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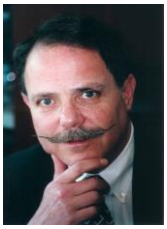
# The Franchise Valuations Reporter

## Our Expertise



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

- Valuations, Damages & Expert Testimony
- Finance, Accounting and Tax

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## Have a Question About Succession Planning for Franchise Owners?

Call us for a free, confidential consultation. And we're always interested in your comments about the newsletter.

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### We Write the Book

**Franchise Regulation and Damages**, the only treatise that covers valuations and damages in franchise disputes, 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.

### DISCLAIMER

## New Tax Law

***New Tax Law's Pass-Thru Deduction***

On August 9, 2018, in response to a deluge of requests for explanation from organizations as diverse as the American Institute of Certified Public Accountants and the International Franchise Association, the IRS issued Proposed Regulations under new Section 199A of the Internal Revenue Code with respect to the so-called "pass thru deduction". The 184 pages of Proposed Regulation Sections 199A-1 through 199A-6 will be reviewed in a special report as soon as possible.

***New Tax Laws Make Timing Divorce Tricky***

It is often the job of financial professionals dealing with franchise owners to plan for and deal with unpleasant events in their clients' lives. The new tax law that took effect in January has added a new trap for unwary but wealthy Americans contemplating divorce. According to a recent article on the topic, starting next year alimony will no longer be deductible by the paying spouse; nor will it be income to the recipient. It's also causing parting spouses to look more closely at benefits for their children and the values of privately owned businesses and partnerships. There is a lot of money at stake. Nearly 600,000 taxpayers claimed alimony deductions totaling more than $10 billion for the 2010 tax year, according to the Internal Revenue Service. Another area impacted in marriage splits is business valuation (including franchises). This has always been an important component of divorce settlements. But the new tax law increases the cash flow of certain pass-through entities - businesses where the taxes on the earnings are paid by the owner, not the company - in a way that raises their value.

***Companies Will Lose the Tax Deduction for Tickets to Sports Events***

At his trial, it was disclosed that Paul Manafort paid $210,600 for his season tickets to the New York Yankee games and took a tax deduction for it. It represents a tax deduction which has been taken for many years by many businesses for sports tickets and stadium boxes. But it was repealed by the Tax Cuts and Jobs Act, which went into effect this year, with a provision stripping the 50 percent deduction for business entertainment expenses. But the new tax law also lowered the corporate tax rate to 21 percent from 35 percent. A *New York Times* article on the subject may be found here. So the question becomes: Do those savings outweigh the increased expense of not being able to write off half the cost of buying tickets? It will require a bean-counters analysis at the taxpayer level.[2]

***New Tax Law's Treatment of Self-Created Intellectual Property***

James M. McCarten, Partner in the Atlanta Office of Burr & Forman, in a recent article in *Intellectual Property & Technology Law Journal* published by Wolters Kluwer wrote, "There are many forms of intellectual property (IP) identified in and covered by US tax law. They include among others, patents, copyrights, trademarks, secret formulas, secret processes, and literary musical and artistic compositions . . . [and] the property listed in code section 197, [such as] certain licenses, permits, franchises, trademarks, trade names, goodwill, customer-based assets, supplier-based assets, and workforce in place . . . The changes made to the tax treatment of self-

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created IP by last year's Tax Cuts and Jobs Act of 2017 will make section 197 intangibles more important to the business practices and strategies" of many taxpayers. Although his article deals mostly with patents, Mr. McCarten was generous enough to offer his thoughts on the how the new law impacts franchising:

> For franchisees (not your question, but important for comparison), the issue is a definitional one. My experience in the franchise world is that most of a franchisee's value will be goodwill rather than IP as it defined for purposes of the new tax law. The changes brought about by last year's TCJA only impacts the types of IP specifically identified in the statue which are "copyrights, patents, inventions, models, designs and secret formulas or processes." Further, a franchisee seldom has any right or ability to sell any IP which is part of what is received from the franchisor. Therefore, the self-created IP tax change should have little to no impact on the value of a franchisee.
>
> For franchisors, though, the result is probably a little different because much of the value of a franchisor comes from its IP. The definitional change which moves self-created IP from capital asset to ordinary income property, will have little if any impact on franchisors which are C corporations; whether measuring the impact by income taxes paid (on the other hand, the TCJA's lower tax rates will certainly have an impact here)or by the impact on an entity's appraised value. C corporations still do not receive favorable tax treatment on the sale or exchange of a capital asset, which means that whether or not self-created IP is a capital asset should have no practical impact on how the proceeds from a transfer of those assets are taxed; the proceeds (less any basis) are taxed as ordinary corporate income at the new 21% rate. So the changes relating to the tax treatment of self-created IP should have no impact on the value of a corporate owner; however, the reduced income tax rate might help increase the value, as the after-tax bottom line will be higher.
>
> The impact on pass-through entities however could, theoretically, be different, but I suspect that any actual change will be negligible. If the asset of a pass-through is self-created IP, the fact that all income received from or because of a sale of such an asset is ordinary income may end up depressing the value of a pass-through entity a little due to the fact that the effective tax rate used when tax affecting the overall value of the entity will be the ordinary rate of the owners; whether a lower capital gain rate might have been available in a hypothetical sale is unlikely to be available or have any practical use in valuing the entity.
>
> While I do not expect the self-created IP change to have any impact from a valuation standpoint, the tax planning for some self-created IP assets will change [but primarily for patents].

## Joint Employer and Vicarious Liability

***7-Eleven Franchisees Plausibly Alleged They Were Misclassified As Independent Contractors***

Individuals who acquired 7-Eleven franchises in Massachusetts survived a motion to dismiss their claim that the franchisor misclassified its franchisee

convenience store workers as independent contractors instead of employees in violation of the Massachusetts Wage Act. The federal court found that allegations that a combination of long hours and unjustified deductions from pay resulted in a wage below that allowed by Massachusetts law were not so threadbare or speculative that they failed to state a plausible claim upon which relief can be based (*Patel v. 7-Eleven, Inc.*, July 20, 2018, Gorton, N.).

***Judge Rejects McDonald's Settlement Over Labor Practices***

A federal administrative law judge in July rejected a proposed settlement between McDonald's and the government in yet another case which is claimed to threaten the viability of the franchise business model. In the trial, which had begun under the Obama administration in 2015, the government contended that McDonald's was liable for numerous labor-law violations committed by its franchisees. A finding for the government could have exposed many franchise companies to enormous liability.

But in January, the new general counsel of the National Labor Relations Board, an appointee of President Trump, was granted a 60-day stay and negotiated a settlement with the company, even though the trial was only days from concluding. But the judge, Lauren Esposito, rejected the settlement, saying it was not "a reasonable resolution based on the nature and scope of the violations alleged and the settlements' limited remedial impact." Judge Esposito argued that a legitimate settlement must at least approach the effectiveness of a remedy resulting from a finding against the company. She said McDonald's refused even to guarantee that its franchisees would abide by the terms.

A news report on the case may be found here.

## Attorneys' Fees

***American Rule Prohibits Award of Attorney Fees to USPTO Under Patent Act***

The Director of the US Patent and Trademark Office was not entitled to an award of attorney fees after prevailing in an appeal by patentee NantKwest from an adverse decision by Patent Trial and Appeal Board. The en banc U.S. Court of Appeals for the Federal Circuit concluded that the provision in 35 U.S.C. §145 which requires a patent applicant to pay "all expenses of the proceedings" fell short of the American Rule's stringent standard prohibiting courts from shifting attorney fees from one party to another absent a specific and explicit directive from Congress (*NantKwest, Inc. v. Iancu*, July 27, 2018, Stoll, K.).

***Exceptional Circumstances Supported Fee Award in Benihana Lanham Act Case***

In a dispute between two Benihana entities, a federal court held that exceptional circumstances existed to permit the prevailing party to be awarded attorney fees and costs under the Lanham Act. The decision offered a definition of "exceptional circumstances". The court noted that Section 1117 of the Lanham Act allows the award of reasonable attorney fees to the prevailing party in exceptional circumstances and explained that under a comparable section of the Patent Act, as per the Supreme Court's decision in *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749 (2014), an exceptional case is one that stands out from others with respect to the substantive strength of the party's litigating position, considering both the

governing law and the facts of the case, or the unreasonable manner in which the case was litigated, considering factors such as frivolousness, motivation, objective unreasonableness and the need in particular circumstances to advance considerations of compensation and deterrence. (*Benihana of Tokyo, LLC v. Benihana, Inc.*, July 25, 2018, Engelmayer, P.).

## Quotations

***Words of Wisdom from Bob Dylan***

*Yes and you who philosophize disgrace and criticize all fears, Bury the rag deep in your face cause now is the time for your tears.*

from "The Lonesome Death of Hattie Carroll"

*The riot squad is restless, they need someplace to go.*

from "Desolation Row"