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Is it Time to Revisit Your State Income Tax Planning?

Scott Smith, 202.508.3430
sdsmith@bakerdonelson.com

Taxpayers should periodically revisit their state income tax planning in light of changes in business direction, economics, corporate transactions and, of course, tax developments. The grim state fiscal outlook portends an increasingly aggressive focus by state legislators and tax administrators on state tax-minimizing structures, particularly those used by businesses engaged in intellectual property licensing and franchising. As a result, the time to revisit planning may be at hand.

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Greetings from *Hospitalitas*

Hospitalitas is the Baker Donelson newsletter for our clients and friends in the hospitality industry – hotels, restaurants and their suppliers. It is published several times a year when we believe we can deliver first class, useful information for your business. Please send us your feedback and ideas for topics you would like to know more about. True to our Southern heritage of hospitality, we'll work hard to make each visit with us something special, and worth repeating.

Loose Lips Sink Ships: Defamation Claims and Their Effect on the Franchisee/Franchisor Relationship

Ellen M. Taylor, 404.221.6507, etaylor@bakerdonelson.com

Let's assume you acquire a new franchise operation, and as a result, turn around the brand and help franchisees recover past due royalties. You may be eager to share the good news for your company, your newly acquired franchisees and your brand. However, statements made to reporters, public relations firms or other third parties may cause unexpected problems. Or assume you are a franchisor embroiled

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Congress Considers National Menu Nutrition Disclosure Standard for Chain Restaurants

Judy Meritz, 202.508.3477, jmeritz@bakerdonelson.com
John Kinney, 202.508.3431, jkinney@bakerdonelson.com

Before Congress adjourned on August 7, key committees in the House of Representatives and the Senate inserted into controversial health care reform legislation identical language that would establish national menu labeling standards for chain restaurants (defined as restaurants with 20 or more locations). The menu labeling language in the pending health reform legislation (H.R. 3200 in the House; bill unnumbered in the Senate) is a modified version of legislation supported by the restaurant industry-backed Coalition for Responsible Nutrition Information (CRNI), called

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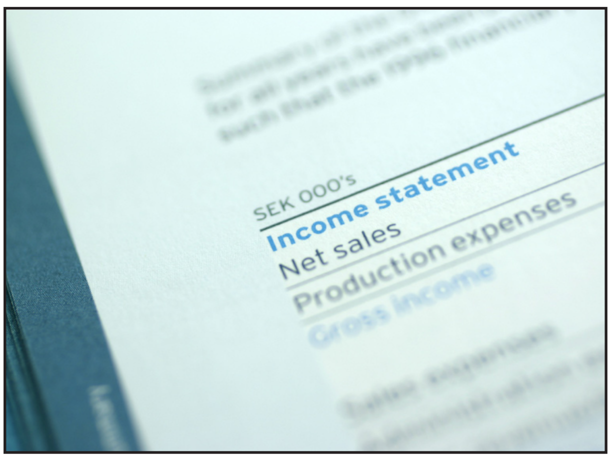
Is it Time to Revisit Your State Income Tax Planning?, *continued*

Highlight of Trends in State Challenges to Tax Planning

So far, 2009 sees the states using various approaches to challenge state income tax planning. Through expanded tax jurisdiction and narrow interpretations of statutory tax benefits, states may be increasing risks of multiple taxation of interstate commerce. Aggressive examinations of the pricing of intercompany transactions and services and a focus on substance and purposive activity continue to mark state audits and challenges. In addition, new legislation targeted at special purpose entities and mandating combined reporting emphasizes that the landscape for state income tax planning has changed in fundamental ways.

Narrowing the Exceptions to the Add-Back Statutes

21 states have enacted "add-back statutes" that disallow expense deductions for intangible and interest expenses paid to a related party. While these statutes are clearly aimed at eliminating the tax benefits of traditional intangible holding company (IHCO) structures, they may also target other planning, such as factoring, internal leveraging, "embedded" intangible planning, contract manufacturing and intangibles amortization. Although predominantly enacted by separate company return states, even some unitary combined reporting states, such as Illinois and Oregon, have enacted these statutes. In unitary states, the statutes are aimed at eliminating tax benefits from planning associated with "80/20 companies," captive insurance companies and offshore special purpose entities.



Depending on a particular state's add-back statute, various exceptions from their application are provided. As economic presence nexus has taken hold, the "subject to tax" exception from these statutes has taken on increased importance. If the related party that receives royalty or interest income is subject to tax in another state (and, for some states, a foreign country that is a party to a U.S. tax treaty), the royalty or interest expense is deductible. However, states such as Alabama and Virginia have sought to limit the benefits of the exception to a post-apportionment basis. That is, the deductible amount of the intangible or interest expense is reduced to the amount of that income that is apportioned to states where the recipient is taxed. For example, if the IHCO apportions 2% of its royalty income to South Carolina and pays income tax, only 2% of the royalty expense is deductible by the payor. *Surtees v. VFJ Ventures Inc.*, 8 So. 3d 950 (Ala. Civ. App., 2008), *aff'd*, 8 So. 3d 983 (Ala. 2008), *cert. denied*, 129 S.Ct. 2051 (2009); *Ruling of Commissioner*, P.D. 07-153 (Va. Dept. of Taxation, Oct. 2, 2007); *Ruling of Commissioner*, P.D. 09-96 (Va. Dept. of Taxation, June 11, 2009).

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Social Media Reality Demands Management Attention

Wendy Robertson
901.579.3128
wrobertson@bakerdonelson.com

Virtually everyone has a camera phone these days, making it easy for bored or disgruntled employees to film what they perceive to be humorous pranks and disseminate the video for the world to see in a matter of a few minutes or even seconds. Unfortunately, what one person considers a harmless prank can cause a disastrous amount of damage for brand owners, wiping out the benefit of millions of dollars in brand advertising and years of goodwill.

Probably the most well-known example of a viral video causing a substantial brand crisis is the Domino's incident. Two North Carolina Domino's Pizza® employees decided to video themselves doing unsanitary and distasteful acts to the food they were preparing. The employees uploaded the video to YouTube, and soon the video had been viewed over one million times.

Domino's managed to get the video removed from YouTube, but considerable damage was already done. Domino's launched a response to the video assuring consumers that the employees' behavior was an isolated incident, that the employees had been terminated and that the store had been sanitized, but they could not erase consumers' memories of that video. Despite having it removed from YouTube, even today the video is available at other sites, so the damage continues indefinitely.

Implementing a social media policy is crucial to preventing brand-damaging viral videos. Of course, the policy and the consequences of violating the policy must also be clearly communicated in order for it to be effective and enforceable. At a minimum, a good social media policy should

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For an analysis of a challenge to the post-apportionment limitation of the "subject to tax" exception and its constitutional questions, see the article that was originally published in Tax Analysts' *State Tax Notes* on June 29, 2009, entitled "Is Virginia's Addback Statute Exception Susceptible to Challenge?"

In addition, a risk of multiple taxation of commerce occurs when a state has enacted an add-back statute without a "subject to tax" exception and applies economic presence nexus. For example, Massachusetts and New Jersey have enacted add-back statutes, but do not provide a "subject to tax" exception. (New Jersey provides the exception but only if the related IHCO is in a foreign country that is party to a U.S. tax treaty, N.J.S.A. § 54:10A-4.4.c.(1).) Both states apply economic presence nexus. *See Geoffrey, Inc. v. Comm'r of Revenue*, 899 N.E. 2d 87 (Mass. 2009), *cert. denied*, U.S. Supreme Court No. 08-1207 (June 22, 2009); *Lanco, Inc. v. Director*, Div. of Taxation, 879 A. 2d 1234 (N.J. App. Div. 2005), *aff'd*, 908 A. 2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007). The IHCO is required to file a return and pay tax on its intangible income, and the licensee is required to add-back its intangible payment expense. While Massachusetts will permit taxpayers to propose appropriate adjustments in audit (Tech. Info. Release, TIR 08-4 (Mass. Dept. of Revenue, Mar. 24, 2008)), New Jersey has been recalcitrant in audits. As addback statutes and economic presence nexus spread, this risk of actual multiple taxation will as well.

Economic Presence Nexus Evolves

When the U.S. Supreme Court in *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 128 S.Ct. 1498 (2008), declined to address Illinois' argument that source of income confers jurisdiction to tax, it may have made source jurisdiction the next nexus battleground. *See Matter of Petition of Shell Gas Gathering Corp. #2*, No. 821569 (N.Y. Div. Tax Apps., June 11, 2009); *Allied-Signal, Inc. v. Comm'r of Finance*, 79 N.Y. 2d 73 (1991). Until then, eyes remain focused on economic presence nexus. States remain frustrated by the inability to collect income or franchise taxes from "virtual" businesses that generate substantial revenue from transactions with businesses or consumers without employees or bricks and mortar presence in their states.

Starting in 1993 with *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E. 2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), states have successfully asserted taxing jurisdiction over IHCOs, issuers of credit card receivables and other businesses with economic, but not physical, connections to a taxing state. This trend continued into 2009 with Massachusetts' *Geoffrey* decision. To date, courts from as many as 13 states have endorsed economic nexus. Unfortunately, most of these decisions miss the forest for the trees. Rather than evaluating whether economic presence nexus imposes an unconstitutional burden on interstate commerce, a number of these courts remain stuck on the question of whether *Quill Corp. v. North Dakota*, 503 U.S. 298 (1992), applies to income tax or only to sales and use taxes.

Nonetheless, a handful of the courts have begun to craft an equally suspect "substantial economic presence" test. *Tax Commissioner v. MBNA America Bank*, N.A., 640 S.E. 2d 226 (W.Va. 2006), *cert. denied*, 551 U.S. 1141 (2007); *Capital One*

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Social Media Reality, *continued*

include:

- A prohibition on all uses of social media which are disrespectful, inflammatory, offensive, dishonest or damaging to the company's business interests. In particular, content and posts should not include slurs, personal insults, obscenity or anything likely to tarnish the image of the brand, the store and the company.
- A requirement that employees be honest regarding their identity and refrain from the use of aliases and pseudonyms. Further, if an employee has a vested interest in a topic of discussion, it should be disclosed.
- A requirement that an employee use a disclaimer when an employee is expressing his or her views through social media and has identified him/herself as an employee of the store or the company. Such a disclaimer might read, "The views expressed herein are mine alone and do not necessarily reflect the views of my store, its owner or the company."
- A prohibition on all uses of social media which disclose proprietary or confidential information belonging to the store, the store owner, the company or anyone else. Such information would include company trade secrets, customer identities, company financial details and business performance, planned acquisitions and future product launches.
- A prohibition on all social media uses of the brand owner's trademarks and logos, as well as those of brand owner's customers, absent written approval from the brand owner.

The policy should be communicated in writing to every employee immediately upon hire, and it should be re-emphasized periodically so that the provisions stay fresh in employees' minds.

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Bank, N.A. v. Comm'r of Revenue, 899 N.E. 2d 76 (Mass. 2009), *cert. denied*, U.S. Supreme Court No. 08-1169 (June 22, 2009). In these cases, continuous and systematic solicitation of business from in-state customers (via mail or telephone) and the sourcing of gross receipts to the states based on financial institution income apportionment statutes satisfied the "substantial economic presence" test. *See also MBNA America Bank, N.A. v. Dep't of State Revenue*, 895 N.E. 2d 140 (Ind. Tax 2008).

Therefore, an income apportionment trend may exacerbate the economic nexus dilemma for corporate taxpayers, especially those with large amounts of gross receipts derived from the performance of services – sourcing these receipts to the sales factor of the apportionment formula based on the location where the benefit of the service is received (market sourcing). Traditionally, receipts from the performance of services (and sales or licensing of intangibles) are sourced based on where the greatest proportion of costs of performance are located. Usually, this is the state where the taxpayer's property and payroll are the greatest. Market sourcing, however, attributes those services receipts to the states where customers receive the benefit of the service or where an intangible is utilized. An increasing number of states, including Illinois and California (in 2011), have moved to market sourcing and away from traditional "costs of performance" sourcing.

In its July 2009 comprehensive Corporate Tax Reform proposal, New York's Department of Taxation and Finance recommends that jurisdiction to tax should be "asserted over corporations without a physical presence in New York where economic nexus was present." As more states move to market sourcing, assertions of economic presence under a "substantial economic presence" rationale against remote service providers, franchisors, management companies, advertising and merchandising companies, procurement companies and the like may increase. In addition to traditional IHCO structures, other types of income tax planning should be revisited in light of the trends evident with economic presence nexus.

Transfer Pricing – Yesterday's Profits, Today's Financial Results

For state tax planning, arm's-length transfer pricing is a critical component. There are a number of methods that can be used to establish arm's-length rates under the Treasury Regulations issued under Internal Revenue Code (IRC) § 482. Businesses commonly use the comparable profits method (CPM) or other profit-based methods (comparable profit-split method or the residual profit-split method) to establish arm's-length intercompany transfer prices. States have also come to rely on the CPM when challenging state income tax planning.

In general, the CPM considers whether the price charged in a controlled party transaction is arm's-length by determining an operating profit of a "tested party"

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Social Media Reality, *continued*

Of course, a social media policy may not prevent every employee from creating damaging videos or other social media content, and you would be wise to prepare for the worst in case it should ever occur. As an initial step, you might consider signing up for a monitoring service designed to alert you to social media content involving your company, thereby allowing you to discover a problem at its earliest stage. There are several companies that offer this type of service for a charge, or you can sign up for a free service such as Google Alerts that provides email updates of the latest relevant Google results on the search terms of your choice.

Consider putting a team together that is tasked with responding to disparaging uses of social media that threaten to go, or have already gone, viral. Such a team should generally be comprised of employees from corporate communications (specifically people well-versed in social media), senior management, and people in the legal and marketing departments. If possible, take the proactive step of establishing a corporate blog and accounts with the big social media players such as Twitter and YouTube. Doing so now will save time later when you need to respond quickly in order to mitigate potential damage to your brand and, of course, if the damaging content is distributed via social media, the response should be delivered through both traditional and social media so that it reaches as many viewers of the damaging content as possible.

Is it Time to Revisit Your State Income Tax Planning?, *continued*

based on objective measures of profitability of comparable, uncontrolled businesses. *See* Treas.Reg. §§ 1.482-5 and -9T(f). If the "tested party" performs nonroutine functions or owns valuable intangible property, then the CPM is generally not suitable, and the residual profit split method (RPSM) may be used. *See* Treas. Reg. §§ 1.482-6, -6T, and -9T(g). Thus, the CPM may be more frequently used in a sales and distribution planning context, whereas the RPSM may be used if the "tested party" performs nonroutine services or functions and owns valuable intangibles.

The CPM, RPSM and other profit-based methods work fine when business is healthy and profits are growing. However, in times of financial distress uncontrolled parties that may have been comparable are no longer as a result of reductions in workforce, plant closures, bankruptcy or other business circumstances. A deteriorating economy will impact operating profits, sales and costs of controlled and uncontrolled companies. The "tested party" may experience reduced revenues and operating profits while the uncontrolled comparables used to set intercompany transfer prices have not experienced similar declines. Uncontrolled comparables may become loss companies meaning that arm's-length results for controlled, intercompany transactions should generate diminished profit allocations. Further, the arm's-length nature of intercompany rates and fees set during a healthy economy will be subject to more intense scrutiny by state tax auditors if they are now driving a related party into a loss position.

In light of the current economic environment, taxpayers may need to reconsider their arm's-length transfer pricing regimes and adjust them accordingly. Changes in the values and risks of functions may also encourage adjustments to structure.

The Old and the New

Taxpayers must remain mindful of other traditional challenges, as well as new legislation aimed at tax planning. For example, states continue to apply the sham transaction doctrine to challenge motive, abuse and economic utility of state income tax planning. The prior 12 months produced a host of cases illustrating successful state challenges to planning using sham transaction and related substance over form doctrines applied to common tax planning strategies. *Wal-Mart Stores East, Inc. v. Hinton*, 676 S.E. 2d 634 (N.C. App. 2009) (captive REIT); *TD Banknorth, N.A. v. Dep't of Taxes*, 967 A. 2d 1148 (Vt. 2008) (investment and loan participation holding companies); *HMN Financial, Inc. v. Comm'r of Revenue*, No. 7911-R (Minn. Tax Ct., May 27, 2009) (captive REIT); *Matter of Talbots, Inc.*, No. 820168 (N.Y. Tax Apps. Trib., Sept. 8, 2008) (IHCO); *TJX Companies, Inc. v. Comm'r of Revenue*, No. C262229-31 (Mass. App., Tax Bd., Aug. 15, 2007), *aff'd*, 903 N.E. 2d 608 (Mass. App. 2009) (IHCO); *IDC Research, Inc. v. Comm'r of Revenue*, Nos. C267868 (Mass. App. Tax Bd., Apr. 17, 2009) (IHCO). Common corporate arrangements that are not tax motivated may also be the subject of such challenges. *United Parcel Service General Services Co. v. Director, Div. of Taxation*, No. 007845-2004 (N.J. Tax Ct., June 5, 2009) (centralized cash management system).

Starting in 2006 and continuing strongly into 2009, a number of states (Massachusetts, Michigan, New York, Texas, Vermont, West Virginia and Wisconsin) have inaccurately believed that mandatory unitary combined reporting will close planning opportunities and generate revenue. While the intent of legislators and state revenue departments may be realized to some degree, the circumstances of other taxpayers may benefit from combined reporting. Nonetheless, a method of apportionment that was once largely found only west of the Mississippi is now firmly entrenched east of the Mississippi.

Conventional Wisdom

Tax planning does not only mean structural change to an organization. It can also relate to tax return positions. It is conventional wisdom that taxpayers have a greater likelihood of negotiating a settlement of a tax assessment than of a tax refund claim, even though the dollars are equal. States are often loath to pay a refund, and it is not uncommon for them to drag out a refund claim hoping for an offset, a better budget situation or, in a few egregious situations, retroactive legislation eliminating refund opportunities as recent Kentucky and Virginia situations attest. Therefore, taxpayers may want to invest more up front assessing the merits of particular tax return positions, potential penalty risks and ruling requests. Not all states will pay refund claims with "IOUs," but the impact of the state fiscal situation on the payment of refund claims and settlement negotiations should also be considered.

Mr. Smith is an attorney in our Washington, D.C. office.

Loose Lips Sink Ships: Defamation Claims and Their Effect on the Franchisee/Franchisor Relationship, *continued*

in a heated dispute with a franchisee over providing business leads. A regular customer asks a member of your sales force his opinion regarding the franchisee. What may seem like an innocuous or offhand, informal, unofficial response by a non-management employee may expose the franchisor to liability. While you may think these statements are protected under the First Amendment right to freedom of speech, this right is not without limits when it comes to business reputations. Damage arising from defamation may be difficult to prove, but dealing with the media and other third parties may become a trap for the unwary.

What types of statements constitute defamation? Defamatory statements can be either written (libel) or verbal (slander). Whether made orally or in writing, courts will consider a statement to be defamatory if it is published to a third party, and damages the reputation of the plaintiff. Where the defamatory language refers to a public figure or relates to a matter of public concern, the injured party must also prove that the statement is false, and the party making the statement knew or should have known that the statement would cause harm.

A statement made only to the injured party, no matter how inflammatory or unsubstantiated, will not support a claim for defamation. However, a defamatory statement need not be published in a newspaper or other widely disseminated media. An offhand comment by an employee to a customer regarding a competitor's business or products may support an action for defamation.

For instance, in *Fashion Boutique of Short Hills, Inc. v. Fendi USA, Inc.*, a Fendi franchisee sued the luxury brand for business slander and disparagement of goods. Fashion Boutique's lawsuit alleged that when its franchisor, Fendi Stores, Inc., decided to open its own retail store in New York City, the franchisor embarked on a campaign of disparagement which caused the loss of Fashion Boutique's entire business. The court found that several statements made by employees of Fendi Stores were actionable – such as statements that Fendi planned to shut down the boutique in the near future, that Fendi was having problems with the

boutique and that products sold by the boutique were not real Fendi products. While these statements were false and actionable, Fashion Boutique was not able to prove that they caused a decline in sales and eventual loss of the business. Franchisors in dual distribution systems should consider the adverse impact of such practices on franchise sales when a prospective franchisee contacts the franchisee of the store perceived to have been impacted by such statements, which may result from commission driven sales people trying to capture customers and sales-related compensation.

Second, in order to recover for defamation, the injured party must prove that the defamatory statements caused actual harm to the party claiming defamation. In *MapInfo Corp. v. Spatial Re-engineering Consultants*, the defendant alleged in a counterclaim against the plaintiff that it lost sales due to plaintiff's personnel making false and disparaging statements to resellers and customers. The only evidence the defendant produced was its perception that it received a "cold shoulder" when it attempted to sell to those customers. The court found this speculation as to why the defendant was given the cold shoulder was not sufficient to prove harm from the alleged defamatory statements.

In some cases, the words are considered defamatory per se, in that they are defamatory on their face. The injured party need not prove any special harm to recover damages. For example, in one case, a national franchisor acquired a brand from a competitor who had an ongoing dispute with a franchisee regarding royalty payments. In an interview regarding the transaction, the national franchisor commented that its management style was different from the previous franchisor. The prior franchisor alleged that by comparing itself to prior management, the national franchisor through innuendo and implication intended to injure the business reputation of the prior franchisor. The prior franchisor also alleged that the statements were defamatory per se, and it did not have to prove that it suffered any special harm from the statements. In determining whether a statement will constitute slander per se, courts look to the plain meaning of the words and will not infer any negative connotation or innuendo.

An exception to defamation applies

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in the context of statements made in the course of judicial proceedings. While statements made in court or in a pleading filed with a court are privileged, the privilege does not extend beyond this limited context. In *Associated/ACC International, Ltd. v. DuPont Flooring Systems Franchise Co.*, Inc. et al., a defendant franchisor filed a counterclaim alleging defamation where the plaintiff franchisee disseminated a press release accusing the franchisor of fraud. In its defense, the franchisee claimed that statements in the press release were privileged, as they merely restated allegations in the complaint, and were attributed to the lawsuit. The court found that statements made by a litigant outside the course of judicial proceedings are not absolutely privileged.

In giving interviews to newspapers or public relations firms, or even discussing business matters with a third party, business owners are well advised to proceed with caution, as seemingly casual comments about a franchisee or competitor may give rise to a defamation lawsuit.

Ms. Taylor is an attorney in our Atlanta office.

Congress Considers National Menu Nutrition Disclosure Standard for Chain Restaurants, *continued*

the Labeling Education and Nutrition (LEAN) Act. The modified version of the LEAN Act is a product of bipartisan negotiations between, on one hand, advocates of more detailed nutrition disclosure by chain restaurants and, on the other, lawmakers who agreed with the restaurant industry's approach to the issue.

To become law, the legislation will have to be passed on the House and Senate floors in identical form before being presented to President Obama for signature. However, because the outcome of health care legislation in the current session of the 111th Congress is highly uncertain, the compromise menu labeling provisions could instead be considered in the House and Senate as a "free-standing" bill. While the political environment appears ripe for congressional enactment of the menu labeling compromise, the final outcome will still largely depend on the congressional calendar and competing legislative priorities in the current session of Congress.

Compromise Legislation

The compromise legislation is an outcome of efforts by chain restaurants to combat an increase in state and municipal laws mandating the disclosure of food nutrition information to consumers as a way to promote health and reduce obesity. The restaurant industry has taken the position that such state and local mandates impair interstate commerce and violate the First Amendment right to commercial speech. However, in 2008, the restaurant industry lost a major legal battle against state and municipal laws mandating nutrition information disclosure on menus. In *New York State Restaurant Association v. New York Board of Health* (545 F. Supp 2d. 363, S.D.N.Y. 2008), the federal district court ruled that while the Nutrition Labeling and Education Act (NLEA) of 1990 preempted state and local governments from regulating nutritional *claims* made by restaurants, it did not preempt them from mandating nutrition *information* disclosure on printed menus and menu boards. The district court's ruling was subsequently affirmed by the U.S. Court of Appeals for the Second Circuit on February 17, 2009.

Faced with the prospect of dealing with multiple nutrition disclosure laws in multiple state and municipal jurisdictions, the National Restaurant Association (NRA) helped form CRNI. CRNI successfully sought support in Congress for the LEAN Act, which would establish national nutrition labeling standards for the chain restaurant industry and preempt state and local regulation in this area. The compromise menu labeling provisions in the House and Senate health reform legislation contain two key objectives sought by the Coalition in the LEAN Act: (1) to only require the printing of caloric information on menus and menu boards (as opposed to the full litany of nutritional information required by NLEA) and (2) the preemption of state and municipal regulations that conflict with national labeling standards.

Key Elements

The compromise legislation approved by both House and Senate committees as part of health care reform legislation would do the following:

Restaurants with 20 or more locations would be required to disclose on a menu, menu board or drive-thru board the number of calories per standard menu item, a statement concerning suggested daily caloric intake, and a statement regarding the availability of additional nutrition information upon request (including trans fats, saturated fat, sodium, cholesterol, carbohydrates, sugars, dietary fiber and protein). Hence, instead of having to disclose all nutrition-related information on menus and menu

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boards, the compromise legislation would only mandate the disclosure of calories. All additional nutritional information would be provided in a written statement maintained on the premises of the restaurant in question and available upon the request of the customer.

It would amend NLEA to specifically establish a national standard for nutrition labeling of food sold in chain restaurants with 20 or more locations from which state/municipal laws could not deviate. However, the compromise legislation does permit state and local requirements "respecting a statement in the labeling of food that provides for a warning concerning the safety of the food or component of the food."

The compromise legislation does not enumerate specific penalties to be assessed in the case of one or more violations. However, under NLEA and accompanying regulations, the general penalty for the first violation can be up to one year in prison or a fine of not more than $1,000, or both. For recurring violations or violations where there was an "intent to defraud or mislead" the penalty rises to three years in prison or a fine of not more than $10,000.

A key element of the compromise legislation is the limit on liability for restaurants that disclose inaccurate nutritional information. Three provisions have been inserted into the legislation intended to limit liability of restaurants for such errors. One provision would require the Food and Drug Administration (FDA) to issue rules establishing the types of information (the "reasonable basis") that restaurants should rely on when determining the nutritional information required to be disclosed. A second provision would require FDA to issue regulations that establish the "permissible variations" in such things as serving size, recipes, ingredients, the methods of food preparation, and the spacing and formatting of menus and menu boards. FDA regulations would also address what constitutes "inadvertent human error" for purposes of determining whether the violation was intentional.

It should also be noted that while the majority of members of the International Franchise Association (IFA) and the NRA support the compromise legislation, there are members of both organizations who believe the "20 location" threshold will be detrimental to their companies. These members advocate instead an income/revenue threshold for determining which chain restaurants should be subject to the federal legislation.

Effective Date

The menu labeling bill does not contain an effective date mandating when the menu labeling standards will go into effect. FDA would be required to issue proposed regulations within one year of the law's enactment regarding permissible variations of food preparation and menus and what constitutes "inadvertent human error."

For more information about pending menu legislation and clarification of the issues FDA will address in regulations it will promulgate as required by the proposed legislation, please contact this article's authors.

Ms. Meritz is an attorney and Mr. Kinney is a senior public policy advisor in our Washington, D.C. office.

Launch of LEED for Retail is Good News for Food Service Industry

Trevor T. Jones, 205.244.3864, tjones@bakerdonelson.com

Restaurant buildings have historically been unable to meet the stringent requirements of previous LEED (Leadership in Energy and Environmental Design) rating systems, but will likely gain ground quickly on other project types under the new LEED for Retail rating system, which is tailored towards the unique characteristics of retail projects.

The number of LEED certified commercial buildings continues to grow rapidly in the United States, even in the midst of the current economic downturn. This growth is the direct result of a number of factors. First, LEED certification, along with other "green" standards, has become increasingly mandatory, as local governments are beginning to add such standards into the codes and ordinances that govern development. Second, the benefits of certification are many, including qualification for government incentives, decreased operating expenses for owners and tenants, increased sales and productivity, happier customers and the development of goodwill in the community. Finally, the efforts of many developers and retailers have ultimately been propelled by a genuine recognition of the need for sustainable commercial buildings and practices.

Unfortunately, only a handful of food service operations have been able to meet even the minimum LEED certification requirements, primarily because previous versions of the LEED rating systems simply did not fit the needs of restaurants. Due to the use of commercial cooking equipment, refrigerators and dishwashers, restaurants are widely considered the most energy intensive commercial buildings in the United States, consuming as much as three times more energy than the average retail locations of the same size. Previous versions of the LEED rating systems did not account for the necessity of increased energy usage by restaurants, and the lack of flexibility inherent in the LEED systems meant that only a few of even the greenest of restaurants could obtain LEED certification.

With the launch by the United States Green Building Council (USGBC) of the new LEED 2009 rating systems and particularly the highly anticipated LEED for Retail rating system, the number of LEED certified restaurants is expected to increase dramatically. LEED for Retail, which is currently in the process of being confirmed by USGBC member vote, will offer certification for retail projects that are classified as either new construction (new or newly renovated stand alone buildings) or commercial interior (spaces within shopping centers or malls). In developing the LEED for Retail program, the USGBC recognized the rigidity of the previous LEED rating systems, and tailored the standards to the specific needs of restaurants and other retailers. These standards offer more options and increased flexibility for restaurant projects, and include a prescriptive path for selecting kitchen equipment and fixtures in order to meet or exceed LEED requirements. LEED for Retail will also allow certain restaurants to attain certification in volume, which is critically important to restaurant chains.

The LEED for Retail pilot program kicked off in 2007, and included more than 80 projects. Large restaurant chains, including McDonald's and Chipotle Mexican Grill, expressed an especially strong interest and agreed to participate in the program by opening learning lab restaurants to test certain green technologies. Chain restaurants—particularly fast food chains—have historically placed an emphasis primarily on high volume at low cost without regard to energy inputs, and have recently been criticized for their impact on both the environment and human health.

Chipotle Mexican Grill management chose its Gurnee, Illinois location to be the chain's learning lab restaurant, and that location recently became the first restaurant to receive the LEED Platinum certification—the USGBC's highest certification level. The Gurnee restaurant features a six-kilowatt wind turbine, Energy Star appliances, energy efficient LED light bulbs, an in-store recycling program, a roof with a high solar reflective index and a 2,500 gallon rainwater cistern.

The McDonald's learning lab, located in Chicago, includes permeable pavement in the parking lot for maximum water drainage, drive through lanes built with reflective concrete, signage constructed around LED light bulbs, a vegetated roof and a rain garden. McDonald's anticipates the restaurant will consume up to 50% less energy, and use 50% less water, than one of its typical sites. The 24-hour Chicago location also includes systems that continuously monitor and collect data from the green technologies so McDonald's can later compare performance at the learning lab to performance at other sites.

Many anticipate that the LEED for Retail program will allow restaurants to quickly gain ground on other commercial project types such as office buildings, which have historically been a more

Launch of LEED for Retail is Good News for Food Service Industry, *continued*

natural fit for LEED certification. If the LEED for Retail pilot program is any indication of what the future holds, then perhaps an unlikely candidate—large restaurant chains—could be "leeding" the way. Baker Donelson is a member of the USGBC and has three attorneys with LEED AP accreditation. The LEED AP accreditation uniquely qualifies them to advise clients in industries related to construction, commercial real estate development and leasing, including builders, suppliers, developers, retail industries, engineers and architects, as to the LEED certification process and requirements. If you have any questions about LEED or any other green technology-related concerns, please contact Kevin Garrison at kgarrison@bakerdonelson.com or 205.250.8333, Stephen Pudner at spudner@bakerdonelson.com or 205.250.8318, or Trevor Jones at tjones@bakerdonelson.com or 205.244.3864.

Mr. Jones is an attorney in our Birmingham, Alabama office.

West Coast Warning: California Targets Nonresident Franchisors

Vincent J. Schilleci III, 205.244.3827, vschilleci@bakerdonelson.com

It appears that California has joined New York in targeting nonresident franchisors. The California Franchise Tax Board (FTB) has taken the position that nonresident franchisors not qualified to conduct business in California are subject to California withholding. The FTB website states when a nonresident payee – in this case, a franchisor – is not qualified with the California Secretary of State to do business in California, and does not maintain a permanent place of business in California, the payor must withhold 7% from all California source income payments that exceed $1,500 in a calendar year. The FTB website further states that California source income includes payment of royalties.

California law exempts nonresidents from 7% withholding if the nonresident is qualified to do business in California. But the nonresident *will* be subject to California income taxes. Even more troubling is Section 17952(a) of the California Code of Regulations (CCR), which provides:

> Income of nonresidents from rentals or royalties for the use of, or for the privilege of using in this State, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises, and other like property is taxable, if such intangible property has a business situs in this State within the meaning of [Section 17592](c).

Section 17952(c) of the CCR provides:

> Intangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State.

If the nonresident's intangible personal property is "employed as capital" in California, the nonresident's effective tax rate will likely be increased. Although this tax approach was undoubtedly directed at the entertainment industry exiles who fled the Golden State for lower tax jurisdictions, its plain language covers franchise royalties.

By way of an example, let's assume that the Franchisor (nonresident, but qualified to do business in California) has $1 million in gross revenues, derives $300,000 of its revenues as royalties from California and has taxable income equal to $200,000. In addition, assume that Franchisor has no payroll in California and employs no capital in California. Using California's allocation formula, the tax on the income is $2,652.

Now assume the following: (i) the value of this same Franchisor is $5 million; (ii) 70% of that value is represented by its trademark and goodwill; (iii) Franchisor's business in California of licensing its intellectual property constitutes the "employing of capital"; and (iv) that such capital employed are deemed to be in the same percentage as revenues earned (i.e., 30%). California's allocation formula then produces a tax due of $3,580.

It gets even worse. Let's now assume that our sample Franchisor is actually a nonresident who is not qualified to do business in California. Under California's new allocation formula, the Franchisor's tax liability then soars to $21,000, resulting in an effective tax rate of 10.5%.

Franchisors receiving California source income from their franchisees should contact their tax advisor immediately to determine whether it makes sense to become qualified to conduct business in California. Because franchise registration under the California Franchise Investment Law requires consent to service of process as a condition to franchising in California, a major reason for not undertaking qualification may be absent for franchisors.

Mr. Schilleci is an attorney in our Birmingham, Alabama office.

"Do It Yourself" May Work Around the House, but Not for Trademark Applications

Wendy Robertson, 901.579.3128, wrobertson@bakerdonelson.com

Today, every business is pinching pennies. In an effort to cut back on expenses, you may be tempted to use a "do it yourself" legal documentation service to incorporate your business, register a trademark or prepare a lease. Proceed with extreme caution if you decide to engage one of the many online providers offering such services.

One leading purveyor of these types of services touts that the company was "founded by attorneys who have worked at some of the most prestigious law firms in the country" and that "all of [their] forms were developed by experienced attorneys, so you can be sure that [their] documents are dependable." The company's disclaimer, however, provides the following additional information about the company and its services:

- The service is not a substitute for the advice of an attorney.
- The legal information provided is not legal advice and is not guaranteed to be correct, complete or up-to-date.
- If you need legal advice for your specific problem, or if your specific problem is too complex to be addressed by their service, you should consult a licensed attorney.
- The company does not review the answers you provide for legal sufficiency, draw legal conclusions, provide legal advice or apply the law to the facts of your particular situation.

In contrast, when you engage an attorney you are getting actual legal advice, and that advice does not come with the caveat that it may not be correct, complete or up-to-date. Further, an attorney does draw legal conclusions and will apply the law to the facts of your particular situation, which provides the peace of mind that your legal matters are being handled with the appropriate level of care.

One service provided by the aforementioned company is the filing of federal trademark applications. Contrary to what you might think (and what do-it-yourself legal documentation services might have you believe), the preparation and filing of federal trademark applications is not merely a matter of filling out forms and is, in fact, full of traps for the unwary. Consider the following:

- You must determine whether you wish to apply for your mark in standard characters (plain typed font) or in a specialized font or color scheme. You may think you will achieve the strongest protection for your mark by registering the mark in a particular font and/or color scheme; however, in many instances you will be best served by registering the mark in black and white standard characters because (1) doing so may provide you with broader rights and (2) you may not have to file a new application in the future if you alter the font and/or color scheme associated with the mark, thereby saving you money in the long run. After all, how often do you change the font and style of your advertising? More frequently than every 10 years?
- Chances are good that the U.S. Trademark Office will issue an Office Action initially refusing your application for registration. According to the Trademark Performance Report available through the U.S. Trademark Office website, in the first quarter of 2009 slightly more than 31% of "TEAS Plus" applications (those filed using the simplest and most efficient application procedure) were approved by the Trademark Office at the outset. This means that the Trademark Office found fault with approximately 69% of TEAS Plus applications, leading those applicants to receive Office Actions requiring a deadline-driven response addressing the problems identified by the Trademark Office. The Trademark Performance Report suggests that the first action approval rate for applications filed using the *standard* TEAS procedure is merely 15-16%, meaning that approximately 85% of those applicants will receive Office Actions requiring a response.

Office Actions can contain a significant amount of trademark legal jargon, and many applicants acting without an attorney therefore simply set them aside and fail to respond appropriately. If an applicant fails to respond within six months of the issuance of the Office Action, the application will become abandoned, in which case the applicant will likely have to file a new application and will have not only forfeited the fee paid to the legal documentation service provider as well as the government filing fee, but may also have lost the benefit of the application priority date. Consulting an experienced trademark attorney familiar with trademark application requirements can reduce the likelihood that you receive an Office Action at the outset and, in the event that an Office Action is issued, your attorney can ensure an appropriate response is filed on time.

"Do It Yourself" May Work Around the House, but Not for Trademark Applications, *continued*

- Your trademark application must be signed by an authorized signatory. An application that is signed by an inappropriate signatory – for example, a representative from the applicant's advertising agency – will likely be void. An experienced trademark attorney can help you avoid this problem by providing you with guidance as to who is considered an authorized signatory for your trademark applications.
- You must be careful when asserting your date of first use of your mark in commerce. Whether you file your trademark application based on current use or your intent to use your mark in the future, before a registration will be issued you will be required to declare that the mark is in use in commerce and provide the date that such use began. Your declaration pertains to every good and service listed in the application, and asserting that the mark is in use for all listed goods and services when it is not and/or the failure to provide an accurate date of first use can cause the resulting registration to be vulnerable to cancellation, especially if the provision of inaccurate information is done knowingly. Further, the Trademark Office has very specific rules regarding what is considered a "use in commerce" and what is not. Getting the advice of a trademark attorney before making any assertions to the Trademark Office regarding use of your mark in commerce may well prevent you from walking headfirst into a challenge to the validity of your resulting registration.

The temptation to use online, low price do-it-yourself services is understandable, but these services are no substitute for the advice of an experienced trademark attorney. Consider the possibility that while do-it-yourself legal documents might seem like a good deal, in the end, many users of these services may find that they have been penny wise and pound foolish.

Ms. Robertseon is an attorney in our Memphis office.