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The Franchise Valuations Reporter

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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.

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Franchise Technology Risk Management

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

Valuations: LLCs, Sub S Corps and Other Pass-Through Entities

With Individual Rates Now Higher Than Corporate Rates Should Franchise Companies Review Their Tax Status?

There are two major valuation issues that apply to S Corporations and other "pass-throughs", such as LLCs, LPs and other similar entities: 1) in doing a Discounted Cash Flow valuation should the estimated income be "tax affected" i.e. have a hypothetical corporate tax rate applied even though in fact the S Corporation does not pay federal taxes? and 2) should the value of the enterprise be discounted for built-in gains which would result in a tax due upon liquidation?

In a comprehensive and authoritative article entitled "Sub S Valuation: To Tax Effect, or Not to Tax Effect, Is Not Really the Question"[1] Daniel Tinkelman, P.V. Viswanath & Glen M. Vogel offer a complete analysis of the tax advantages and/or disadvantages of the pass-through entity (Sub S, LLC, LP etc.) vs. the C corporation on income or cash flow.

The authors reduce the overall current cash flow economic advantage or disadvantage of the pass-through entity, which depends on the various tax rates, to algebra. The formula, which may not be absolutely precise but is very damn good, is as follows:

$$\frac{\text{(1 minus Personal Rate)}}{\text{(1 minus Corp Rate) X (1 minus rate on dividends and capital gains)}}$$

A chart of historic results shows the following:

Year	Individual	Corporate	Capital Gains	Dividends	S Corp Premium Factor
1960	91%	52%	25%	91%	0.25
1970	72%	49%	32%	72%	0.82
1980	70%	48%	37%	70%	0.91
1986	50%	46%	20%	50%	1.16
1990	28%	34%	28%	28%	1.52
1994	40%	35%	28%	40%	1.29
1998	40%	35%	20%	40%	1.16
2002	39%	35%	15%	39%	1.11
2004	35%	35%	15%	15%	1.18

The results using their formula show the tax benefit tipping in favor of operating as pass through entities when the premium factor number is higher than one. If one applies their formula to the year 2013, the results

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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.

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are as follows:

2013 Pass Through Entity Tax Advantage	
Personal tax rate	39.6%
Corporate tax rate	34.0%
Personal tax rate on equity: dividends and capital gains	20.0%
Pass through benefit	1.14

[1]Tax Lawyer, Vol. 65, No. 3. p. 555

Baby Boomers: Exit Strategies

Succession Planning Must Include Planning for a Succession Emergency

Many closely-held companies - even those with a succession plan - fail to consider implementation in an emergency. Even among publicly held companies, only 17% of the 100 largest US companies specified that they had an emergency plan.[1]

Baby Boomers in franchising must face what is not only probable, but surely inevitable: an orderly succession of management and perhaps ownership of the business with the objective of a smooth transition and preservation of value. There is no one-size-fits-all solution to this problem and Baby Boomers in franchising would be well served to consult professionals to construct a succession plan and exit strategy that covers their individual situations.

[1] Jason Schloetzer and Edward Ferris, "Preparing for a Succession Emergency," The Conference Board Director Notes (Feb. 2013).

Valuations and Damages in Franchise Disputes - Don't Forget We Write the Book

Some readers may not know that CCH's "Franchise Regulation and Damages," which Bruce updates three times a year, is the only treatise that covers valuations of franchises, dealerships and distributorships and the law of damages concerning all claims made in franchise litigation and arbitration.

Valuations and Taxability of Intangibles

TCPI Symposium Explores Implications of Cloud Computing and Other IP Issues

CCH recently reported on the 14th Annual Tax Council Policy Institute (TCPI) Symposium held February 13 and 14, 2013, and its discussions of the taxation - foreign and domestic - of intangibles. Some of the topics discussed may affect franchising:

Intangibles in the Cloud - Most of the net worth of franchise companies is made up of Intangible Property (IP) substantial portions of which are memorialized in computer format. Determining the taxation of income earned at the "source" for such assets in the era of "cloud computing" is creating "sourcing" problems on the international level and "nexus" problems on the domestic tax map.

Transfer Pricing Issues - Another issue common to franchise companies engaged in international transactions is the proper place to recognize income on IP. Remember that Glaxo-SmithKline was recently charged more than $5 billion for improperly handling this issue. And something else should be noted: Samuel Maruca, IRS director of transfer pricing operations, made clear that the Service has basically jettisoned its desire/demand that valuators use the CUT (comparable unrelated transaction) method because "typically, there are no comparable uncontrolled transactions that can be used to determine a reasonable value." We've been saying that for years. We are well-versed in this area and available for consultation.

Whose Employee? Franchisor or Franchisee?

Employee vs. Independent Contractor: The Awuah Saga Continues

The issue of employee vs. independent contractor has come up repeatedly in the *Awuah* and related litigations. The most recent decision in that litigation held that a subgroup of a certified class was bound by the arbitration clauses in their franchise contracts which they claimed they never saw.[1] But more recently the issue has spilled over to claims under the Fair Labor Standards Act.

In *White v. 14501 Manchester, Inc*[2] a class of all current and former hourly-paid employees who worked in franchised Hotshots restaurants and who shared in any tip pool for a three-year period was conditionally certified in a case brought against the restaurants' franchisor under the Fair Labor Standards Act (FLSA). For the purposes of conditional certification, the franchisor "permitted or suffered to work" all employees at the restaurants in its system, *even those at franchised restaurants*. The employees allege that their forced participation in the tip pool, whereby they were required to share tips with other back-of-the-house and non-tipped employees, such as cooks, dishwashers, and doormen, violated the FLSA.

The U.S. Supreme Court noted that whether a relationship was covered by the FLSA turned on the economic realities of the working relationship rather than technical definitions related to employment. Given the FLSA's broad definition of "employee" and its remedial purpose, the franchisor's franchise arrangement demonstrated sufficient control for conditional class certification. The franchisor unsuccessfully argued that the employees were not similarly situated because they included the employees of three independently owned and operated franchises that were not controlled by the franchisor.

In another case, *Russell v. Happy's Pizza Franchise, LLC*[3], a subclass of pizza restaurant franchisee employees that brought suit against a franchisor, the franchisor's owner, and two franchisees was allowed to proceed with discovery on the issue of whether the franchisor was an "employer" of the employees under the meaning of the FLSA, despite a provision in the franchise agreement explicitly prohibiting the franchisor from exerting control over the wages and hours of franchisee employees. The employees alleged that the defendants violated the FLSA by failing to pay overtime for hours worked in excess of 40 hours per week.

In particular, the employees sought additional discovery in order to classify the franchisor as an employer for purposes of the FLSA, which defined an employer as "any person acting directly or indirectly in the interest of an employer in relation to an employee." The franchisor contended that it had already provided 16,000 pages of documents, including the franchise agreement. The Court held that although the provision in the franchise agreement absolved the franchisor of responsibility as an employer "on paper," the employees could still conduct discovery to determine whether the prohibition of control espoused in the agreement existed in reality. Under Sixth Circuit precedent, economic reality controlled whether a party was an employer, rather than common law concepts of agency.

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[1] *Awuah v. Coverall North America, Inc.*, CCH Business Franchise Guide ¶14,976 (CA-1 Dated December 27, 2012)
[2] CCH Business Franchise Guide ¶14,985. (DC ED Missouri Dated November 30, 2012)
[3] CCH Business Franchise Guide ¶14,983. (DC WD Michigan Dated January 16, 2013)

More Reasons to Harden Your Network Security

"Trojan: JS/BlacoleRef.AW"

If you see the heading above in your computer system's logs, you have been hacked. We know of several recent penetrations using the infamous Blacole virus which is just one example of malware that can infect your system, track your keystrokes and steal your passwords. And such malicious programs are readily available for sale in online hacker supermarkets!

Henry Chan, Franchise Valuations' in-house network security expert advises: Keep your anti-virus software up to date and run full scans regularly. To find out about penetration testing or for a network security consultation, we invite you to contact Henry and mention that you are a subscriber to this newsletter.

Links to Recent Articles on Cyber-Crime

Some Victims of Online Hacking Edge Into the Light

Malware on Oil Rig Computers Raises Security F ears

Nearly Every NYC Crime Involves Cyber, Says Manhattan DA