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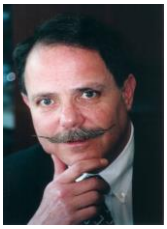
The Franchise Valuations Reporter

Franchise Technology Risk Management

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.

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Washington State's B&O Tax

A Little Understood Levy That Applies to Almost Every Franchise Entity

Washington's current Business and Occupation (B&O) Tax, which is an excise tax on the privilege of engaging in business in the State, was originally adopted as a part of the Revenue Act of 1935; it is basically a sales tax-type statute imposed on an income tax-type base.[1] The current rates of the B&O Tax vary according to classifications of business receipts: from 0.484% for "royalty income" to 1.5% for receipts from "other business activities". In a group of recent pronouncements that should be given due consideration by franchise companies doing business in the State, it has been held that entities that collect and pay over for other businesses - even when they make no profit on the transaction - are obligated to pay the B&O tax on amounts received. Amounts paid to independent contractors cannot be deducted from the taxable base unless there is a pure agency relationship.

The same reasoning would seem to apply to a purchasing cooperative (used in franchising), an advertising fund (used in franchising) and almost any other entity that operates in Washington State and performs a function of collecting and paying over. And a past decision seems to prove the point: In Excise Tax Advisory No. 3041.2009[5], it was held that where a cooperative corporation comprised of several franchise dealers sets up the corporation to allow for the payment of patronage dividends in order to comply with federal law, the patronage dividends could not be deducted for purposes of (B&O) taxes. A patronage dividend given under these circumstances is not a deductible discount because the discount was not provided as a part of the sale of a particular article. Similarly, where patronage dividends are provided as year-end refunds to members per the terms of a nonprofit cooperative association's bylaws, the association cannot take these patronage dividends as a valid deduction for discounts. Patronage dividends paid out in this manner are not discounts of the sale price and are not a bona fide price reduction for specific items sold to the members.

In one determination from April of this year it was held that a clinic for treatment of asthma and allergies could not exclude from its B&O tax gross income amounts it paid to an independent contractor doctor.[2] The Appeals Division noted that the taxpayer's obligation to pay the doctor arose from its contract with the doctor and not from its relationship with its patients. Under Washington case law, where contractual obligations exist to pay a third-party service provider, the taxpayer's obligations cannot be characterized as solely agent liability.

Two more rulings were handed down in July. In one it was held that a real estate broker and property manager that provided maintenance services for others' property was not entitled to exclude commissions shared with clients from B&O tax liability. The taxpayer's argument that it paid the commissions to its clients as rebates was rejected. It had also argued that it did not earn this amount so it should not be included in the measure of tax. However, per WAC 458-20-128, the taxpayer's gross income included commissions "however designated which the agent receives" and it was demonstrated that the commissions were paid to the taxpayer at HUD closings. Held: the taxpayer could not deduct these amounts from its B&O tax.[3]

In the second July pronouncement it was held that the B&O tax also carries

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 Wolters Kluwer Law & Business web page here.

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successor liability. The taxpayer, a contracting company, was liable as a "successor" for unpaid Washington B&O tax because it acquired more than 50% of the predecessor's tangible and intangible assets which makes such person acquiring the assets the "successor." In the case at issue, the predecessor transferred its hard assets and the taxpayer acquired more than 50% of the intangible assets, too, as it retained the same email address, phone number, website address, logo, and customer list. Thus, it was liable for its predecessor's B&O tax liability.[4]

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[1]The tax was upheld by the Washington Supreme Court in 1933 [*State ex rel. Stiner v. Yelle* (1933, SCt) 174 Wn 402, 25 P2d 91]. In 1959, the Legislature attempted to extend the tax to income from the rental of real estate, but the Washington Supreme Court ruled that such a tax constituted double taxation because the income was derived from the real estate itself, which was already subject to property taxation.
[2] *Tax Determination* No. 13-0321, Washington Department of Revenue, April 30, 2014. The exclusion for advances and reimbursements under WAC 458-20-111 did not apply because the taxpayer had no agency relationship with its patients and, therefore, could not show that its liability to pay the independent contractor doctor arose out of any such agency relationship.
[3]*Tax Determination* No. 13-0380, Washington Department of Revenue, July 31, 2014
[4]*Tax Determination* No. 14-0043, Washington Department of Revenue, July 31, 2014
[5]Washington Department of Revenue, February 2, 2009, CCH ¶202-918.

Valuations: Tax Court on Personal Goodwill

One Company on One Date Yields Five Valuations Ranging From $0 to $92 Million

The Word, a §501(c)(3) organization, is a religious broadcasting network that was televised through the activities of STN, a company that provided cable uplink services to that single customer and was owned 100% by Franklin Adell. But his son, Kevin, who was president of STN, was the force behind the entire operation - the network and the uplink business - because of his personal relationships with churches and religious leaders even though Kevin had no employment contract with STN, and there was no non-compete agreement.

When Franklin made his final journey to the Other Side on August 13, 2006, his estate tax return valued STN at $9.3 million. And there it remained for four years until the estate filed an amended return claiming that STN was actually worth zero because all the value was embodied in the personal goodwill of Kevin, not Franklin or the enterprise. In response, the IRS issued a Notice of Deficiency claiming STN was actually worth $92 million. The parties ended up in Tax Court where the estate's expert issued a revised valuation of $4.3 million and the IRS countered with a revised valuation of $26 million. Ultimately the Tax Court validated the original filing value of $9.3 million.

During the proceedings, the estate had argued vigorously that the IRS expert had greatly undervalued the pivotal role the son played in operating both companies and his personal relationship with customers pointing out that if he quit, he could compete directly with the company. And in an ultimate irony, after the proceedings, the son actually did quit and took all of the business with him to a new company he formed leaving the value of STN actually at zero. See *Estate of Adell v. Commissioner*, CCH Dec. 59,981(M), T.C. Memo. 2014-155, 108 T.C.M. 107, 2014 Tax Ct. Memo LEXIS 153 (Aug. 4, 2014)

Cybersecurity

Survey of Corporate Directors Shows Reputation, Cybersecurity, and Regulation as Top Risks

According to the Business Valuation Wire, the accounting firm of EisnerAmper released its fifth annual survey of directors serving on the boards of more than 250 publicly-traded, private, not-for-profit, and private equity-owned companies across a variety of industries. The report, "Concerns About Risks Confronting Boards," reveals that directors are worried about reputational risks, cybersecurity, and regulation; and a majority believes that internal auditing is very helpful in risk identification.

Lessons About Insurance Coverage from Recent Mega-Breaches
This month it's Home Depot. Last month it was Target which reported at least $235 million as its costs related to its 2013 data breach of which it was able to recover only $90 million under cyber liability insurance coverage.

How many wake-up calls will it take? All franchise company executives should be evaluating the protection they have against this potentially crippling risk that can arise from laptop loss as happened recently in California, hacking as happened with Target and Home Depot or employee theft which happens everywhere. [See *The Franchise Valuation Reporter,* July 2014, Cybersecurity: Quantifying Business Risk for Average Clean-up Costs.]

A review of risk analysis shows that specific cyber insurance coverage is essential. Without it, not even the costs of litigation defense are covered [See *The Franchise Valuation Reporter*, April 2014, Cybersecurity: No Coverage for the Cost of Defense Under General Liability Policy].

If your business has not yet suffered a cyber-loss consider yourself lucky but plan for the future - call us. If you have been breached you should call us also to get a cyber-review under attorney-client privilege.

Links to Recent Articles on Cyber-Crime

Supermarket Chain Supervalu Investigating Potential Data Breach

UPS Says 51 Retail Stores Breached by Malware

Retail Spends Less on Cybersecurity than Banking, Healthcare

Home Depot Confirms Data Breach