Stromsted v. Commissioner, T.C. Memo. 1972-2 (1972)

Payments made by a successor franchisee to prior franchisees, as a condition of obtaining the franchise, are not considered a retained income interest of the prior franchisees but are income earned by the successor franchisee.

Summary

Victor Stromsted, a Dale Carnegie franchise sponsor, made payments to three predecessor sponsors as part of agreements to acquire their franchise territories. The IRS disallowed Stromsted's deductions of these payments as royalties, arguing they were capital expenditures. Stromsted argued these payments were retained income interests of the predecessors and thus not taxable to him. The Tax Court held that the payments were income to Stromsted, not retained income of the predecessors, because Stromsted earned the income through his own efforts and the predecessors retained no economic interest in the franchises. The court also denied amortization of these payments as they were for an intangible asset with an indeterminate useful life.

Facts

Dale Carnegie & Associates, Inc. licenses sponsors to conduct Dale Carnegie courses in specified territories. Dale Carnegie had a policy since 1957 to provide outgoing sponsors with payments, typically 6% of gross tuitions for up to 10 years, by successor sponsors. Prior to September 1, 1961, Dale required successor sponsors to make these payments directly to predecessors. After September 1, 1961, Dale formalized this through an intermediary, Dale Carnegie Service Corp. (Intermediary). Stromsted became a Dale Carnegie sponsor, succeeding Michels, Metzler, and Herman in different territories. He entered agreements to pay each predecessor a percentage of gross receipts for a period, mirroring Dale Carnegie's policy. Specifically, he agreed to pay Michels 6% of gross receipts for 10 years, Metzler 10% of tuitions from the first 150 students, and Herman 50% of the license fee paid to Dale for 10 years, capped at five times Herman's average annual license fee. Stromsted deducted these payments as royalties, which the IRS disallowed.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Stromsted's income taxes for 1962-1965, disallowing deductions for payments to predecessor sponsors. Stromsted petitioned the Tax Court, initially arguing the payments were amortizable capital expenditures. He later amended his petition to argue the payments were retained income interests of the predecessor sponsors and not taxable to him.

Issue(s)

1. Whether payments made by Stromsted to his predecessor Dale Carnegie

sponsors constituted retained income interests of the predecessors, and therefore not taxable to Stromsted.
2. If the payments were not retained income interests, whether they were amortizable under Section 167 of the Internal Revenue Code.

Holding

1. No, the payments made by Stromsted to his predecessor sponsors did not constitute retained income interests of the predecessors because Stromsted earned the income and the predecessors held no continuing economic interest in the franchises.
2. No, the payments were not amortizable because the franchise licenses were intangible capital assets with an indeterminate useful life.

Court’s Reasoning

The court reasoned that the crucial factor is who earned the income. Quoting *Lucas v. Earl*, 281 U.S. 111 (1930), the court emphasized that “income is taxed to the party who earned it.” The court found that Stromsted was the “sole generating force” behind the income. “Only through petitioner’s efforts was it possible for each of his predecessors to receive the disputed payments of income.” The predecessors did not retain any economic or property interest in the franchises. The agreements were essentially “third-party beneficiary agreement[s] between Dale and petitioner wherein, as part of the cost of acquiring the franchise territories worked by his predecessors, petitioner agreed to make the income payments in question.” The court distinguished cases where sellers retained a continuing interest based on the success of the business, noting here the payments were a condition of acquiring the franchise from Dale, not a purchase of a business from the predecessors. Regarding amortization, the court cited Treasury Regulation §1.167(a)-3, stating intangible assets with indeterminate useful lives are not depreciable. The Dale Carnegie licenses had automatic renewal clauses, making their useful life indeterminate during the years in question.

Practical Implications

Stromsted clarifies that payments from a successor franchisee to a predecessor, mandated by a franchisor as a condition of franchise transfer, are generally considered part of the successor’s income, not a pass-through of income to the predecessor. This case highlights the importance of analyzing the substance of franchise transfer agreements, focusing on who generates the income and the nature of the payments. For tax purposes, such payments are treated as costs of acquiring the franchise, potentially capital expenditures, and not as royalty payments or retained income interests. This decision impacts franchise law and tax planning in franchise transfers, particularly where franchisors impose payment obligations on successor franchisees. Later cases would cite *Stromsted* when distinguishing between payments for a business acquisition versus payments as a condition of a new franchise grant from a parent company.

