LJN LAW JOURNAL NEWSLETTERS

LJN'S FRANCHISING BUSINESS & LAW ALERT®

Volume 11, Number 9 • June 2005 ALM

Should You Make an Earnings Claim?

By Lee R. Dickinson

If there is one question in the minds and on the lips of potential franchisees, it is "How much money can I make with this concept?" Franchisors may answer this question, of course, but with great care and consideration as to what, how, and when they answer it.

Under both the UFOC guidelines and the FTC Rule, a franchisor is not *required* to make any representations concerning the actual, average, projected, or forecasted sales, profits, or earnings likely to be realized by operation of the franchise. If a franchisor does make such representations, it must do so in strict compliance with the "earnings claim" requirements of the FTC Rule or Item 19 of the UFOC Guidelines. In short, an "earnings claim" is any information given at the direction of the franchisor to a prospective franchisee from which a specific level or range of actual or potential sales, costs, income, or profit from franchised or non-franchised units may easily be ascertained. Currently,

continued on page 2

- SPECIAL SUPPLEMENT -

Full Coverage of the IFA Legal Symposium Is Included Inside This Issue

Tax Nexus Update for Franchisors

By Bruce S. Schaeffer

Franchisors thinking of expanding into new jurisdictions, and even those that are not changing anything, should be wary. State and local governments, in this time of deficits, are constantly looking for ways to increase their revenues by broadening the scope of their taxes.

According to a report for the Council on State Taxation, "*Total State and Local Business Taxes 2000-2004,*" released in April 2005, over the last 4 years:

- state and local taxes on businesses have risen faster than total state and local taxes, and business has paid 52% of the increase over those years;
- the corporate income tax represents only 8% of state and local taxes nationally (and the corporate share of federal taxes is about the same); and
- individual income taxes paid by owners of non-corporate businesses represent only 4% of total state and local business taxes.

The states, which generally must run on balanced budgets, are searching for revenues from any source so that they don't have to cut domestic programs too drastically.

But, desperate as they are, the states' ability to tax is limited. A foreign corporation is only subject to a state tax if there is a sufficient nexus between the taxing state and the foreign corporation. The underlying prohibition has two sources: the Due Process Clause and the Commerce Clause of the U.S. Constitution. Until the 1992 decision by the U.S. Supreme Court in *Quill Corporation v. North Dakota*, (112 S.Ct. 1904, 504 U.S. 298, 119 L.Ed.2d 91 (1992)), most courts did not see any major differences in the concept of "nexus" as defined by the two clauses. *See Orvis Company v. Tax Appeals Tribunal* 630 NYS2d 680, 86 NY2d 165 (1995) at p.682 "Until *Quill Corp. v. North Dakota*, the constitutionally required nexus between the taxing state and the activity, entity or property subject to the tax was applied indistinguishably for purposes of both Due Process and Commerce Clause analysis, *ie*, a definite link or minimum connection (*see, National Bellas Hess v. Department of Revenue,* 386 U.S. 753, 756-757, 87 S.Ct. 1389, 1391, 18 L.Ed.2d 505; *Scripto v. Carson,* 362 U.S. 207, 210-211, 80 S.Ct. 619, 621, 4 L.Ed.2d 660)." But *Quill* decided that on the same facts "nexus" may be found under the Due Process clause, while it may be lacking under the Commerce Clause.

continued on page 3

In This Issue

Earnings Claim

continued from page 2

existing franchisor-operated unit, provided that the earnings claim information is limited solely to the actual operating results of the specific unit being offered for sale.

Both the FTC Rule and Item 19 permit a franchisor without existing franchisees (or even a franchisor without an operating history of its own units) to make an earnings claim. The inexperienced franchisor's claim of past performance can be based only on its operation of an affiliated business substantially similar to that being franchised. Any claim regarding potential future performance should be prepared as a projection in accordance with the statement on standards for accountants' services on prospective financial performance issued by the American Institute of Certified Public Accountants, Inc., as such a future claim is presumed to have a reasonable basis.

Whether or not the franchisor determines to include earnings claim information in its franchise offering document, the franchisor must use caution to avoid earnings claim liability. If the franchisor or its salespersons make an unauthorized or an inaccurate earnings claim, the result may be a franchisee lawsuit for rescission, restitution, or other relief. In many states, the making of an unauthorized or inaccurate earnings claim could result in civil penalties and criminal sanctions. Most franchisors that decide to make an earnings claim do so only with regard to levels of sales, earnings, or profits actually experienced by the franchisor and/or its franchisees. If a franchisor projects sales, profits, and income, it is warranting that such sales, profits, and income are likely to occur. If the franchisor is wrong, it may ultimately be required to prove to a jury that it had a reasonable basis for making those claims. While not every franchise lawsuit involves improper earnings claims issues, Item 19 is usually the first place an aggrieved franchisee looks after its franchise financially underperforms or fails.

Should You Make an Earnings Claim?

So, should you or your franchisor client make an earnings claim? When making that decision, you should take the following considerations into account:

- You (or your client) are giving information that a potential franchisee undoubtedly will want to know.
- You (or your client) will have a greater degree of control over what "earnings claim" information is being given to prospective franchisees, whether by you or your broker.
- You (or your client) may incur liability for making earnings claims that do not have a "reasonable basis." To this end, always compare apples to apples, oranges to oranges. For example, do the reported locations have the same costs of labor and products/services as those being franchised? Are they the same type/size of location that is being franchised? Do they offer the same products/services as a location being franchised?
- You (or your client) must carefully consider what information should be included in an earnings claim. It is safest to include historical information based on actual performance — but, in doing so, also consider such factors as the number of locations being reported (the more the better); whether you are reporting gross or net figures; if you include ranges of revenues/sales/profits, you would do well to also include means, medians and/or modes for that information to account for and better explain the high and the low.
- Are there any locations that seem to be "odd" in terms of performance, whether high or low, when compared with others? Consider what might make these locations different from the franchised concept, if anything.
- Happy, successful franchisees do not sue. If you are a new franchisor, you might do well to see how your first few franchised units perform before making an earnings claim.
- Research to see what your particular industry is doing in terms of making earnings claims.
- Things you never want to hear: *"Let's base it on the 10 top-performing locations." "Those locations are operating at losses. Let's leave them out."*

Conclusion

The decision whether to include an earnings claim should be taken very seriously. There is no single, decisive factor to consider in making that determination. For established franchisors with multiple outlets, it may be preferable, easy, and relatively safe to make an earnings claim that provides range and averages of gross revenues, especially if sales are being made by brokers or other third parties. For the new franchisor, however, there is often greater risk. Whether a new concept or a well-established one, tread carefully.

—❖—

Tax Nexus

continued from page 1

The main issue in the franchise context is whether the operation of a franchise by a franchisee in a particular state can be deemed a sufficient connection with that state by the franchisor to constitute a "nexus" for tax purposes. And there may be one "nexus" rule for sales tax purposes and another for income tax purposes. Frequently, the decision turns on whether or not the franchisor is "doing business" or has a "presence" within the jurisdiction.

There has been tremendous debate about this issue since South Carolina's *Geoffrey* decision in 1993 (*Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.Car., 1993), *cert. denied*, 510 U.S. 992 (1993)). In that case the court ruled that a Toys R Us subsidiary was subject to South Carolina tax even though it had no offices or employees in South Carolina and was funded solely with intangibles (the Geoffrey the Giraffe trademark). Toys R Us paid a royalty to Geoffrey that was deducted from its South Carolina taxes and reported in Delaware — a "phantom tax" jurisdiction which levied no tax.

The *Geoffrey* case was described by one of the foremost authorities in the field as "a decision with staggering income tax implications." (*see* Hellerstein, "State and Local Taxation of Intangibles Generates Increasing

continued on page 4

Tax Nexus

continued from page 3

Controversy" 80 *J. Tax'n* 296 (5/94)). Opponents of the decision condemned it on due process grounds, on commerce clause grounds, and for incorrect apportionment analysis. It has even been described as jeopardizing the license revenues of Walt Disney, Mickey Mouse, and Michael Jordan (*see* Minear and Rudnick, "South Carolina Extends the Reach of State Income Taxes to Franchisors" *Franchise Legal Dig.* (Fall 1993)). But the states were acting to put the brakes on a strategy, heavily marketed by accounting firms, whereby businesses have incorporated their intangibles in "phantom tax" jurisdictions to avoid paying state and local taxes. The use of this structure has been described by one angry judge as follows:

> So, here's the tax avoidance scheme: First, a corporation creates a separate person in a state that does not tax that person's income. Second, the [taxpayer] assigns the patent or trademark to the new person, essentially for free. Third, the [taxpayer] agrees to pay the new "person" royalties for use of the patent or trademark. This new "person" — which received the patent or trademark rights for free — then claims that it has no connection with [the taxing state] and owes [the taxing state] no tax on the income it derived from [its] sales in [the taxing state] ... This certainly is clever, but [the result] is absurd. *Acme Royalty Company v. Director of Revenue* Supreme Court of Missouri 96 S.W.3d 72 (2002) from dissent of Judge Michael A. Wolff at p. 77.

After *Geoffrey* there were other important and sometimes conflicting decisions. For example, *Lanco, Inc. v. Director, Division of Taxation*, an income tax case, applied the *Quill* rules, which require a "physical presence" (and which should have been limited to sales tax cases) and disagreed with *Geoffrey*'s result (Case No. 005329-97. Filed Oct. 23, 2003 (the court has designated this opinion as NOT FOR PUBLICATION). On the other hand, *Kmart Properties*, an unpublished New Mexico case, disagreed with *Geoffrey*'s reasoning, but came to the same result. (*See In the Matter of the Protest of Kmart Properties, Inc.*, New Mexico Taxation and Revenue Department, No. 00-04, Feb. 1, 2000; CCH NM-TAXRPTR, ¶400-976, which found Kmart liable for both sales and income taxes on the royalties it received from its New Mexico operations.)

However, since the *Lanco* decision in 2003 practically every subsequent state decision (or legislative action) has rejected the incorporated intangibles scheme. For example, in *Rayonic Corporation v. Dept of Treasury* (MI Court of Appeals (Nov. 23, 2004) STATE-ARD, ¶401-120 (CCH)), Michigan's high court found that maintaining a sales staff of only four people within Michigan was sufficient "presence' to yield tax nexus and overcome a *Quill* challenge. The court found: "A tax will sustain a Commerce Clause challenge when it: (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state."

And in the more important case of *A&F Trademark, Inc. v. Tolson*, (North Carolina Court of Appeals (Dec. 7, 2004) (CCH) STATE-ARD, ¶202-301), which concerned the same taxpayer as New Jersey's *Lanco* decision — a Delaware subsidiary incorporated to own trademarks of The Limited, Abercrombie & Fitch, and Victoria's Secret — the court found that merely licensing a trademark for use in North Carolina was sufficient to subject the licensor to tax in that state.

The North Carolina court and several other courts have now clearly rejected the use of interposed licensing subsidiaries, treating them as a contrivance with no legitimate purpose other than avoiding taxes. This disallowance, coupled with the recent passage of "royalty add back" statutes in several states, should sound the death knell for these schemes which incorporate intangibles in "phantom tax" jurisdictions to avoid state and local taxes. In *A&F Trademark* the North Carolina Court of Appeals cited both *Geoffrey* and *Kmart* with approval, rejected the reasoning of New Jersey's *Lanco* decision, and found that the use of a trademark within the jurisdiction was itself sufficient to provide "presence" meeting the *Quill* test for tax nexus. There should be some monstrous state and local tax assessments coming soon. Although the fact pattern in *A&F Trademark* is not the same as in the normal franchisor-franchisee relationship, there is a high probability that franchisors will be caught in the same net and should consider setting aside reserves. This would apply particularly to company-owned stores that pay royalties.

Another strategy to obtain a similar result, *ie.* avoidance of state and local taxes, (although using a different mechanism) was also recently disallowed in *Louisiana v. Autozone Properties* (STATE-CASE-HIGH-CT, STATE-ARD, ¶201-824 (3/24/05). Initially, Autozone was one big corporation. Then came the I-can-save-you-state-and-local-taxes discussion with its accountants and voila, Autozone became three entities: Stores, Development, and Properties. Stores, operated the retail stores and paid a very large percentage rent to Development, which was a real estate investment trust ("REIT"). Result: Stores filed tax returns in Louisiana but effectively avoided Louisiana income and franchise taxes by taking rent deductions that wiped out all its income. Development also filed tax returns in Louisiana and included all the rental income from Stores, but took a dividends paid deduction (available to REITs) to the extent of all of its income. REITs have to distribute at least 90% of their income to the shareholders to maintain their status.

Ultimately, the dividends were received by Properties, a Nevada corporation which did *not* file Louisiana tax returns and was the sole shareholder of Development. Properties argued that its intangibles, *ie.* the stock in the REIT, unlike the intangibles in *Geoffrey*, were not located in Louisiana because Properties kept all the intangible stock in Nevada. Accordingly, when Louisiana sought to impose taxes, Properties filed a "declinatory exception of lack of personal jurisdiction" (no right to tax because no long-arm jurisdiction),

continued on page 5

Bruce S. Schaeffer is president of Franchise Valuations, Ltd., in New York. He is co-author with Byron Fox of "Franchise Regulation and Damages," which will be published by CCH this summer. Schaeffer can be contacted by e-mail at *bschaef123@aol.com* or by calling 212-689-0400.

Tax Nexus

continued from page 4

which was sustained by the trial court and the appellate court. The Supreme Court of Louisiana reversed.

In its argument on appeal, the state made the startling (even to a cynical old tax practitioner) assertion that "the lower courts have countenanced a tax abuse strategy that will have a far-reaching, negative impact on the state's economy since this and other similar tax schemes are robbing the state of 42% of its corporate income base." Thus Louisiana's fiscal survival seemed to require a decision finding taxability.

As can be seen by the table to the right, findings of "nexus" and taxability have abounded of late.

However, this cascade of decisions to tax out-of-state licensors of trademarks may be pre-empted by federal legislation. On May 2, 2005, a bill was introduced in the House of Representatives titled the Business Activity Tax Simplification Act of 2005, which basically outlaws all state assertions of nexus without "physical presence." In the proposed bill, physical presence is defined very generously, with many exemptions, and contains no attribution rules and no requirements for consolidation with related parties. Thus, it can be argued that if the proposed bill becomes law, the federal government will be guilty of fiscal murder of the already revenue-strapped states if the statistics quoted by the *Autozone* court are correct.

—❖—

SELECTED RECENT NEXUS AUTHORITIES AND DECISIONS

STATE	STATUS
AL	Legislation proposed to eliminate tax deduction for royalties paid to out-of-state licensor.
AZ	Bill passed by both houses and presented to governor that would phase out multiple factor apportionment formula and limit it solely to a single factor — sales (*ie*, revenues). Effect will be to increase corporate income tax on out-of-state franchisors (5/9/05).
GA	Effective for tax years beginning after 1/1/06, taxpayers computing GA corporate and personal income taxes will no longer be allowed to deduct "intangible property costs and expenses" (*ie*, royalties, etc.). This was done by eliminating three factor apportionment formula and limiting it solely to a single factor — sales (*ie*, revenues).
IN	A retail clothing store chain was required to include amounts paid to affiliate corporations for trademark royalty and interest payments in its consolidated return for Indiana income taxes because the payments were derived from sources within Indiana. *Letter of Findings Nos. 02-0087 and 02-0310, Indiana Department of Revenue, April 1, 2005.*
KY	*Annox Inc v. Revenue Cabinet* (2/17/05) held that CLEC (Competitive Local Exchange Carrier — like phone company) which was required to register in state as utility to do business in the state had sufficient tax nexus with KY because its operating tangible property (rented phone lines) and "franchise" were located within the state.
LA	Dept. of Revenue brought suit to collect income taxes paid to out-of-state entities which received royalty payments, such as Geoffrey, Wendy's, and H&R Block (Jan. 2004).
LA	*Bridges v. Autozone Properties* held that REIT that collected rents from Autozone stores and paid them out completely to out-of-state owner made out-of-state owner subject to LA taxes. Finding that trademark use in the state was enough to yield "presence" in the state sufficient to provide tax nexus (3/29/05).
MD	State won litigation taxing royalties paid to out-of-state licensors that were related. *Comptroller v. SYL Inc* and *Comptroller v. Crown Cork and Seal* (6/9/03).
MI	Appeals court held that even small workforce in state was sufficient to yield tax nexus. *Rayovac v. Dept. of Treasury.*
MS	Legislation proposed to eliminate tax deduction for royalties paid to out-of-state licensor.
NC	Taxpayers asserted they did not have a substantial nexus with North Carolina because they had no physical presence and to tax them would violate Commerce Clause. NC high court held that: 1) *Quill* requirement of physical presence only applied to sales tax, not income tax; and 2) chose to follow *Geoffrey* that trademark use was "presence" within state. *A&F Trademark v. Tolson.*
NJ	*Lanco* decision that found no nexus without "physical presence" was completely overturned by state's enactment of a royalty add back statute.
NM	*Kmart* decision makes royalties subject to income and sales tax; prior decisions held franchisor income was subject to "gross receipts" tax (like sales tax).
NY	Royalty add back statute enacted 2004.
NY	Computer hardware manufacturer with only one sales rep in NY whose activities were limited to soliciting orders with no office was not sufficient for nexus. TSB-A-05(7)C 4/1/05.
NY	Court of Appeals (highest NY Court) declined to review *Sherwin Williams* decision in which Tax Appeals Tribunal was upheld by court in finding that a corporation was required to file a combined tax return with its trademark subsidiaries.
NY	Court of Appeals held that income received by TN resident from NY employer was all subject to NY income tax because TN resident was "telecommuting" for employee's convenience and that only work done in TN for the "convenience of the employer" would remove the remuneration from NY tax. *Huckaby v. NYS Division of Tax Appeals* (3/29/05).
SC	*Geoffrey* decision finding trademark is nexus (1993).
VA	Royalties and interest on payment of royalties to affiliated company holding intangible rights were disallowed as deductions (same effect as royalty add back statute). VA Dept of Taxation *Ruling of Commissioner P.D. 05-29.*