Memorandum

To: San Francisco – Auditing (LC:EH) Date: January 4, 1971

From: Tax Counsel (JKM) - Headquarters

Subject: REDACTED TEXT

This is in reply to your memorandum dated August 24, 1970, in which you requested that we advise as to the application of tax as a result of certain business activities engaged in by REDACTED TEXT.

We understand that REDACTED TEXT acquires leases on real properties, improves the properties, and equips the improvements as restaurants. It then franchises the restaurants for approximately $29,000 per restaurant (leasehold improvements, $9,000; fixtures and equipment, $15,000; franchise fee, $5,000). REDACTED TEXT receives down payments and carries the balances itself. In addition to the monthly payments therefor, franchisees also pay rent, fees for food and supplies, and other fees to REDACTED TEXT each month.

In some cases, franchises have not been successful. According to REDACTED TEXT representatives, it agrees to operate such franchises until new franchisees are engaged to operate them. The franchisees are relieved of their monthly obligations to pay rent, fees for food and supplies, and other fees to REDACTED TEXT, but they are not relieved of their monthly payments on the leasehold improvements, fixtures and equipment, and franchisee fees. Apparently, such agreements with franchisees are oral, not written.

In practice, in the instance in which a franchise has been operated by REACTED TEXT and then resold, REDACTED TEXT franchised the restaurant for $40,000, a sum which included interest in the amount of $11,600. Monthly payments therefore were $676.67, and the franchisee made only one payment before defaulting. From the information set forth in the franchisee close-out form BT-406, it appears that REDACTED TEXT started to operate the franchise on February 17, 1970.

REDACTED TEXT operated the franchise until February 23, 1970, when the franchise was resold for $31,500, the $2,500 increase being an increase in the franchise fee (New franchisee application for seller permti – February 23, 1970.) REDACTED TEXT negotiated this sale, executed the contract with the new franchisee, and was designated in the contract as the seller. Subsequent thereto, REDACTED TEXT issued a release to the prior franchisee in which it was recited that the parties agreed to terminate the sublease and to cancel the franchise and security

agreement, and the franchisee agreed to convey all property rights, title, and interest in equipment, inventory, etc., to REDACTED TEXT and to pay REDACTED TEXT the sum of $4,279.98 (prior purchases, advertising, and delinquent payments less inventory on hand.) No credit was allowed the franchisee for that portion of his one payment attributable to principal or for the additional $2,500 received by REDACTED TEXT from the new franchisee.

Since this release was not entered into and/or dated until the franchise was resold, REDACTED TEXT contends that it transferred title for the franchisee to the new franchisee simultaneously with its acquisition of title and that it did not repossess or repurchase the franchise or resell it. REDACTED TEXT did not report and pay sales tax on the sale of the franchise to the new franchisee.

As REDACTED TEXT finances these sales, its sales of tangible personal property constitute purchase money chattel mortgage sales, and in those cases where franchisees are not successful, REDACTED TEXT would be repossessing the tangible personal property under these mortgages rather than repurchasing it. In this instance, in repossessing the tangible personal property thereunder, REDACTED TEXT cancelled the franchise and security agreement. Since the only consideration received by the franchisee was the cancellation of the unpaid balance of the mortgage, the transfer of the tangible personal property to REDACTED TEXT was not a taxable sale (Cal. Tax Serv. Ann. No. 1782.15).

As REDACTED TEXT agreement to operate this franchise until a new franchisee was engaged to operate it was oral, and as REDACTED TEXT release was not entered into and/or dated until the franchise was resold, it is difficult to establish the date upon which REDACTED TEXT repossessed this franchise. Since the franchisee closed out its seller permit on February 16, 1970, and since REDACTED TEXT took possession of the franchise and began to operate it the following day, we would regard REDACTED TEXT as having repossessed this franchise on February 17, 1970, absent clear and convincing evidence in effect as of that date that in taking possession of the franchise, REDACTED TEXT was not repossessing the franchise but was only operating it on the franchisee behalf. In any event, since REDACTED TEXT negotiated the resale, executed the contract with the new franchisee, and was designated therein as the seller, REDACTED TEXT repossessed the franchise at some time prior to the resale of the franchise to the new franchisee and as the seller of the franchise, REDACTED TEXT was obligated to report and pay sales tax incurred as the result of its sale.

As the repossessor of the franchise, under these circumstances, REDACTED TEXT does not owe tax on the cost of the fixtures and equipment therein as a result of its use of them prior to its resale of the franchise. As noted, the transfer of the tangible personal property to REDACTED TEXT under the mortgage was not a taxable sale, and thus, use tax is inapplicable because the property repossessed was not “purchased from any retailer” (§6201).

Finally, in three other instances REDACTED TEXT is operating franchises which it previously sold but which have not yet been resold. As you are no doubt aware, when a franchisor repossesses a franchise under a purchase money mortgage and continues to operate it rather than attempting to resell it, potential tax avoidance is a distinct possibility, particularly, for exampe, if the franchisor is able to take advantage of the returned merchandise exclusion (regulation 1655(a)).

We have tentatively concluded that when a franchisor repossessed a franchise and continues to operate it rather than attempting to resell it, we will not assert use tax upon the franchisor use of fixtures and equipment therein unless it can be established that the repossession was a sham. It would appear that such would rarely be the case. When a franchisor repossesses a franchise and continues to operate it rather than attempting to resell it and takes advantage of the returned merchandise exclusion, however, we will assert use tax upon the franchisor use of fixtures and equipment therein.

JKM:smb