McDonald's Gets a Break Today in *Canterbury*

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When a buyer purchases a franchise (as in an asset purchase), the amount allocable to the franchise may be amortized over 25 years if, as is typical, the franchisor maintains a degree of control over the franchisee's conduct of its business. If H.R. 11 is passed, the 25-year amortization period would go down to 14 or 16 years, a number that is far more palatable. But even a 25-year amortization period can be significant compared with the alternative of no deduction and no amortization. Any portion of the purchase price allocable to goodwill—generally a dreaded word, of course—cannot be amortized. Now, however, a decision involving a McDonald's franchise suggests that goodwill may not be such a dreaded concept in the context of a franchise purchase.

The Tale of *Canterbury*

Canterbury, 99 TC No. 12 (1992), a case appealable to both the Sixth and Ninth Circuits, suggests that franchise buyers should feel good about the purchase price paid for the franchise, even if it involves a premium. There, two buyers purchased an existing McDonald's restaurant, including the franchise, from an existing franchisee. The purchase price exceeded the value of the tangible assets purchased. The buyers allocated the premium element to the franchise, then amortized this amount pursuant to Section 1253(d)(2)(A).

No Free Lunch, Argues IRS

According to the Service, the buyers allocated too much of the cost of the intangible assets to the franchise, and not enough to nonamortizable intangibles such as goodwill. Under the IRS view, the only amount that could be allocated to the franchise was the amount the franchisor actually charged the buyers for the franchise.

The Tax Court, however, launched into a detailed analysis of the ways in which a McDonald's franchise can be obtained, including the acquisition of a new restaurant, the acquisition of an existing restaurant, business facilities lease arrangements, and so-called "rewrites," in which 20-year McDonald's franchise terms are extended.

The court then determined that McDonald's followed the practice of charging less than market value for new McDonald's franchises so as to foster long-term relationships with franchisees. As to the premium, the court freely admitted that a McDonald's franchise encompasses attributes that have traditionally been viewed as nonamortizable goodwill.

Indeed, one of the things one gets when one buys a McDonald's franchise is the expectancy that customers will return to the restaurant. This goodwill is a product of the franchise, however, and cannot be separately disposed of.

Accordingly to the government, this meant that the value connected with the expectancy cannot be amortized because it is not separate and distinct from goodwill. The government relied on *Newark Morning Ledger Co. v. U.S.*, 945 F.2d 555 (CA-3, 1991), *cert. granted*, 112 S.Ct. 1583 (1992). Yet, in the court's view, a franchise (or trademark or trade name) is quite different from other types of intangibles, including those involved in *Newark Morning Ledger*.

You Deserve a (Price) Break Today

The purchase price of the franchise, according to the court, should be determined by subtracting the value of the tangible assets and going-concern value from the purchase price. The theory is that, except for going-concern value, all other intangible asset value is attributable to the franchise. The court determined that the buyers could amortize the amount of the purchase price allocated to the franchises.

This case suggests that with virtually any franchise acquisition, the entire cost of the franchise—whether allocable to tangible or intangible assets—should be deductible. It is possible that other courts might view the McDonald's franchise as unique. After all, McDonald's statistics indicated that a new franchise, within a week, will reach the level of sales it will average over the first year, and that sales tend to remain constant through the life of the franchise. It was on this basis that the court determined that there was no goodwill separate and apart from that inherent in the franchise.

Nonetheless, *Canterbury* is an important development, one that arguably should give a break to any franchise buyer. Given the fact that franchise buyers do not always face a bed of roses once the sale closes (for a recent example concerning Subway Sandwich Shops, see "Sandwich-Shop Chain Surges, but to Run One Can Take Heroic Effort," *Wall St. J.*, 9/16/92, p. A1), this is a positive development. ■