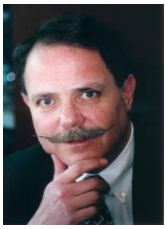
Volume 5 - Issue 8 **August 2013**

The Franchise Valuations Reporter

Our Expertise



Within the franchise, distribution and dealership context, we are experts in:

- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security and E-discovery of Electronically Stored Information

We offer a free initial consultation. If any readers have questions, you are welcome to email or phone us and we will provide our best answer as quickly as possible.

Bruce S. Schaeffer, Editor
Bruce@FranchiseValuations.com
212.689.0400

We Write the Book

Franchise Regulation and Damages, the only treatise that covers valuations of franchises, is updated 3 times a year.

For more details, to see a Table of Contents or to place an order, go to the CCH web page here.

Franchise Technology Risk Management

Our franchise law and computer forensics experts provide consulting and implementation of

Franchise Real Estate Ownership and the Obamacare 3.8% Surtax

Conventional Wisdom: Hold the Business Real Estate in a Separate Entity
Problem: Liability for the Obamacare Surtax

Internal Revenue Code Section 1411 which went into effect on January 1, 2013, was enacted as part of the Affordable Care Act (Obamacare) and imposes a tax of 3.8%, called the net investment income tax (NIIT), on certain so-called "net investment income" (NII) if a Taxpayer's adjusted gross income exceeds $250,000 per year for taxpayers filing a joint return.

Facts:
Here's a commonplace situation: A Taxpayer owns 10 franchises and separately owns the real estate parcels where the businesses operate, through real estate holding LLCs where he has all management authority under the LLC Operating Agreements. He works full time running the entire enterprise and does not allocate his time between real estate operations and franchise operations nor does he keep any sort of diary of his workdays.

The Taxpayer files a joint return with his wife; and his sister and children are also owners of LLC interests in the real property LLCs. The Taxpayer has income from "rental activity" (i.e. the LLCs) in excess of $500,000.

Issue:
Is the Taxpayer liable for the 3.8% surtax? Are his children (or his sister) who are non-managing owners of LLC interests in the real property liable for the 3.8% surtax?

Tests to Determine Liability for the Tax
The first test to determine whether the Taxpayer is liable for the surtax is whether he has Adjusted Gross Income (AGI) greater than $250,000. Under the facts he does, so we must move down the decision tree.

The second test is whether the Taxpayer has NII as defined which includes rental income. He does, so that leads to the third test: whether the Taxpayer's rental income is per se "passive" under IRC Sec 469 (c).

This answer turns on the final two tests: the fourth test is whether the Taxpayer's rental activities are a "trade or business" as defined by Reg. Sec. 1.469-9. But it is the fifth test - whether the Taxpayer "materially participates" in the rental activity - which is generally the most problematic because that requires that the Taxpayer spend more than half his time on the real property activities and spend more than 750 hours per year doing it.

So even assuming that the Taxpayer's LLCs qualify as a "real property trade or business" only a Taxpayer who "materially participates" in the real property trade or business is exempt from the 3.8% surtax and that requires devoting more than half the Taxpayer's time to the real estate venture. That is a requirement almost impossible to meet for people who run active businesses like our franchise owner.

all aspects of cyber security, ESI management and e-discovery for franchise systems - from preparation of cyber security and ESI-related policies and procedures manuals through collection, preservation, processing, production and presentation.

To inquire about our services, please e-mail
Henry@FTRM.biz
or call (212) 689-0400

DISCLAIMER

The information provided in this newsletter is for informational purposes only and should not be construed as legal or expert advice which can only be obtained from appropriate professionals. Franchise Valuations, Ltd. and Franchise Technology Risk Management provide such expert advice on the topics addressed herein.

Please visit our websites at
www.FranchiseValuations.com
and
www.ftrm.biz

Conclusion
Thus, in this example, the Taxpayer (and his sister and children if they meet the NII threshold) will probably be liable for the 3.8% surtax because the rental income will be deemed "passive" due to the failure to meet the "materially participates" test.

This liability should be planned for - because it is subject to estimated taxes and potential estimated tax penalties!

Accord: *Merino v. Commissioner*, U.S. Tax Court, CCH Dec. 59,586(M), T.C. Memo. 2013-167, T.C.M. (Jul. 16, 2013) where the taxpayer was subject to penalties (even though his records were destroyed by flood) for failing to keep a contemporaneous "diary" tracking and allocating his labors to prove he "materially participated" in the real estate operations.

Expert Testimony: Daubert Challenges

PricewaterhouseCoopers Releases Survey

According to a new report, among financial experts, appraisers fared best at getting past *Daubert* challenges while economists were the least likely to survive. And accountants and economists were the experts most frequently challenged according to PwC's 2012 study which highlights the following nine trends over the past 12 years:

1. The number of challenges to expert witnesses increased, but success rates remain steady.
2. The number of challenges to financial expert witnesses rose to the highest level in the last 13 years, while the rate of successful challenges remained consistent with the historical average.
3. Five federal circuits (Second, Fifth, Sixth, Seventh and Ninth) adjudicated more than half of all *Daubert* challenges to financial expert witnesses.
4. Plaintiff financial expert witnesses were challenged more frequently, consistently two to three times as often as defense experts, but plaintiff experts' exclusion rates were lower than defense experts' exclusion rates in seven of the last nine years.
5. Economists and accountants were the most frequently challenged financial expert witnesses. In 2012, appraisers were the most likely to survive a challenge while economists were the least likely to survive.
6. The case type affected the frequency and outcome of *Daubert* challenges to financial expert witnesses, with intellectual property experts experiencing the highest exclusion rate.
7. For the first time in 13 years, lack of relevance was the top reason financial experts were excluded.
8. Of the 156 *Daubert* challenges they considered in 2011 and 2012, appellate courts overturned the lower courts' rulings in part or in whole for 32 experts.
9. Exclusions more commonly resulted from the misuse of accepted methodologies than from the introduction of unusual or untested analytical methods.

Expert's Report Sufficiently "Reliable" to Survive Daubert Challenge
In *Jack Tyler Engineering Co. v. Colfax Corp.*,[1] an expert witness' report that calculated a distributor's lost profit damages was held reliable and the manufacturer's motion to exclude the report was denied. The manufacturer argued that the report should be excluded under Rule 702 of the Federal Rules for containing unreliable assumptions. The manufacturer agreed that the methodology itself was appropriate but argued that the expert made a number of baseless assumptions in applying the methodology.

The Court ruled that while the expert's assumptions were possibly not

based on substantial evidence, they were also not so unrealistic and contradictory as to suggest bad faith such that the report should be excluded. The manufacturer's concerns that the expert did not account for all of the relevant factors needed to accurately calculate the distributor's lost profits did not warrant excluding the expert's testimony, but could be addressed by the manufacturer at trial.

---

[1]DC Tenn., CCH Business Franchise Guide ¶15,044

Valuation: Oppressed Shareholder - Fair Value

Unusual Case Allows Discount for Lack of Marketability in Family Dispute

As a general rule, in a "fair value - oppressed shareholder" dispute no discounts are taken from enterprise value when computing the dissenting shareholder's buyout price. But in *Wisniewski v. Walsh*[1], an 18-year-long family fight over a multi-million dollar company resulted in one brother named Norbert bringing a shareholder oppression suit against his brother and sister. But he was hoist by his own petard! The Court found he was the oppressor, not the oppressed, and although the trial court had refused to apply any discounts in the payment he was due in spite of his behavior, the Appellate Court disagreed. It penalized him by forcing him out of the company and applying a lack of marketability discount, saying, "Norbert should not be rewarded when his conduct not only harmed the other shareholders but necessitated this forced buyout."

---

[1]2013 N.J. Super. Unpub. LEXIS 724 (April 2, 2013)

Valuation: Goodwill Accounting

Good News for Acquirers of Franchisors - FASB Eases Goodwill Impairment Testing Under New Proposal

In many acquisitions of franchisors over the past decade, there has been a substantial allocation to the asset "goodwill" on the acquirer's balance sheet which currently has to be tested annually for impairment in value. However, on July 1, 2013, the FASB issued an "Exposure Draft", one of three newly released proposed Accounting Standards Updates, derived from its Private Company Council entitled "Intangibles-Goodwill and Other (Topic 350)" which will go a long way toward simplifying the burden of goodwill impairment testing.

Under the proposal there would be fewer impairment calculations because: (1) impairment testing would only need to be done upon the occurrence of a triggering event; (2) impairment would be assessed at the entity level rather than at the reporting-unit level; and (3) goodwill could be amortized over a short useful life (not to exceed 10 years).

Employee vs. Independent Contractor: The Auwah Saga Continued

Janitorial Franchises Under Attack in Massachusetts

In *Depianti v. Jan-Pro Franchising International, Inc.*[1] a judge of the United States District Court for the District of Massachusetts certified the following questions to the Massachusetts high court:

[1.] Whether and how to apply the 'right to control test' for vicarious liability to the franchisor-franchisee relationship...; and

[2.] Whether a defendant may be liable for employee misclassification where there was no contract for service between the plaintiff and defendant."

The MA Court answered the first question, "Yes," with further discussion and the second question, "Yes."

Arbitration: Contractual Stipulation: Class Action Waiver: Waiver of Multiple Damages
In another case[2] the Massachusetts Supreme Judicial Court declined to invalidate a class action waiver provision in an arbitration clause contained in franchise agreements between a janitorial business franchisor, System4 LLC, and its franchisees because *AT&T v. Concepcion*, 131 S.Ct. 1740 (2011) required a finding that the clause was not preempted by the Federal Arbitration Act.

In light of *Concepcion*, Massachusetts public policy in favor of class proceedings in certain contexts could no longer serve as grounds to invalidate a class waiver in an arbitration agreement, and because the plaintiff franchisees were unable to demonstrate that they lacked the practical means to pursue their relatively substantial claims on an individual basis, the trial court's invalidation of the arbitration clause because it barred class proceedings and prohibited an award of multiple damages, was reversed and the dispute remanded for further proceedings.

Arbitration: Illinois Wage Payment and Collection Act
In *Chatman v. Pizza Hut*[3], after removal to federal court it was decided that a franchisor's online employment application was valid and enforceable with respect to an arbitration agreement which contained a class action waiver. The case was brought on behalf of a delivery driver alleging violations with respect to wages and minimum wages and the court ruled the arbitrator should decide whether or not to allow the class action.

---

[1]Supreme Judicial Court of Massachusetts, CCH Business Franchise Guide ¶15,069, (Jun. 17, 2013)
[2] *Machado v. System4 LLC*, Mass. Sup. Jud. Ct., CCH Business Franchise Guide ¶15,076
[3]2013 U.S. Dist. LEXIS 73426 (ND IL May 23, 2013)

More Reasons to Harden Your Network Security

Links to Recent Articles on Cybercrime

Five Charged in Hacking of Financial Companies
The victims in the scheme, which prosecutors said ran from 2005 until last year, included JCPenney; 7-Eleven; JetBlue; Heartland Payment Systems, one of the world's largest credit and debit processing companies; and the French retailer Carrefour.