UNITED STATES TAX COURT
WASHINGTON, DC 20217

H R B-DELAWARE, INC. & SUBSIDIARIES,)
Petitioner(s),)
v.) Docket No. 28129-12.
COMMISSIONER OF INTERNAL REVENUE,)
Respondent)

O R D E R

H R B-Delaware, Inc. & Subsidiaries (H R B-Delaware) moved for summary judgment, but then the Commissioner undertook third-party discovery. The parties then agreed that that discovery led to nothing that would undermine the need for a decision on the motion, and didn't even lead to any additional evidence to supplement the motion or the Commissioner's response. The usual rules for summary judgment apply.

The motion calls for the application of old case law to a half-century old contract, and seeks a ruling that there is no genuine dispute about a material fact -- valuation of intangible assets -- that is only rarely capable of decision through summary judgment.

Background

The key document is a 1963 contract between H & R Block, the largest tax-preparation company in America, and two then-young business partners who had formed a company, H & R Block, Inc., a Texas corporation, to serve as national H & R Block's primary Texas franchisee for an initial franchise fee of only $15,000 and what seems, to an untrained eye, a very low royalty rate of only 5%, if remitted promptly.

Franchise law back in 1963 was not the specialty it is today. There was no FTC Franchise Rule, 16 C.F.R. secs. 436-437, there were no uniform franchise offering circulars, and California had not yet passed the first state franchise investment law, *see* California Franchise Investment Law, Cal. Corp. Code secs. 31000-31516. Franchises were for the most part contracts like any other. And this contract was typed out and even bears the personal signatures (and promises of noncompetition) of both Henry and Richard Bloch. There are certainly many standard paragraphs, but also a great deal of nonstandard language.

There are a few provisions that are especially important:

> The franchise was a personal and nonassignable license;
>
> A breach by national H & R Block entitled the franchisee to exclusive use of the H & R Block name in Texas; and
>
> The term of the agreement was for four years, "automatically renew[able] for successive periods of one (1) year each unless terminated by either party, as a result of a breach of this Agreement."

There were no provisions to govern the leasing of office space (except a ban on the franchisee's assignment of its leases without national H & R Block's permission) and the franchisee got to keep its books, records, and customer lists.

Of course, 1963 was a long time ago, when "internet" was probably thought by intelligent speakers of English as having something to do with commercial fishing. But fast forward to the late '90s and national H & R Block saw that its future needed to include making tax-preparation software widely available. Its franchisees saw this as a massive violation of the noncompete clauses in their franchise agreements and sued in Missouri state court.

The Texas franchisee was a party to that suit. While it was pending, the franchisee's owners converted their C corporation into an S corporation, effective at the start of 2000. They then dropped out of the Missouri suit after they reached a settlement with national H & R Block.[1] Part of this settlement took the form of a long amendment to the original franchise agreement that greatly altered the original terms and seems to have been part of national H & R Block's goal of standardizing its franchise agreements. Some of the key new terms:

> Gone was the language of personal and nonassignable license, replaced with free assignability subject to approval by national H & R Block, which it promised not to unreasonably withhold;
>
> Gone was the language giving the franchisee any right to use the H & R Block name in the event of a breach; and
>
> Gone was the original franchise term, replaced with a 60-year term renewable for 10 years at a time.

There was also an explicit reservation to national H & R Block of any good will existing or created by the franchisee, and a provision that detailed what national H & R Block would pay for the franchisee's assets upon termination of the contract. Perhaps the most significant change was the insertion of a new clause that gave national H & R Block the right to buy the franchisee at the end of the 60-year term, or at any of the 10-year renewable terms, at a price to be determined by a formula spelled out in detail in the contract.

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[1] By this time, ownership of both national H & R Block and the Texas franchisee had become quite complex in ways that don't affect our analysis. Our use of the term "national H & R Block" includes such entities as "HRB Royalty, Inc. a Delaware corporation with its principal place of business in Nassau, The Bahamas" and H&R Block, Inc.; our use of the term "franchisee" includes the original franchisee, which had morphed into H&R Block, Ltd. and was owned by a welter of other entities.

As events developed, national H & R Block decided in 2008 to buy out the franchisee. The price was well more than $100 million.

This motion is about the tax consequences of part of that sale.

Discussion

Remember that the franchisee had been a C corporation until 2000, when it converted into an S corporation. S corporation shareholders get to avoid two layers of tax, but there are some unusual consequences when an existing corporation converts. The one featured here is the triggering of a tax on assets whose value at the time of conversion is greater than their adjusted basis. Such assets have what section 1374(d)(1)[2] calls "unrecognized built-in gain." If the S corporation recognizes (i.e., which usually means "sells") an asset with built-in gain (BIG) within ten years, *see* sec. 1374(d)(7), section 1374(a) imposes a tax (the BIG tax), which for H R B-Delaware would be 35% of the gain.

The gain here was quite large for some of petitioner's long-term assets, and the Code imposes the BIG tax on the "disposition of *any* asset" with BIG. *See id.*

When petitioner sold its assets in 2008, it reported a net BIG tax of nearly $4 million on its return. In computing this tax, petitioner stated that one of its assets on which it had BIG when it converted into an S corporation was its "franchise rights," which it valued at $11.9 million. The Commissioner subsequently determined that those rights were worth more than $28.4 million.

But, after filing its petition, H R B-Delaware took a more careful look at the situation and now asks us to determine that those rights -- and it says there is no genuine dispute here -- were worth nothing at all. If it's right, it'll probably be entitled to a refund of any overpayment.

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[2] All section references are to the Internal Revenue Code in effect for 2008, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

Petitioner argues that the rights are what are called "franchise rights," which are intangible assets such as good will and the going-concern value that a business typically develops over time. It argues, however, that the peculiar terms of its 1963 contract with national H & R Block made those rights worth nothing to it as a matter of law, and it cites to old caselaw of ours in which we analyzed this much earlier generation of franchise agreements.

The Commissioner disagrees. He argues that the BIG tax has to be computed using the value of *all* intangible assets, not just the franchise rights; that valuation questions can't be resolved through summary judgment; and that petitioner is misreading the old caselaw to argue that the franchise rights were not valuable to it.

1. *What assets are being valued?*

In its petition, H R B-Delaware assigns error to the Commissioner's determination that "the fair market value of Petitioner's intangible assets as of January 1, 2000, was $28,486,000." The Commissioner argues in his answer to the motion that this means it's unclear what asset valuations are in dispute: "[P]etitioner's other intangible assets have value. Petitioner undoubtedly enjoyed some business because it was a Block franchisee. The disputed and unresolved factual question is to what extent petitioner attracted customers for other, independent reasons." If true, that would be a plausible ground for successful opposition to the motion. Petitioner, however, correctly points out that there is no genuine dispute that the valuation determined by the Commissioner in the notice of deficiency is the fair market value of petitioner's franchise rights -- the $28,486,000 figure is described in the Commissioner's own "Explanations of Items" on Form 886-A as his conclusion on a dispute with petitioner about the value of the "FMV of Franchise Rights."

This is sufficient to let us conclude that the dispute between the parties is limited to the value of those "franchise rights." (If the Commissioner does dispute the value of other intangible assets that petitioner might owe BIG tax on, we note our Rules treat motions to amend pleadings at this stage of the litigation liberally.)

2. *Can this valuation dispute be decided on summary judgment?*

The Commissioner also argues that "[b]ecause valuation is a factual determination, summary judgment is not appropriate here." That's true for many valuation questions, of course, but our Rules allow us to consider on a summary-judgment motion "what material facts exist without substantial controversy and what material facts are actually and in good faith controverted." Rule 121(c); *see also Estate of Quick v. Commissioner*, 110 T.C. 172, 181 (1998).

So that's what we will do here.

3. *Is there a genuine dispute about the value of petitioner's franchise rights?*

The previous questions are preliminary to the main event here, which is whether petitioner has established that the franchise rights that it was granted in the 1963 contract were worth -- as of January 1, 2000 -- nothing.

Petitioner's argument flows from two old cases in which the value of franchise rights, similar to those granted in petitioner's 1963 contract, were at issue. The first is *Akers v. Commissioner*, 6 T.C. 693 (1946). The franchise agreement in *Akers* must have been one of the first to get tangled in Tax Court, and featured a dispute about the calculation of the going-concern value of a liquidated corporation that Akers owned. His corporation was named the Capitol Cadillac Co. which, for several years in the early twentieth century, had a GM franchise to sell cars in the DC area. According to the terms of Capitol Cadillac's contract, GM could terminate the contract at will on three months' notice, and for cause without notice under various other circumstances. *Id.* at 694. Akers decided to liquidate the company and put its assets into a partnership. *Id.* at 696. GM was okay with this, but the Commissioner said the liquidation triggered taxation on about $55,000 in "going-concern value." *Id.* at 699.

We found that there was no going-concern value, because the "franchises were not assignable and by their terms were made personal contracts between the parties. Such good will or going-concern value as the corporation might have created during its existence was subject at all times to be divested by termination of the franchises without action by the corporation." *Id.* at 700. This meant, we reasoned, that "the good will, if any, was bound to the franchises and ceased as something out of which the corporation could use or derive profit when the franchises were terminated." *Id.*

We note that we arrived at this conclusion after a trial, which implies that it might be a finding limited to the particular facts presented. But then we encountered a very similar situation in *Zorniger v. Commissioner*, 62 T.C. 435 (1974) when a taxpayer made a gift to his son of shares in a closely-held corporation that held a Chevrolet franchise. The parties agreed on the value of the corporation's physical assets, but disputed whether the corporation had valuable good will. *Id.* at 443. We copied from *Akers*, 6 T.C. 693, our reasoning that "no goodwill could exist in a nontransferable, personal service contract the privileges of which could be divested from the taxpayer under circumstances completely beyond his control." *Zorniger*, 62 T.C. at 445. And though we held a trial, at which the Commissioner put on an expert witness to estimate the value of the good will, we made our conclusion a holding of law and not just a finding of fact:

> Such testimony is not being disregarded because of its quality but instead because the nature of the corporation's business reflected in its agreements with the Chevrolet Division precludes a finding of goodwill.

Id. at 445-46; *see also Ruhlman v. Commissioner*, 35 T.C.M. 349, 352 (1976).

H R B-Delaware's argument is now plain. Its 1963 contract was just like the old franchise contracts at issue in these old cases. It too was nonassignable, and personal to the principal of the initial franchisee. And, because it was by its terms indefinitely renewable unless breached, it too was terminable at will by operation of state law before the date of renewal. *See Armstrong Bus. Servs., Inc. v. H & R Block*, 96 S.W.3d 867, 877-78 (Mo. Ct. App. 2002).[3]

The Commissioner argues that these cases are distinguishable. He cites cases where we did recognize that there might be good will in a business dependent on terminable-at-will franchises. *See, e.g., Falstaff Beer, Inc. v. Commissioner*, 322 F.2d 744 (5th Cir. 1963), *aff'g* 37 T.C. 451 (1961). But we have long distinguished such cases as arising from the different situation where an existing franchisee has successfully transferred his existing business to a third party: "We find those cases to be inapposite. In each case, the seller of the business involved transferred to the buyer the opportunity to succeed to the seller's

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[3] *Armstrong* construed national H & R Block's contracts with other franchisees -- H R B-Delaware having settled by then. There is no choice-of-law provision in the 1963 contract, but the law of Texas (the other state whose law might reasonably apply) is the same on this point. *See Trient Partners I Ltd. v. Blockbuster Entertainment Corp.*, 83 F.3d 704, 708 (5th Cir. 1996).

business clientele. No third party in those cases was involved in deciding who would take over the business." *Ruhlman,* 35 T.C.M. at 352.

He also argues that cases like *Akers*, 6 T.C. 693 and *Zorniger*, 62 T.C. 435 are distinguishable because they featured businesses that sold products, not services. We don't see how that makes a difference in the value of franchise rights, or closely associated concepts like good will and going concern. The cases don't make this distinction and the common element in all of them is that a franchisee under these old contracts had no intangible asset of value apart from the right to do business under the franchisor's name.

In the more than 50 years since petitioner's first contract with national H & R Block, franchise contracts have become more elaborate and state franchise law often gives potentially valuable rights to franchisees independent of their contracts. As the Commissioner points out in his last argument, the 2000 amendment that petitioner negotiated with national H & R Block *did* give it some valuable intangible rights (including especially the deletion of the nonassignability provision). But we have to decide if there is any genuine dispute left to try about the value of petitioner's franchise rights as of January 1, 2000.

There isn't. They were worth zero, which means petitioner doesn't owe the BIG tax in the amount that the Commissioner determined. It is therefore

ORDERED that petitioner's motion for partial summary judgment is granted. It is also

ORDERED that on or before March 28, 2019 the parties shall submit settlement documents or file a status report that describes their efforts to settle the case or narrow the remaining issues to be tried.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
January 29, 2019