Canterbury v. Commissioner, 99 T. C. 223 (1992)

Subsequent franchisees may amortize the full purchase price allocated to a franchise, even if it exceeds the initial franchise fee paid by the original franchisee.

Summary

Petitioners, McDonald's franchisees, purchased existing McDonald's restaurants and allocated part of the purchase price to the franchise, which they amortized. The Commissioner argued that the franchise value should be limited to the initial franchise fee charged by McDonald's. The Tax Court held that the full purchase price allocated to the franchise by subsequent franchisees was amortizable under section 1253(d)(2)(A), rejecting the Commissioner's position that it should be limited to the initial fee. The court found that the franchise encompassed all significant intangible assets, including goodwill, allowing for full amortization of the allocated costs.

Facts

Petitioners purchased existing McDonald's restaurants in San Diego and Cleveland areas between 1972 and 1984. They allocated the purchase price between tangible assets and the McDonald's franchise, claiming amortization deductions for the franchise portion under section 1253(d)(2)(A). The Commissioner challenged these allocations, asserting that the franchise value should be limited to the initial franchise fee charged by McDonald's, which was significantly lower than the amounts allocated by petitioners.

Procedural History

The petitioners filed petitions in the United States Tax Court challenging the Commissioner's determinations regarding their tax liabilities for the years in question. The cases were consolidated for trial, focusing on the issue of the proper allocation of the purchase price to the McDonald's franchise for amortization purposes.

Issue(s)

1. Whether the amount allocated by subsequent franchisees to the purchase of a McDonald's franchise may be amortized under section 1253(d)(2)(A) even if it exceeds the initial franchise fee charged by McDonald's to the original franchisee?

Holding

1. Yes, because section 1253(d)(2)(A) allows for the amortization of the full purchase price allocated to the franchise by subsequent franchisees, without limitation to the initial franchise fee paid by the original franchisee.

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Court’s Reasoning

The court rejected the Commissioner’s argument that the franchise value should be capped at the initial fee, finding that McDonald’s had valid business reasons for charging a lower initial fee. The court determined that the franchise included all significant intangible assets, such as goodwill, which were inherent in the McDonald’s system and trademarks. The court cited Rev. Rul. 88-24 and its own precedents to support the position that subsequent franchisees could amortize the full amount allocated to the franchise. The court also noted that the proposed regulations under section 1253 did not limit amortization to the initial fee, and the experts’ testimony supported the petitioners’ allocation method.

Practical Implications

This decision allows subsequent franchisees to amortize the full purchase price allocated to a franchise, which may significantly affect the tax treatment of franchise acquisitions. It clarifies that the value of a franchise can include more than just the initial fee, encompassing the goodwill and other intangibles associated with the franchise. This ruling may influence how franchise agreements are structured and how franchise sales are negotiated, as buyers can now amortize larger portions of the purchase price. It also impacts the IRS’s ability to challenge such allocations, potentially leading to changes in how the IRS audits franchise transactions.

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