The Tax Man Cometh: An Overview of State Efforts to Get Into Your Pocket
(Or, Everything You Wanted to Know About State Tax Nexus for Franchisors, But Were Afraid to Ask…)

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Franchising involves a variety of relationships with franchisees:

- Use/licensing of TMs, Logos, Trade Secrets, Software
- Inventory/sales of required products or ingredients
- Training of store managers, employees

Unless the stores are company-owned (e.g., by the franchisor or related affiliate entity), the expectation is that the franchisor is not engaged in business in the state(s) or territory allotted to the franchisee.

- Franchisor receives its royalties/license fees (and upfront fees).
- Franchisee pays its expenses and taxes.
States previously have distinguished between *income tax* “nexus” and *sales tax* “nexus”.

- Income tax nexus generally required the “taxpayer” to have some type of physical nexus to the state.
- Sales tax nexus generally was based on transactional connection to the state (i.e., taxable products were sold to a resident or were brought in to be used there by a resident).

The US Supreme Court (and Congress) drew lines to help businesses understand when the Commerce Clause established federal preemption over states that were overly-aggressive in seeking *income tax* nexus.
Prior to 2011, most states did not seek to impose income tax on an out-of-state franchisors if they did not have a physical presence in the state.

Thus, unless there were company-owned stores in the state or there were franchisor employees in the state (under certain other legal structures), franchisors did not have physical nexus and did not expect to be subject to state income tax.

That meant the risk of a state seeking to impose income tax on the franchisor’s income was not of material concern.

NOTE: the current NLRB “joint employer” efforts may ultimately affect state nexus issues, too, if the NLRB succeeds.
KFC Corp., a Delaware corporation with principal offices in Kentucky, licensed trademarks and recipes to independent franchisees in Iowa. KFC, itself, had no corporate locations, other property, or employees in the state. It solely received royalties in exchange for the franchise licenses.

The Iowa Department of Revenue assessed *income tax* on that royalty income.

KFC litigated the issue in state courts; ultimately, the case was decided by the Iowa Supreme Court...
Holding by the Iowa Supreme Court: KFC Corp’s licensing agreements with Iowa franchisees constituted sufficient nexus with the state for the imposition of state income tax.

In a second holding, the court concluded that the U.S. Supreme Court likely would find that the use of KFC’s intangibles by Iowa franchisees amounted to the “functional equivalent” of physical presence.

KFC was the first case to hold that a franchisor has sufficient nexus with a state for income tax purposes when its only connection with the state is the use of its intellectual property by franchisees in the state.

In other words, the ONLY connection that KFC had to Iowa was the contract requiring a payment by the franchisee of the royalty amounts due.
AND, TO THE HORROR OF FRANCHISORS AND TAX PROFESSIONALS EVERYWHERE, THE U.S. SUPREME COURT DENIED CERT!

This means the U.S. Supreme Court refused to hear the case, thus leaving intact the holding and precedent of the adverse Iowa Supreme Court decision...
Why KFC was a Surprise?

Prior cases involving the taxation of out-of-state corporations with no physical presence largely addressed the use of intangible holding companies—tax planning vehicles which often had no substance and/or no non-tax business purpose.

- Example: consolidated group sets up a DE IP company to hold and license IP to the group; DE doesn’t tax that licensing income, but the state payor entities get a deduction.
- States began enacting “add back” rules to deny those deductions.

*KFC involved an attack on a widespread business model—franchising—which is not a “tax planning” vehicle or abuse.*
Yes, Wendy’s did prevail about the same time that KFC lost its case, but its facts were different...

► The Wendy's International, Inc. captive insurance subsidiary, Scioto Insurance, owned Wendy's trademarks and operating practices.

► Scioto licensed these intangibles to Wendy's International (in addition to Scioto conducting its insurance business as a licensed insurance company); Wendy’s International entered into sub-license agreements with Wendy's franchisees in Oklahoma.

► The Oklahoma Supreme Court held that Scioto did not have nexus with Oklahoma, and was not subject to income tax there, because the source of Scioto's income was the wholly out-of-state (bilateral) contract with Wendy's International, and not the sub-license agreements that Wendy’s International entered into itself with the in-state franchisees. Scioto Insurance Co. v. Oklahoma Tax Comm'n, No. 108943, 2012 WL 1520847 (Okla. May 1, 2012).
While this distinction in the holding by the Oklahoma Supreme Court suggested certain planning ideas, for the most part franchisors were not prepared to make changes to align themselves with the facts in Scioto.

And, despite our continuing FaegreBD efforts at education, U.S. franchisors generally do not (yet) have captive insurance companies to utilize.

While captives are a valuable insurance tool for both franchisors/owners and franchisees alike, care must be taken to assure that the captive conducts itself as an “insurance company” under the Internal Revenue Code.
Arizona: Here, an out-of-state franchisor granted in-state franchisees a license to use service marks, for which the franchisor collected royalty income. The Arizona Department of Revenue held the franchisor had nexus with Arizona through this licensing activity even though the franchisor lacked physical presence in Arizona. (See Arizona DOR Hearing Office Decision, No. 200700083-C (March 27, 2008))
In Reality, Lots of States Can Attack Franchisors!

► Many states have statutory language that defines franchising as an “unprotected activity” under P.L. 86-272. See, e.g., Montana and North Dakota.

► Other states have statutory language indicating the licensing of intangible property can create nexus. See, e.g., Nebraska and Wisconsin.

► Any state that employs an economic nexus standard, even if they have not attacked franchisors in the past, could conceivably expand their interpretation of nexus to attack out-of-state franchisors.

► The jurisdictions that currently have an economic nexus standard are: AK, AL, AR, AZ, CA, CO, CT, DC, FL, GA, HI, IA, ID, IL, IN, KS, LA, MA, MD, ME, MI, MN, MO, MS, MT, NC, ND, NE, NH, NM, OH, OR, RI, SC, UT, VA, VT, WI, and WV.
So What Do the States Latch onto When Looking at Out-of-State Franchisors?

- Licensing, trademarks and other Intangibles
- Service fees
- Visits by Franchisor personnel to Franchisees (occasional or frequent)
- Agency relationships
- Providing free-of-charge supplies or equipment
- Conducting in-state training
- Delivery of product in company-owned vehicles
- Sometimes, just the fact that the franchisor earned income from within the state — the so called “factor nexus.”
How Bad Can it Get?

► Exposure to double taxation (the “home state” of the franchisor, plus the “nexus state” of the franchisee)
► Unlimited look back because no returns were filed in the “nexus state” (i.e., the statute of limitations has not tolled—for the franchisor, or for thee…)
► The need for developing detailed records to carry the burden of proof against the asserted tax liability
► Compliance costs (including interest and penalties, plus costs of contest)
► Lower profitability
What Can FaegreBD Do to Help a Franchisor Evaluate Exposure?

FaegreBD can:

► Evaluate a particular state’s level of aggressiveness in asserting nexus. (Not all states tax to the full extent allowed by the Constitution.)

► Advise and defend franchisors in the event of nexus assertion by state tax auditors

► Help the franchisor assess and, if agreed, implement amnesty or voluntary disclosure opportunities.

► Integrate responses to different states, such as evaluating whether a voluntary disclosure in one state might provide an opportunity to claim a refund in the state where the income was originally reported.

► Help the franchisor anticipate a potential tax liability in pricing to the franchisee or consider agreements that gross up the tax (i.e., shifts the tax burden) to franchisees; consider “modified” or partial gross up arrangements

► Assist the franchisor / community with lobbying efforts, both at the federal and state level, to promote legislation requiring physical presence for income tax nexus.
THE END ... for now...

Thanks for your attention.
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