: Taxes Due	34,000
Net	$ 66,000
Franchisee	
Current Cost	$100,000
Less: Present discounted value of right to deduct $10,000/year each of next 10 years	22,814
Net Cost	$ 77,186

The fact that this transaction cost the franchisee more than it benefits the franchisor reflects the "deferral" tax factor, which can be considered a double-edge 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), the franchisee is placed in the situation of having the effective rate of its tax deductions reduced to approximately 23 percent, even

though it is subject to the 34 percent bracket.

From the franchisee's point of view, if the initial franchise fee payment was currently deductible, the current value of the tax deduction would be $34,000, thus reducing the net cost of the franchisee to $66,000. This represents a substantial reduction in the real (i.e., after-tax) cost to the franchisee.

II. *Good Will and Going Concern Value*

"Good will" and "going concern" value are the intangible assets that a purchaser is least likely to want to buy in the acquisition of an operating business. The IRS, on the other hand, under present law is going to argue that the taxpayer purchased "good will" and "going concern value". The reason for the IRS position is simple: because "good will" and "going concern value" are considered to have no ascertainable useful life, they are unamortizable. Thus the taxpayer has less deductions and, therefore, the Treasury more revenues.

A. *Good Will in the Normal Business Context*

As the Court in *Canterbury* said "One of the principal intangible assets likely to be found when ownership of an operating business is transferred is good will. Good will represents the expectancy that old customers will resort to the old place of business. [citation omitted] The essence of good will is a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely [citation omitted]. Good will is characterized as the expectancy of continued patronage for whatever reason. [citation omitted]"[2]

Another intangible often acquired when an operating business is transferred is "going concern value". Although in *Canterbury*, there had been a stipulation of a minimum allocation to going concern value nonetheless, the Court addressed the issue. The Court described this intangible as follows: "Going concern value is defined as the additional element of value which attaches to property by reason of its existence as an intricate part of a going concern [citation omitted]. Going concern value relates less to the business reputation and the strength of customer loyalty than to the operating relationship of assets and personnel inherent in an on-going business [citation omitted]. Going concern value is characterized by the availability of an acquired business to continue to operate and generate income without interruption during and after acquisition [citations omitted]."[3]

B. *In the Normal Franchise Context*

(1) *Good will.* In practically every franchise agreement there are specific contract clauses dealing with good will. Although the specific wording may vary, the essence of every such contract clause is that all good will inures to the benefit of the franchisor, and that the franchisee specifically disclaims any rights in such good will. The McDonald's franchise agreement includes the following clauses:

> In the event of such a termination [i.e. for franchisee's breach] there shall be no payment by Licensor for intangible assets of Licensee" and, more specifically;
>
> Licensee acknowledges ... (g) That McDonald's is the sole owner of the trademarks, trade names, service marks and good will associated therewith, and Licensee acquires no right, title, or interest in those names and marks other than the right to use them only in the manner and to the extent prescribed and approved by Licensor.[4]

Strangely, this issue of contractually reserved good will was not addressed at all by the Court in *Canterbury*.

(2) *Going concern value.* A franchised business cannot be operated at all without the consent of the franchisor. The consent and license granted by the franchisor is embodied in the franchise agreement; it is characterized for tax purposes as the "franchise rights". Accordingly, an argument can easily be made that without the "franchise rights" the business simply would not be allowed to operate; therefore, no allocation should be given to going concern value separate and apart from "franchise rights".

However, as noted above, in the *Canterbury* case going concern value was not really before the Court. It was the subject of a separate stipulation. The Court referred to an acceptance by both sides "that operating McDonald's restaurants have comparatively little going concern value, when that term is understood to mean avoided start-up costs."[5] The Court felt they should accept the determination of the taxpayer's expert that such

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[2] *Charles D. Canterbury v. Commissioner of Internal Revenue*, 99 TC No. 12... Dec. 48,420 at p. 5101.

[3] *Ibid.* at p. 5103.

[4] Special thanks to Paul J. Schaffhausen, Federal Tax Counsel, McDonald's Corporation.

[5] *Canterbury op. cit.* at p. 5104.

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"avoided start-up costs" constituted the amount of going concern value that was separate from the franchise.

The essence of the franchise relationship is that the franchisee is buying the franchisor's know-how. Clearly this know-how embodies many elements closely associated with the start-up of the business. Intellectually, it is very difficult to see how these "avoided start-up costs" can be segregated from the general "franchise rights" (e.g. site selection, design, advertising) all of which are generally provided as part of the franchise rights.

C. *The Unique McDonald's Facts*

The "findings of fact" in the *Canterbury* case run almost eleven pages of double column small type. It is as close to a Court ordered public relations piece as can be found. It is absolutely laudatory of McDonald's. The Court discusses the history and philosophy of McDonald's franchising system particularly emphasizing the philosophy of the founder, Ray Kroc, that "high up front franchise fees could prevent franchisees from making a reasonable profit".[6] Therefore, there was a particular corporate policy to maintain low franchise fees. How many franchisors operate under the same philosophy?

The Court found, "the initial franchise fee charged by McDonald's was $950.00 until 1960, $12,500.00 between 1960 and 1987 and $22,500.00 since 1987. McDonald's has not increased its initial franchise fee to reflect increased sales. For instance, while the franchise fee remained $12,500.00 between 1960 and 1987, the average gross sales of McDonald's restaurants in those years rose from $249,099 to $1,350,000."[7] Not many franchisors, if any, can duplicate these facts.

The Court also noted McDonald's refusal to require franchisees to buy equipment and products from the franchisor and McDonald's rules, since 1969, of franchising only one restaurant at a time and refusing territorial agreements.

The Court went on to discuss the "System" provided by McDonald's which included: (a) site selection and construction of the physical plant; (b) designs and color schemes for the restaurant and signs; (c) owner/operator, manager and crew training; (d) equipment layouts; (e) food formulas and specifications; (f) operations specifications, assistance and monitoring; (g) inventory, accounting and bookkeeping methods; (h) product research and development; and (i) advertising and promotional materials.

This is a reasonably common list of the elements of a franchise system. However, the Court's findings of fact go through the specifics of McDonald's behavior with respect to each area. The findings are an incredible tribute to McDonald's attention to detail and to what they call "QSC" or "quality, service and cleanliness".

The Court in *Canterbury* specifically details McDonald's precision standards with respect to the purchase of meats for its hamburgers and emphasizes the expenses incurred in formulating precise computerized procedures for the cooking of french fries.

The Court also details the application process and McDonald's "highly regarded training program", and goes on to address the franchisor's frequent monitoring of each and every franchise site; the fact that the franchisor has "the largest television advertising budget in the United States to promote a single brand" and then focuses on the operating results of both franchisee owned and company owned McDonald's restaurants. It is an awesome story of growth, hard work and success.

The findings of fact also discuss how difficult it is to obtain a McDonald's franchise. A prospective franchisee can either acquire a new restaurant or an existing restaurant but there is probably no other franchise as difficult to acquire.

In 1985 when there were some 6,620 operating McDonald's restaurants there were 48 new franchisees granted rights. The Court noted that "Typically, a new store will meet its projected annualized volume level within the first week of operation".[8] That is remarkable. How many other franchisor's can assert and prove such statistics?

The findings of fact also noted that almost always McDonald's controls the real estate, either through direct ownership or sub-leasing. It is sometimes said that McDonald's is as much in the real estate business as they are in the hamburger business.

Then in a final showing of the system's power the Court noted two specific instances where the franchise was withdrawn. Robert Ahern operated a McDonald's restaurant in La Grange, Illinois. McDonald's was dissatisfied with Mr. Ahern's operation and his franchise was terminated. The Golden Arches and all signage or other indicia of

[6] *Ibid.* at p. 5091.
[7] *Ibid.*
[8] *Ibid* at p. 5098.

McDonald's was removed and Mr. Ahern reopened his restaurant as a hamburger restaurant called "Berney's". McDonald's subsequently opened a new restaurant within two blocks of Berney's. Berney's went out of business in less than one year.

Then the Court noted

> Another example involved Eli Schupack. Mr. Schupack operated a McDonald's restaurant in Omaha, Nebraska, from 1965 to 1981. Mr. Schupack was also in the unique position of owning the restaurant premises. McDonald's refused to grant a rewrite to Mr. Schupack and after the franchise expired, the Golden Arches and all signage, trademarks, and trade names identifying the restaurant as a McDonald's were removed. Mr. Schupack reopened the restaurant as "Dodge City Hamburgers" and offered the same type of food products as the former McDonald's restaurant. Mr. Schupack retained his crew employees and managers. Despite their efforts, sales immediately fell substantially, and the Dodge City Hamburgers restaurant ultimately failed. Subsequent to the closing of Dodge City Hamburgers, McDonald's opened a new restaurant in November 1982 within a few blocks of the former Dodge City Hamburgers restaurant location. Sales at that new McDonald's restaurant during its first full 12 months of operation (December 1982 to November 1983) were $1,212,556, as compared with sales at Mr. Schupack's McDonald's restaurant during the last 12 full months of its operation (August 1980 to July 1981) of $1,304,541.[9]

III. *The IRS Arguments in Canterbury*

The IRS put forth many theories in *Canterbury* as to why the amount paid was not a "franchise fee" under Section 1253 and therefore not deductible. The arguments were many and weak.

A. *The Franchisor's "Franchisee Fee" for New Franchises Establishes the Amount Which can be Amortized as the "Franchise Fee".*

The IRS position was that the price McDonald's charged for new franchises ($12,500 during the years at issue) was a "perfect" market which established the value of all McDonald's franchises. The Court disagreed, finding that "McDonald's had legitimate and long standing reasons for charging less than market value for new McDonald's franchises."[10] The Court traced this philosophy to Mr. Kroc, McDonald's founder, citing his belief that McDonald's should emphasize the long term relationship with franchisees rather than try to maximize up front profits—they wanted owner/operators, not investors.

B. *Purchaser of an operating franchise may not amortize an amount as a franchise fee greater than the amount that the original franchisee paid.*

The IRS argued that, as a matter of law, subsequent franchisees could not amortize an amount greater than the franchise fee paid by the original franchisee. The Court found no authority for the IRS position either in the statute or case law and noted that the IRS failed to cite any. Then the Court specifically noted that the IRS position was directly contrary to a previously published Revenue Ruling.

> Respondent [IRS] has issued a Revenue Ruling that specifically permits a subsequent franchisee to amortize the full price paid for the franchise. Rev. Rul. 88-24, 1988-1 C.B.306.[11]

The Court went on to say, "The fact that the ruling specifically contemplates, and indeed limits, the amount which a subsequent franchisee can amortize, and yet says nothing about limiting that amount to the amount paid by the initial franchisee, gives rise to the inference that the subsequent franchisee may amortize the full purchase price of a franchise, even if it exceeds the amount paid by the original franchisee."[12]

The Court cited *Jefferson-Pilot Corp. v. Commissioner* [Dec. 48,147], 98 T.C.—(1992) and *Tele-Communications, Inc. v. Commissioner* [Dec. 46,970], 95 T.C. 495 (1990) which both allowed subsequent franchisees to amortize franchise costs in excess of the amount paid by the original franchisee.

C. *A Purchaser of an Operating Franchise Acquires Other Non-amortizable Assets Such As Good Will and a Large Portion of the Purchase Price Should Be Allocated to Those Intangibles.*

The IRS argued that a large portion of the purchase (to the extent that it exceeded the "franchise fee" originally paid to the franchisor) should be allocated to intangibles such as good will.

The Court dismissed this argument effectively saying that the seller of an operating

[9] *Ibid.* at p. 5099-5100.
[10] *Ibid.* at p. 5100.
[11] *Ibid.* at p. 5100.
[12] *Ibid.* at p. 5100.

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franchise had no good will to sell because all these assets belong to the franchisor.

The Court phrased the issue as follows:

> A McDonald's franchise encompasses attributes that have traditionally been viewed as non-amortizable good will. However, to the extent that these attributes are embodied in the McDonald's franchise, trademarks and trade name, their cost is amortizable under the explicit provisions of Section 1253(d)(2)(A). On the other hand if petitioners acquired intangible assets, such as good will, which were not encompassed by or otherwise attributable to the franchise, then a portion of the purchase price should be allocated to such assets.[13]

It was found that there was a tremendous amount of good will associated with McDonald's. However, the Court felt that it was attributable to the good will inherent in the McDonald's system finding that, "because of the structure of McDonald's, that good will inheres in the McDonald's trade name and trademarks. . ."

> . . . . The rights and benefits conferred by a McDonald's franchise are not assets that the franchisee may use or sell apart from the franchise.[14]

Therefore, the Court specifically found that the purchasers acquired no good will that was separate and apart from the good will inherent in the McDonald's franchise.

D. *The provisions of Section 167 govern the depreciation and amortization of intangibles.*

The Court disposed of this argument quickly, finding that, "The rules under Section 167 do not override the specific provisions of Section 1253(d)(2)."[15] The Court felt that the assets covered by Section 1253, by their very nature, are not normally separate and distinct from good will and that the value of a franchise depends in large part on the good will inherent in the franchisor's "system". The Court found that the trademarks and trade names are the embodiment of good will and that in enacting Section 1253(d)(2) Congress specifically provided for the amortization of "a franchise, trademark or trade name".

E. *There must be an allocation to going concern value.*

The Court found that many of the elements which traditionally make up "going concern value" were really encompassed in the McDonald's system. The ability of an acquired business to continue to operate and generate income without interruption during and after acquisition was attributed to the franchisor's expertise. The avoidance of the foibles of a start-up operation was also attributed to the franchisor. The Court found, "McDonald's vast experience in opening and operating restaurants means that many of the issues that a new business faces, and which are typically resolved only through trial and error, are already resolved through application of the McDonald's system. For instance, a new franchisee does not have to identify reliable suppliers because McDonald's provides the franchisee with a list of suppliers. Similarly, a new franchisee does not have to experiment with various procedures to determine the most efficient means for preparing its products and serving its customers because the McDonald's system already provides specific detailed instructions which describe the best operational methods and which reflect McDonald's years of experience in operating literally thousands of restaurants."[16]

The Court noted that both sides seemed to agree that "going concern value" was minimal with respect to the acquisition of a McDonald's franchise if it is understood to mean "avoided start-up costs".

F. *Other intangibles.*

Additionally, the IRS argued that a purchasing franchisee also acquired the expectancy that McDonald's would renew the franchise. The Court felt that franchise renewal expectations are generally not considered separate intangible assets. To whatever extent the expectancy of "rewrite" (renewal) existed it was a part of the franchise itself and not a separate asset.

Finally, the IRS argued that existing franchisees have an "inside track" on acquiring other franchises. The IRS argued that the right to this "inside track" was a separate non-amortizable asset to which part of the purchase price should have been allocated.

The Court had three responses to this argument: "First, it is not entirely clear that existing franchisees have an 'inside track' on acquiring existing franchises. . . . Second, even if this alleged 'inside track' did exist it would only be of value to buyers who did not already own a McDonald's restaurant. . . . [and] Third, whatever, 'inside track' may

[13] *Ibid.* at p. 5101.

[14] *Ibid.* at p. 5101-5102.

[15] *Ibid.* at p. 5103.

[16] *Ibid.* at p. 5103.

exist as a result of being a franchisee results from and is an attribute of the franchise."[17]

Thus, all of the IRS arguments, with the exception of a small allocation to going concern value, were rejected.

IV. *New Amortization Legislation*

As previously noted, the *Canterbury* case dealt with sixteen transactions which took place between 1972 and 1984. Now there are new amortization proposals before Congress. The "Revenue Bill of 1992" in the Senate Finance Committee amendment to H.R. 11. (Section 4551) would create a new Internal Revenue Code Section 197 which would relate to the amortization of good will and certain other intangibles. Under the proposal a new category of asset would be created: "Section 197 Intangibles". These would be intangible assets acquired after the date of enactment and held in connection with the conduct of a trade or business or an activity described in Section 212. It would exclude intangibles which were created by the taxpayer.

The proposed definition in Section 197(d) would read as follows:

(d) *Section 197 Intangible.*—For purposes of this section—

(1) *In General.*—Except as otherwise provided in this section, the term "section 197 intangible" means—

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customer),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

The proposed Section 197(f) contains certain special rules. Section 197(f)(4) reads as follows:

(4) *Treatment of Franchises, Etc.*—

(A) *Franchise.*—The term "franchise" has the meaning given to such term by section 1253(b)(1).

(B) *Treatment of Renewals.*—Any renewal of a franchise, trademark, or trade name (or of a license, a permit or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

(C) *Certain Amounts Not Taken into Account.*—any amount to which section 1253(d)(1) applies shall not be taken into account under this section.

Furthermore, section 1253 would be amended as follows:

(c) *Amendments to Section* 1253.—Subsection (d) of section 1253 is amended by striking paragraphs (2), (3), (4), and (5) and inserting the following:

(2) *Other Payments.*—Any amount paid or incurred on account of a transfer, sale or other disposition of a franchise, trademark, or trade name to which paragraph (1) does not apply shall be treated as an amount chargeable to capital account.

(3) *Renewals, Etc.*—For purposes of determining the term of a transfer agreement under this section, there shall be taken into account all renewal options (and any other period of which the parties reasonably expect the agreement to be renewed).

Under the proposed new law the argument over whether or not intangibles are amortizable, and if so over what term, would be avoided. However, the House and Senate versions contain different time tables for the amortization. The Senate version would provide a fourteen year uniform amortization period for intangible assets while the House version would provide a sixteen year uniform capitalization period.

It is questionable as to whether or not, in this election year, a tax bill will be passed. If the intangibles provisions of H.R. 11 are not passed in 1992, "it is very unclear," espe-

[17] *Ibid.* at p. 5105.

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cially in light of the forthcoming Supreme Court decision *Newark Morning Ledger*, as to the "form" that the issue will take in the future.[18]

So far the legislation is suffering a rocky ride. Senator Paul Simon offered an amendment to delete good will from the list of intangibles eligible for the sixteen year uniform amortization but on September 27, 1992, the amendment to strike good will was defeated by a vote of 75 to 19.

It is very important to note that if good will is treated as an asset separate and apart from the franchise, it may be subject to different treatment than that which applies to the amortization of the franchise itself. It must be emphasized that other franchisors will be very hard pressed to present a state of facts anywhere near as strong as those presented by McDonald's. In such cases the "franchise fee" portion of the payment may be amortizable under section 1253 and the "good will" portion (and/or other such intangibles) may either be non-amortizable or amortizable under different rules.

V. *A Modest Proposal—The Overriding Royalty*

The differing treatment (discussed above) of the buyer and seller results in a mismatch so that it costs the buyer more to acquire a franchise than the seller actually receives. To provide for comparable treatment for both sides to the transaction, perhaps sellers of operating franchises should borrow a concept from the oil industry—the overriding royalty.

An overriding royalty, in the mineral or oil context is a right which entitles its owner to a specific fraction of production, in kind or in value, and is not burdened with the costs of development or operation. It is different from a normal royalty in that it is created from an operating interest and its term is coextensive with that of the operating interest from which it was created.

The same could apply in the franchise context. The seller of an operating franchise instead of receiving an up-front "franchise fee" (or purchase price which is amortized by the buyer under § 1253) could take back an overriding royalty as a percentage of gross revenues, over and above the royalties paid to the franchisor.

In terms of analyzing the buyer's financial substance the franchisor's criteria should be exactly the same as they are currently. The proposed buyer should be required to have the same amount of funds as if he were to pay an up-front "franchise fee" or purchase price. However, if the buyer and seller are willing to work together, and the seller is willing to take a portion of the sales price over time rather than all at once, then the costs to the buyer can be reduced while the amount received by the seller can be increased.

This anomaly would be achieved because the mismatch between buyer's and seller's tax situation would be removed. Therefore, the present value cost to the buyer could be reduced while increasing the present value received to the seller. They could split the tax benefits.

Moreover, the availability of this procedure would not be affected by the proposed new amortization provisions. Why? Because the new proposed amortization provisions, do not apply to section 1253(d)(1) "Contingent Serial Payments" (i.e. royalties). The overriding royalty payments would fall within section 1253(d)(1) as amplified by Revenue Ruling 88-24 which held that payments to the seller of an operating franchise constituted payments to be treated by the transferee under section 1253(d)(1).

Therefore, let us go back to the original example in Part I above. As can be seen, it cost the buyer $77,186 to net the seller a present value of $66,000 if amortized over 10 years and $85,483 if amortized over 25 years.

If the buyer's costs were paid ratably as an overriding royalty over the remaining term of the franchise agreement (which we shall assume for our purposes to be ten years) then a royalty payment of $13,637 per year deductible by the buyer at a 34% rate and taxable to the seller at a 34% rate would yield net after tax payments of $9,000 per year. Using an interest factor of 8%, the present discounted after tax value of that payment equals $60,390.73. An after tax payment of $10,000 per year (which would require a pretax royalty of $15,151) yields a present value of only $67,100.

Because the royalties would be deductible when paid by the buyer and not taxable by the seller until received, there would no longer be a mismatch. The present cost to the buyer would be exactly the same as the present value of the receipts by the seller.

[18] BNA Daily Tax Report 9-18-92 quoting Peter Cobb, Business Tax Counsel for the Joint Committee on Taxation on Sept. 17, 1992.

Therefore, a royalty of $17,424 per year before taxes for a total of $174,240 over the ten years (which would actually cost the buyer and yield the seller $11,500 per year after taxes) would have a present discounted value of $77,165.94.

Accordingly, in terms of present discounted after tax costs, it is no more expensive to the buyer to pay $174,240 as a royalty over ten years, than it is to pay $100,000 up front. Simply put, the seller will receive more while the buyer's costs can remain the same or be substantially reduced if the buyer would otherwise be subject to 25 year or 16 year amortization.

Franchisors may have mixed feelings about this. On the one hand, anything that effectively enhances the prices for franchise resales, naturally enhances the value of the system overall. On the other hand, some franchisors may be of the opinion that once a franchisee sells his operation they want him out of their system completely. Of course, if the franchise being sold is company owned, the franchisor should have no reservations about effectively increasing its yield. If the amortization period is ten years the net receipts received by the seller can be increased by 16.6% (i.e., from $66,000 to $77,186). To the extent that the amortization period is twenty-five years (as under present section 1253 to the extent that "franchise fee" exceeds $100,000) the differential is 28.7% going from $66,000 to $85,483.

To determine the percentage overriding royalty that would have to be charged to equal $100,000 of purchase price, the parties would simply work backwards from the annual sales upon which the royalty is based. Therefore, if, as in *Canterbury*, there are annual sales of $1,304,541 (the revenues of Mr. Schupack's McDonald's restaurant) an overriding royalty of less than 1½% of sales would yield a royalty payment of $17,424 per year. This would cost the buyer and net the seller $11,500 per year after taxes for a present value to the seller and present discounted cost to the buyer of $77,165. Such a small additional royalty in light of the fact that it would abrogate a required up-front payment should not crimp the operations of the purchasing franchisee. Such an arrangement, being tied to gross revenues, also constitutes a built-in adjustment for inflation.

Conclusion

The *Canterbury* case holding that there should be no allocation to good will may not be reliable precedent for other franchise operations. The overriding royalty should be considered as an alternative. Of course, such a transaction could only be structured with the express approval of the franchisor. However, if it costs nothing, and nets a selling franchisee (or in a case of a company owned store a selling franchisor) more money, the idea of an overriding royalty should not be cavalierly dismissed.

[¶ 10,091] Manufacturer Did Not Breach Maine Motor Vehicle Dealer Law, Commit Fraud

Schott Motorcycle Supply, Inc. v. American Honda Motor Co., Inc.

U. S. Court of Appeals, First Circuit. No. 91-2170. Dated September 29, 1992. Appeal from U. S. District Court, District of Maine.

Maine Motor Vehicle Dealer Law

Common Law—Breach of Oral Promises—Commitment to Motorcycle Market—Existence of Written Contract—Modification or Novation.—Allegations that a motor vehicle manufacturer breached its oral promises to continue its commitment to the motorcycle market were properly dismissed on the grounds that the parties were bound only by the terms of a written dealership agreement and that there was no contractual modification or novation. The dealership agreement provided that it could not be modified except by written instrument, and there was no evidence of any such instrument. The dealer's argument that the written agreement was revoked when the dealership principals changed and the dealer was converted from a proprietorship to a corporation was not alleged in the complaint, which mentioned only the written dealership agreement and included a copy of the written agreement. The complaint's references to oral representations were quite reasonably understood by the trial court as supporting the dealer's claims of fraud rather than the formation of a separate contract. **Back reference: ¶ 1620.**

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