Volume 6 - Issue 6

June 2014

The Franchise Valuations Reporter

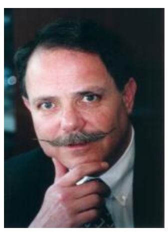
Franchise Technology Risk Management

To Our Canadian Readers

We want you to know that we intend to comply fully with the **Canadian Anti-Spam law** going into effect this year. If you wish to continue receiving this newsletter, please let us know so we have your consent on record.

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

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

Franchise Technology Risk Management

Taxability of Franchise Advertising Funds

Federal Income Tax Liability

Purpose
Advertising, primarily systemwide and uniform, often lies at the heart of a successful franchise operation because systemwide advertising is far more productive and valuable than the aggregation of individual franchisee programs. Generally, franchisors require franchisees to pay a certain percentage of gross proceeds toward a common (i.e., systemwide) advertising program.

The operation of pooled advertising programs involves collecting, holding and disbursing the advertising monies and raises four basic tax questions with respect to the federal income tax:

(1) Do payments to the fund constitute income for tax purposes? If so, to whom?
(2) What is the tax status of the fund? Is it a separate taxpayer? If so, is it classified as a trust, an association taxable as corporation, or a ledger account on the franchisor's books?
(3) Are payments into the fund deductible, and, if so, when?
(4) If the fund earns money before it is disbursed for advertising, what is the status of such earnings?

Planning Considerations
Without reviewing the specific case precedents[1], it is safe to say that according to the Courts, the state of the law is as follows:

"Under *Seven-Up* and its progeny, [the taxpayer] was not required to enter formal trusts with Vendors in order to avoid the accrual of income. As the Tax Court stated in *Ford Dealers*,
'[W]hen a taxpayer receives trust funds, which he is obligated to expend in entirety for a specified purpose and no profit, gain, or other benefit is to be received by him in so doing, the funds are not includable in gross income.'"[2]

Yet, in spite of its consistent failure, the IRS has yet to acquiesce in decisions concluding that franchisee payments to a pooled advertising fund are not income to the fund.[3] Thus, the prudent taxpayer and franchisor counsel must assume the possibility of an attack by the IRS to be a potential risk. In light of the costs attendant upon any contest with the IRS, good planning requires staying as close to favorable precedent as possible.

The first issue to be considered in designing a pooled advertising campaign for a franchisor is the structure to be adopted. In *Insty-Prints*, the foremost authority in the area, the format of the fund was changed during the course of operations from a book entry on the franchisor's books to a trust entity. This was done without changing the basic franchise agreement or prospectus and it's clear that is not a good idea - it is asking for trouble.

Nonetheless, the Tax Court said: "We agree with petitioner that whether the fund is organized as a bookkeeping account, a trust, or an association, if the franchisee payments are sufficiently restricted as to use, they are not gross income."[4] However, using a separate entity is surely more prudent because:

DISCLAIMER

- it substantially reduces the likelihood of the sponsor being deemed taxable;
- if interest is earned that is to be taxable, it can be taxable to a separate entity, presumably at a lower tax rate; and
- the documents executed in forming the separate entity can be used to memorialize the filing position.

On the other hand, using a separate entity carries certain problems because:

- it clearly adds to the IRS argument that the recipient of the fund contributions is a separate entity; and
- it seems to enhance the IRS argument slightly that such separate entity must be taxable because it does not qualify as an exempt organization under any provision of the Code.

In either case, a review of the court decisions shows that there are three main elements necessary to hold that contributions to the fund are not gross income:

1. the contributions are not payments for products or services provided by the sponsor or the entity;
2. the recipient of the contributions is subject to clear restrictions as to what purposes funds can be expended; and
3. the recipient is under a clear obligation to spend the funds.

Thus, sound planning requires a written agreement embodying all the rights and obligations of the parties. Drafting points that should be considered are:

- The governing instrument for the advertising fund should expressly restrict the use of funds and income thereon solely to advertising purposes.
- Documents should clearly state that no profit, gain or other benefit shall inure to the franchisor.
- Contributions to the fund should be segregated from the franchisor's corporate assets and treated separately for accounting purposes.
- The governing instruments should require that no contributions to the fund or income thereon can revert back to the franchisees or the franchisor prior to termination of the fund.
- The documents should allow occasional contributions by the franchisor as long as they are subject to the same restrictions on use as franchisee contributions.
- Franchisees should be given some role in administration of the fund and accountability through reporting of fund activity by the franchisor or the fund itself.

Finally, many pooled advertising funds are used as the recipients of significant vendor rebates based on franchisee purchases and investment income on fund balances. It is important to draft the documents in a manner that will allow the fund to accept these contributions. Also, it may be prudent to draft language in the documents to expressly commit to spending the vendor rebates first, followed by expenditures of the investment income and, finally, the franchisee contributions in order to further minimize tax exposure on excess funds not spent by the year-end of the pooled advertising fund.

---

[1]For a more complete discussion see Schaeffer, Bruce,"Tax Aspects of Franchising," BNA Tax Management Portfolio 559-3d Chapter IV.

[2][98-2 USTC ¶50,750] *Affiliated Foods, Inc. v. Commissioner of Internal Revenue* U.S. Court of Appeals, 5th Circuit, 97-60504, 9/28/98, 154 F3d 527. Affirming, reversing in part and remanding the Tax Court, 72 TCM 1226, Dec. 51,647(M), TC Memo. 1996-505.

[3]*E.g.*, *The Seven-Up Company v. Commissioner*, 14 T.C. 965 (1950), *Broadcast Measurement Bureau, Inc. v. Commissioner*, 16 T.C. 988 (1951),

and *Ford Dealers Advertising Fund, Inc. v. Commissioner*, 55 T.C. 761 (1971) (nonacq. 1974-2 C.B. 5), aff'd per curiam, 456 F.2d 255 (5th Cir. 1972), and *Angelus Funeral Home v. Commissioner,* 47 T.C. 391 (1967), aff'd, 407 F.2d 210 (9th Cir. 1969), Rev. Rul. 74-318, 1974-2 C.B 14 and Rev. Rul. 74-319, 1974-2 C.B. 15. But see Field Service Advice Memorandum,FSA 001867, August 7, 1996: Inclusion in income: Year income taxable: Notice of determination: Franchisor: Franchisee: Restaurant advertising fund., FSA 001867,Internal Revenue Service, (Aug. 7, 1996) holding that a restaurant advertising fund, which is operated and managed by the franchisor, was not subject to taxation with respect to funds received from franchisees and designated for advertising and promotional purposes.

[4]*Frank & Freda Schochet, Trustees of Insty-Prints, Inc. Nat'l Ad. Fund Trust v. Comr.*, 44 T.C.M. 556 (1982), T.C. Memo 1982-416.

Image Upgrade Payments to Franchisees Are Taxable

Includible in Income Currently But Only Deductible Over 15 Years

The IRS Office of Chief Counsel issued General Legal Advice Memorandum 2014-004 on April 7, 2014, ruling that payments made by automobile manufacturers to their franchisees under "facility image upgrade programs" are immediately includible in the taxable income of the franchisees. The GLAM is not specific to the automotive industry, however, and could apply to any type of manufacturer/franchisee relationship. However, franchisees may only obtain offsetting deductions through depreciation of the property upgrades, typically over a 15-year period for retailers. Thus, an economic no-gain transaction becomes inordinately taxable - perhaps forgivable loans would be a better structure.

Cyber-Security: Are You Protected?

Cyberattack Insurance a Challenge for Business

According to the New York Times, "Julia Roberts's smile is insured. So are Heidi Klum's legs, Daniel Craig's body and Jennifer Lopez's derrière. But the fastest-growing niche in the industry today is cyberinsurance."

We have been screaming hair-on-fire about this for five years and this newsletter has written about the issue repeatedly with the most recent discussion being from Adam Cottini of Arthur J. Gallagher Risk Management Services, Inc. in our April 2014 issue. There is no longer any excuse for not having cyber-insurance and there is no longer any excuse for not having a penetration test viz. the lawsuits against the directors and officers of Target.

For insurance, get in touch with Adam Cottini or T.J. Bradley at Gallagher: (Adam_Cottini@ajg.com or TJBradley@ajg.com). For penetration testing call our Henry Chan at 646.637.2075.

Valuation: California Property Tax Valuation of Hotel Did Not Include Sufficient Deductions for Intangible Assets

Flaws Found In the Way Assessor Used Income Method

As reported by CCH, a California county assessor who used the discounted cash flow method to value a hotel for property tax purposes improperly failed to attribute a portion of the hotel's income stream to the value of intangible assets and deduct that value prior to assessment. The trial court was reversed, and the case was remanded with instructions. [1]

The assessor's income method failed to account for the value of the hotel's work force, the leasehold interest in the employee parking lot, and an agreement with a golf course operator. The appellate court ruled that the assessor and the local county assessment appeals board ignored the hotel's expert report and testimony that the intangible assets were necessary to the beneficial or productive use of the property and that the fair market value of those assets was improperly subsumed in the valuation. While removing the management and franchise fee from the hotel's income stream, the assessor did not explain how that deduction captured the majority of intangible property and admitted that other intangible assets should be deducted.

However, the Court also held that the hotel failed to provide substantial evidence that the income method used was invalid for failing to deduct the value of goodwill. The assessor said, and the board agreed, that the goodwill in this case should be valued at $0 in light of the fact that the management and/or franchise fee deductions would largely capture the goodwill for the hotel.

---

[1]*SHC Half Moon Bay v. County of San Mateo*, Court of Appeal of California, First District, 137218, May 22, 2014.

Cybersecurity

More Reasons to Harden Your Network

Banks: Credit Card Breach at P.F. Changs