



The Franchise Valuations Reporter



Featured Expert: Michael Seid



In this month's lead article we present Michael Seid, Managing Director, MSA Worldwide, who brings his considerable expertise to bear on the subject of managing noncompliant franchisees. MSA is the leading strategic and tactical advisory firm in franchising. MSA's clients include emerging franchisors to many of the most recognized brands in franchising in the United States and internationally. MSA is acknowledged for its service excellence and the practicality of its advice.

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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



Default and Termination: Analyzing and Dealing With Noncompliance

Sometimes a Managed Exit, Not Termination, is the Answer

In a [recent 2-part article on dealing with the noncompliant franchisee](#), Michael Seid focuses on ways to exploit the situation - short of default and termination - so as to achieve potential benefits for the system. Below is a summary of the high points of his thought-provoking discussion.

Seid says, ". . . it is good practice, even with an isolated occurrence, to gain an understanding of the underlying cause of the problem. Understanding the root causes of noncompliance can surface underlying issues the franchise system may need to consider in formulating a change strategy."

Seid stresses the need for differentiation between a strictly legal approach and a management approach to a noncompliant franchisee. He is not a fan of "automated form default letters or automated processes when problems with franchisees arise." He stresses the need to "obtain a clear understanding of what has taken place, what steps have already been taken to deal with the problem, any history of previous issues, what discussions have taken place, and what (if any) offers have been received or suggested."

Even a single instance of noncompliance might be an early warning of problems to come. "The lack of compliance on one issue could be part of a bundle of other issues that the system may be facing, and may be a leading-edge indicator of broader concerns for the system that should be evaluated and addressed." While noting the need for franchisors to be consistent in enforcing their rights under the franchise agreement, he advocates that managers "[t]ake a step back from your rights under the agreement and any emotions you may be feeling about the franchisee and that single event."

Simply picking up the phone can bring the temperature of the conflict back down to a reasonable level even if the relationship must end. "Preferable to terminating a franchisee is often giving them the opportunity, with support, to simply exit the system, if they or you know that conflicts will continue. In those situations, creating an environment where the franchisees can leave the system with dignity and as much equity as they can reasonably retain will be far more beneficial to both parties than the termination option."

Is It In the Culture?

There may be something in the culture of your franchise system that increases noncompliance or dissatisfaction, according to Seid. Without lessening the requirement that franchisees meet their obligations under the franchise agreement, Seid says "we frequently find that it is the structure of the franchise system, or the methods used in managing franchisee recruitment or franchise relations, that have baked into the DNA of the program the factors contributing to potential conflict issues."

According to Seid, "One of the early lessons I was taught as a franchisor was that we live in a glass box: how we treat franchisees at their most vulnerable is looked upon and evaluated by the other franchisees in the system." Legal actions and other forms of punishment may keep franchisees in line, but Seid advises using management skills to "foster a level of cooperation throughout the franchisee community; this creates a culture of compliance

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



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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](#).

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

and facilitates the ability to manage change so that dealing with the occasional problems becomes much easier long term."

Seid suggests that franchisee dissatisfaction can be rooted in many factors:

- the cultural flow of how the system is managed;
- the types and level of communications and information provided;
- the level and beneficial nature of support you provide to each class of franchisee;
- how you include franchisees in the strategic process;
- your views on protecting the equity franchisees have built in their businesses;
- the structure of your initial and continual fees;
- the other revenue streams for the franchisor; and
- how you have dealt with evolution of the brand.

Income Tax Nexus and FIN 48: Franchisor Accounting for Uncertain Tax Position

Time For a Nexus Review

Now that the time of year for many franchisors to update the financial information in their FDDs is upon us, it's worth reminding our readers (as we did in 2010 referencing Announcement 2010-9) that the IRS requires companies with assets of at least \$10 million that file with the SEC to provide information about questionable tax transactions. And the IRS rule piggybacks FIN 48, which addresses "accounting for uncertainty in income taxes" and includes uncertainty about state and local taxes.

Financial Accounting Standards Board (FASB No. 48 - Accounting for Uncertainty in Income Taxes) calls for the recognition and measurement of all tax positions taken or expected to be taken by all U.S. companies. It has been effective since 2006 and applies to all entities that prepare GAAP financial statements.

According to the AICPA, "The accounting for all material positions taken (or expected to be taken) on any income tax return is governed by FIN 48. Income tax returns include those that were filed or that should have been filed with **local, state**, federal, and international taxing authorities. FIN 48 specifically applies to positions such as: . . . (3) **the decision not to file a tax return in a particular jurisdiction for which such a return might be required.**" (emphasis added)

FIN 48 requires companies to determine whether or not a tax position will be sustained upon examination by the taxing authority. Upon completing this "more likely than not" assessment on each position taken, companies are required to determine the amount of benefit to recognize in the financial statements.

Certain so-called experts have repeatedly taken the position, and continue to maintain the position, that there is a reasonable argument that absent "physical presence" a franchisor does not have income tax nexus with a jurisdiction - that economic nexus is insufficient for income tax liability. This position has been an abject loser in courts throughout the country, consistently and repeatedly, since the South Carolina Geoffrey case in 1993 and KFC vs Iowa in 2010 - 22 consecutive years of losses and denials of Cert by the US Supreme Court.

For sales tax nexus (as opposed to income tax nexus) "physical

presence" is most often a requirement. But all the rules are different and are fact specific.

Call us for a confidential nexus review.

Using "Roll Over" Proceeds for Business Start Ups

Process Calls For Meticulous Documentation

We are often asked about using retirement funds to invest in a new franchise. As we have previously written in this newsletter, we are not big fans of using one's last savings to invest in a new business at a later stage in life. But for all who are determined to proceed, here are the steps required for what appears to be an IRS-countenanced ROBS transaction:

1. Form a C corporation
2. Install a profit sharing plan at C corporation
3. Make amendment to "approved" format of qualified plan
4. Amendment takes the form of a one paragraph provision to permit the plan to invest up to 100% of assets in employer securities (i.e. the newly formed C corporation)
5. Individual who has 401-k plan executes a direct trustee-to-trustee transfer of the 401-k proceeds
6. Prior 401-k account probably liquidated
7. Proceeds are parked in the new C corporation's trust (profit sharing plan)
8. Amendment provision is acted on immediately
9. Individual directs the newly formed C corporation to exchange all its stock for all the proceeds in the new profit sharing plan (from the old 401-k)
10. Corporate shares now held by the new qualified plan as plan assets are booked as equal in value to the amount of the purchase price
11. Provision permitting stock investment is then rescinded and eliminated by a second amendment
12. No further allocation of stock to future participants are permitted

The process is covered in IRS Memorandum for Director, Employee Plans Examinations issued October 1, 2008. Benetrends and Guidant - two of the big players in this market - use similar formats.

The Awuah Odyssey, Continued

Bizarre Twist in the "Whose Employee or Independent Contractor Is It?" Saga

The State of Washington Court of Appeals has now weighed in on the employee vs. independent contractor issue with respect to Jan-Pro cleaning franchises.

In a mixed opinion, the court found franchisors to be employers of their franchisees if the franchisees had no employees of their own, yet not employers of their franchisees if the franchisees themselves had employees. You can read the [full opinion here](#).

Valuations: Sham Transactions and Charitable Deductions

Judge Demands More Information Before Ruling

An LLC, formed solely for the purpose of making a charitable contribution, acquired and contributed a successor member interest in another LLC to a University. On its 2003 income tax return the LLC (and through it, its members) reported a charitable contribution of property worth \$33,019,000. The IRS determined that the LLC overstated the value of the contribution by \$29,119,000 and that the LLC " was a sham partnership formed for the sole purpose of acquiring the successor member interest and donating it to a charity, and its members did not join together in good faith and act with a business purpose in the present conduct of a business enterprise."

In response, the LLC moved for partial summary judgment arguing that, as a matter of law, the doctrines of "sham transaction" and "lack of economic substance" put forth by the Service to disallow the deduction by refusing to respect the LLC entity were not applicable to the determination of a taxpayer's charitable contribution deduction. In a Tax Court memo decision, Judge Halpern denied the LLC's motion as there were outstanding fact issues.

Recommended Reading: CCH's Antitrust Law Daily

An Excellent Source for Franchise Decisions

I write a treatise for CCH, so I may be biased, but our readers should be aware of ***Antitrust Law Daily*** - a daily email service from Wolters Kluwer Law & Business that provides the latest case law, statutory, and rulemaking developments in antitrust and trade regulation law, [including franchising](#). It also covers advertising, consumer protection, privacy, civil RICO, and state unfair trade practices law.

Subscribers receive a daily email message containing news stories on the most recent developments, along with links to the full text of cases, statutes, and regulatory materials. Stories are archived on IntelliConnect for searching and browsing. We recommend their 14-day free trial. For more information, [visit their site](#), call customer service at 800-449-6435, or contact your Wolters Kluwer account representative.

Cybersecurity

Loss of \$215M to BEC Email Scam

According to the most intrepid cybersecurity reporter, Brian Krebs, the FBI's Internet Crime Complaint Center (IC3) has warned about a global scam that targets businesses that regularly perform wire transfer payments. The so-called Business Email Compromise (BEC) is sophisticated in that it uses emails to mimic legitimate requests for payment from what appear to be trusted suppliers.

How big a scam is it? There have been over 1,198 victims in every state in the U.S. In addition, complaints have been received from victims in 45 other countries.

In its [Alert issued January 22, 2015](#), the IC3 describes different versions of the BEC scam and proposes measures to avoid becoming a victim.

Links to Recent Articles on Cybercrime

[U.S. States Review Anthem Breach; Connecticut Seeks Data on Attack](#)