STATE TAXATION OF FRANCHISORS

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October 13-15, 2010
Hotel Del Coronado
San Diego, CA

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I. INTRODUCTION

This paper is designed to provide franchisors and their counsel with an overview of the myriad tax changes in recent years that are shifting the landscape regarding the manner in which franchisors have traditionally been required to calculate, pay and, in some cases, report their state income taxes and state sales and use taxes. Legislative changes and court decisions are at the forefront of state efforts to expand revenue collection. In other cases, however, profound tax impacts may arise from shifts in administrative agency interpretations of state tax statutes and regulations that had been applied for years. State tax laws are rapidly evolving at a fluid pace. Accordingly, franchisors need to be diligent regarding their understanding of recent tax law changes as well as pro-active in initiating responses designed to minimize the potential adverse consequences of such changes.

II. IMPETUS FOR STATE TAXATION OF OUT-OF-STATE ENTITIES

A. States Face Daunting Budget Deficits

The Center for Budget and Policy Priorities estimates that 46 states will face budget shortfalls for the fiscal year beginning July 1, 2010, and that 48 states endured significant shortfalls in the prior fiscal year ending June 30, 2010. The decline in state revenue has been triggered by a decrease in state collection of a number of taxes, including property taxes that are generally based on real estate values.

High unemployment exacts a toll on state coffers as well, creating the dual impact of reducing state collections of personal income taxes, and contributing to falling sales and use tax revenue due to the reluctance of budget conscious consumers to splurge on non-essential purchases. States have reacted by slashing budgets, cutting services and imposing work furloughs on government workers. The spending cuts in many cases, however, have not been sufficient to bring state budgets back into balance. As a result, states are under intense pressure to increase revenue.

B. Resistance to Rate Increases

Although tax increases may be viewed as a “quick fix,” the reality is that state options to increase revenue are limited by political concerns. Most state legislatures are loathe to pursue income tax rate increases or other measures that would fall exclusively on home state taxpayers. As a result, states have undertaken a delicate balancing act: increase revenue, but where possible shift the tax burden to out-of-state companies conducting business with in-state taxpayers. Such efforts, in theory at least, enhance the state’s fiscal position while avoiding the hue and cry from local concerns that could otherwise derail revenue raising efforts.

*The authors would like to acknowledge the assistance of Paul Russell, an associate in the Dallas office of Baker Botts L.L.P., in preparing this paper.

1 ELIZABETH McNICHOL AND NICHOLAS JOHNSON, CTR. ON BUDGET AND POLICY PRIORITIES, RECESSION CONTINUES TO BATTER STATE BUDGETS; STATE RESPONSES COULD SLOW RECOVERY 1 (2010), http://www.cbpp.org/files/9-8-08sfp.pdf. The Center is a non-profit policy organization that works at the federal and state level on fiscal policy and public programs by conducting research and analysis to help shape public debate.
C. Expansion of the Tax Base Through Targeting of Out-of-State Taxpayers

State legislation targeting out-of-state taxpayers is, in many instances, not obvious from the governing legislation. For instance, many states have in recent years switched their income apportionment formula from the traditional three factor property, payroll and sales formula to single sales factor apportionment. Such a switch benefits in-state taxpayers (who would likely have a higher apportionment factor if in-state property and payroll were considered), to the detriment of out-of-state taxpayers, who must then calculate their taxable income in single factor sales states based solely on the taxpayer’s total market provided by state customers, with no further diminution in the apportionment formula for payroll and property that are likely to be more heavily concentrated in the taxpayer’s home jurisdiction. In other cases, however, the intent of the legislature could not be more unmistakable.

Washington recently amended its Business and Occupations tax to require apportionment to Washington of certain receipts from royalties and services that had previously been sourced outside of Washington. In enacting the new provisions, the Washington legislature bluntly declared “the legislature finds that out-of-state businesses that do not have a physical presence in Washington earn significant income from Washington residents from providing services and or collecting royalties on the use of intangible property in [Washington] . . . the legislature intends to extend [Washington’s] business and occupation tax to these companies to ensure that they pay their fair share of the cost of services that [Washington] renders and the infrastructure it provides.”

The lessons are clear: out-of-state taxpayers doing business with in-state consumers or businesses, typically have little or no voice in a state’s political debates and elections. As a result, state legislators desperate for revenue, are adopting the path of least resistance by increasing tax rates and the tax base on out-of-state businesses, thus helping to avoid raising the ire of local taxpayers.

D. Built in “Home Field” Advantage to State in Taxpayer Challenge and Appeal Process

In some cases, state actions raise legitimate questions about nexus to tax and the sourcing of income method adopted by the state. Unfortunately, taxpayers who choose to challenge these provisions may face a “stacked deck” of procedural obstacles.

Initially, as discussed above, an out-of-state taxpayer will generally not be able to influence an in-state legislature determined to raise tax rates. Second, a taxpayer seeking to challenge new tax provisions is forced to do so on the state’s terms. This means responding to state assessments and pursuing state administrative remedies (typically by filing a protest and proceeding through to an administrative hearing), before being able to take the matter to court. To do otherwise risks dismissal based on a failure to exhaust administrative remedies. Then, if a taxpayer is willing to spend the time and money to pursue litigation, it must often persuade a state court that the state’s legislature has overstepped its constitutional boundaries in what are

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3 It should be pointed out that these state revenue raising efforts are not always successful. On June 8, 2010, the taxpayers of Maine voted to overturn previous legislation that would have extended Maine’s sales tax to a variety of taxes falling disproportionately on out-of-state taxpayers visiting Maine. See Maine Tax Code People’s Veto, Question 1 (2010), http://www.maine.gov/sos/cec/elec/pets02/pets02-1.htm.
typically very gray areas of the law. These factors combine to make challenges to the ever increasing number of new state tax provisions formidable at best.

III. HOW CAN STATES DO THIS? THE BASIS FOR STATE TAXATION OF OUT-OF-STATE FRANCHISORS

A. Constitutional Basis and Supreme Court Cases

1. Physical Presence Requirement for Sales and Use Tax Nexus

In Complete Auto Transit, Inc. v. Brady, the U.S. Supreme Court established four requirements that must be satisfied in order for a state to tax an interstate transaction:

1. The tax must be applied to an activity that has a *substantial nexus* with the state;
2. The tax must be fairly apportioned to activities carried on by the taxpayer in the state;
3. The tax must not discriminate against interstate commerce; and
4. The tax must be fairly related to services provided by the state. 4

For sales and use tax collection purposes, the U.S. Supreme Court confirmed in Quill Corp. v. North Dakota that *physical presence* within the taxing state is a prerequisite to a finding of substantial nexus. 5 As stated by the Court in affirming its earlier holding in National Bellas Hess, Inc. v. Department of Revenue of Illinois, 6 an out-of-state “seller whose only connection with customers in the State is by common carrier or the United States mail,” does not have sufficient nexus to permit that state to impose sales and use tax collection obligations and thereby is “free from state-imposed duties to collect sales and use taxes.” 7

The Quill Court continued its analysis of the physical presence standard by noting that “whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office.” 8 Accordingly, for sales and use tax purposes, a significant portion of disputes with taxpayers in recent years has centered on what constitutes physical presence and not whether physical presence itself is a nexus prerequisite. Quill clearly establishes that physical presence, however defined, is required in order for a state to subject an out-of-state taxpayer to sales and use tax collection and remittance obligations.

2. Public Law 86-272

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6 386 U.S. 753 (1967).
7 504 U.S. at 315.
8 Id. at 315.
In 1959, in *Northwestern States Portland Cement Company v. Minnesota*, the U.S. Supreme Court undertook an analysis of permissible state income taxation on interstate commerce transactions.9 In *Northwestern States Portland Cement Company*, the Court, for the first time, explicitly concluded that there was no commerce clause barrier to imposing a fairly apportioned direct income tax on a foreign corporation that carried on an exclusively interstate business within the taxing state.

The Court reiterated that there must be a connection between the taxpayer and the taxing state, the absence of discrimination in the state’s taxing provisions, and fair apportionment to preclude the possibility of multiple taxation. The *Northwestern States Portland Cement* case created significant protests and alarm among the business community.

As a result, the Senate held hearings on the *Northwestern States Portland Cement* decision and in response to business demand for immediate congressional action adopted Public Law 86-272 as 15 U.S.C. § 381-384 (“P.L. 86-272”). P.L. 86-272 precludes states from imposing “a net income tax” on income derived from interstate commerce if the only business activities within the taxing state are the solicitation of orders for sales of tangible personal property, provided the orders are sent outside the state for approval or rejection and such orders are subsequently filled by shipment or delivery from a point outside the state. In the years since the enactment of P.L. 86-272, states have narrowly construed its provisions.

For example, P.L. 86-272 explicitly provides protection from the imposition of a net income tax. However, states like Ohio now contend that P.L. 86-272 does not offer protection from a gross receipts tax. Moreover, P.L. 86-272 applies explicitly to the sales of tangible personal property. States have interpreted these provisions as not affording P.L. 86-272 protection to leases of tangible personal property or sales of services or of property that is not tangible personal property. As a result, since the business of a franchisor typically does not involve, or is not limited to, the sale of tangible personal property to a franchisee, P.L. 86-272 generally does not provide protection for the franchisor.

The Multistate Tax Commission, to which 47 states have some level of membership, has provided a list of activities it considers protected or not protected by P.L. 86-272. Non-protected activities include “entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchisor or licensor to its franchisee or licensee within the state.”10 Accordingly, state revenue agencies are likely to adopt the position that P.L. 86-272 provides no protection for franchisors seeking to avoid income tax nexus in the state where franchisees are located.

3. **Supreme Court Has Not Established Clear Guidelines for Income Tax Nexus**

Despite providing a degree of clarity with respect to the requirements for sales and use tax nexus, the Supreme Court has, to this point, declined to adopt a physical presence standard for income tax nexus purposes. In the absence of a Supreme Court decision

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requiring physical presence for income tax nexus, states have adopted their own nexus positions that do not require physical presence.

Initially, the trend was judicial and seemed to be limited to situations that at least required taxpayers to have an in-state presence of intangible property. As the Supreme Court continued to remain silent, however, states have become emboldened and now find nexus in cases where an out-of-state taxpayer merely targets business from customers in the state. (See discussion at Section III.B.1 below.) Moreover, state legislatures have also gotten into the act. As a result, many states no longer make a pretense of requiring a taxpayer to have a physical or intangible presence, but instead have lowered their nexus standards to require only a designated volume of receipts generated from in-state customers to create nexus. (See discussion at Section III.B.4 below.)

B. What Are State Arguments for Franchisor Nexus?

1. Licensing Nexus (Nexus based on in-state presence of intangible assets)

South Carolina was the first state to assert income tax nexus based on the presence of intangible property or other economic connections.11 In Geoffrey, Inc. v. South Carolina Tax Commission, an out-of-state taxpayer was deemed to have nexus for income tax purposes arising from the license of its intangible property to an affiliate conducting business in South Carolina. The court concluded that the taxpayer held accounts receivable in South Carolina arising from license fees it received based on the sales of an affiliate that was using the taxpayer’s trademarks. The South Carolina court rejected the taxpayer’s reliance on the physical presence standard of Quill noting that it “is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. . .that the presence of these intangibles is sufficient to sustain a tax is settled law.”12

Since Geoffrey, a number of other state courts have reached nexus conclusions for income tax purposes, without a finding of in-state physical presence on the part of the taxpayer. For example, the New Jersey Supreme Court affirmed the lower court’s decision in Lanco, Inc. v. Director, Division of Taxation.13 In Lanco, the taxpayer licensed its intangible property including trademarks, tradenames and service marks, to its affiliate Lane Bryant which was conducting retail operations in New Jersey. Lane Bryant made royalty payments to Lanco.

The New Jersey Division of Taxation took the position that Lanco was subject to New Jersey’s corporate income tax. In concluding that Lanco was indeed subject to the tax despite the lack of physical presence in New Jersey, the court concluded that “the physical presence requirement applicable to use and sales taxes is not applicable to income tax

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12 437 S.E.2d at 20.
and that the New Jersey Business Corporation Tax may be constitutionally applied to income. . .from licensing fees attributable to New Jersey.”

2. **Attributional Nexus (Nexus based on the in-state presence of an affiliated entity or independent contractor)**

In addition to nexus created by the licensing of property, states have, on occasion, attempted to assert nexus against an entity based on the acknowledged nexus of an affiliate. In *Bloomingdale’s by Mail Limited v. Commonwealth Department of Revenue*, the taxpayer was headquartered in New York and conducted a nationwide mail order business from Virginia, including sales to Pennsylvania customers solicited through mailed catalogs. The taxpayer, however, had no retail stores, distribution houses, sales houses, warehouses, business locations or any other office or employees in Pennsylvania.

However, several of Bloomingdale’s retail stores, which were owned by the taxpayer’s parent, were located in Pennsylvania and sold items that were also available through the mail order catalogs. The court determined that the mail order subsidiary did not have nexus in Pennsylvania because the Bloomingdale’s stores in Pennsylvania did not solicit orders on behalf of the taxpayer “*nor act as its agent in any fashion* and [the taxpayer] does not solicit orders through Bloomingdale’s.” As such, since no agency relationship existed between the taxpayer and Bloomingdale’s, the court declined to impute Bloomingdale’s Pennsylvania nexus to the taxpayer.

In *SFA Folio Collections, Inc. v. Bannon*, the taxpayer, SFA, was a New York corporation owned by Saks & Company, another New York corporation which also owned Saks-Stamford, a separate corporation operating a retail store in Connecticut. The Connecticut Commissioner of Revenue sought to attribute the nexus of the parent company and Saks-Stamford to SFA which made mail order sales into Connecticut. The Connecticut Supreme Court however, concluded that SFA did not have nexus for Connecticut purposes since it did not “have any solicitors, canvassers, sales person, authorized agents, or representatives in Connecticut.” Like the taxpayer in *Bloomingdale’s*, SFA used the “Saks Fifth Avenue” trademarks owned by the parent company. Nevertheless, absent more, this trademark use was not sufficient to establish Connecticut nexus for purposes of collecting use tax.

In *Current, Inc. v. State Board of Equalization*, Current, a Colorado-based mail order company with “no employees, inventories or facilities in California”, was acquired at the end of 1987 by Deluxe Corporation (“Deluxe”). Deluxe maintained 6 manufacturing plants, 35 field sales representatives and 16 supervisory and sales personnel in California and held a California seller’s permit. Upon its acquisition by Deluxe, the State Board of Equalization

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14 Id. at 1242.
16 Id. at 778.
17 585 A.2d 666 (Conn. 1991).
18 Id. at 669.
asserted that Current acquired nexus in California pursuant to a statutory provision providing that a retailer “owned or controlled by the same interest which own or control any retailer engaged in the business in the same or similar line of business in this state” is deemed to be engaged in business in California.\(^\text{20}\) The California Court of Appeals concluded that the California statute was unconstitutional as applied to Current, in part, because the parties stipulated to the fact that “Current and Deluxe ‘did not have integrated operations or management, were organized and operated as separate and distinct corporate entities and neither . . . was the alter ego or agent of the other for any purpose.’”\(^\text{21}\) Given these undisputed facts, California’s attempt to assert nexus based on mere common ownership, was unconstitutional.

Since franchised locations are typically owned by franchisees, nexus derived through ownership affiliation is typically not a major concern in the franchise context. Moreover, the cases cited above examined nexus for sales and use tax collection purposes, not income tax purposes. Nevertheless, franchisors should note that some states assert sales and use tax nexus against franchisors based on the in-state presence of franchisees.\(^\text{22}\)

### 3. Registration Nexus (Nexus based on qualification to do business or other state registration)

Business qualification or registration is generally not sufficient to create income tax nexus.\(^\text{23}\) Registration, however, may subject a taxpayer to minimum tax liability in states that impose a minimum tax. Thus, one of the consequences of California business qualification by a franchisor is that the franchisor becomes subject to at least the California minimum tax (currently $800), and also becomes obligated to file a California income tax return.\(^\text{24}\)

Franchisors should also be mindful that registration for sales and use tax purposes, even where such registration could not be compelled by the state, may serve as a waiver of a taxpayer’s subsequent nexus defenses to tax collection obligations.\(^\text{25}\) Thus, holders of a California Use Tax Certificate of Registration are required to collect tax from purchasers, give receipts therefore, and pay the tax to the Board in the same manner as retailers engaged in business” in California.

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\(^\text{20}\) Id. at 391.

\(^\text{21}\) Id. at 391.

\(^\text{22}\) See, e.g., Mo. Rev. Stat. § 144.605(2)(c) (2009) (providing that “maintaining or having a franchisee or licensee operating under the sellers trade name in this state if the franchisee or licensee is required to collect sales tax,” creates nexus for the franchisor).


\(^\text{24}\) See Cal. Rev. & Tax. §§ 23153(b)(2) and (d); Cal. Rev. & Tax. § 18601(a).

\(^\text{25}\) See, e.g., California State Board of Equalization, Sales and Use Tax Regulation 1684(c) (August 2001) (providing that “retailers who are not engaged in business in this state may apply for a Certificate of Registration-Use Tax”) (codified in Cal. Rev. & Tax Code §§ 6203, 6204, 6226, and 7051.3).
New York, however, has concluded to the contrary. In *In re New Milford Tractor Co.*, 26 a Connecticut distributor of John Deere tractors voluntarily registered in New York as a dealer at John Deere's request, although the dealer reported no sales. Subsequently, the Department asserted that a taxpayer "who files a certificate of registration automatically assumes the obligations of a vendor."27 The Tribunal found against the Department and held for the taxpayer, concluding that "we cannot accept the Division's argument that by voluntarily registering, [the taxpayer] waived its Commerce Clause protection and agreed to be liable to collect the use tax."28

4. **Nexus Arising from Targeting In-State Customers or From Level of Sales Activity within the State**

In *Tax Commissioner v. MBNA America Bank, N.A.*, the West Virginia Supreme Court reviewed the appropriateness of imposing the state's corporation net income tax and business franchise tax on a non-resident bank.29 The taxpayer was incorporated and had its principal place of business in Delaware and issued and provided credit card services to customers in West Virginia but had no assets either tangible or intangible, or employees in West Virginia. MBNA used mail and telephone solicitations to promote its business to West Virginia customers.

In rejecting the premise that physical presence was required for income tax nexus, the West Virginia Supreme Court concluded that "rather than a physical presence standard...a significant economic presence test is a better indicator of whether a substantial nexus exists for Commerce Clause purposes."30 The court determined that the taxpayer "continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia", and that, therefore, the taxpayer had nexus in West Virginia.31 As such, the taxpayer's "systematic and continuous business activity in [West Virginia] produced significant gross receipts attributable to its West Virginia customers which indicated a significant economic presence sufficient to meet the substantial nexus" test.32 Thus, the intentional targeting of the state's commercial market, even in the absence of intangibles in the state, was deemed sufficient for income tax nexus.

The extension of a state’s income tax and business activity tax nexus reach occurs through specific legislation as well as judicial interpretation. In the last few years, Michigan, Ohio and Washington have all adopted broad based statutory nexus provisions. These states now permit nexus determinations to be based on the quantity of receipts generated from in-state customers without regard to the necessity of an in-state physical

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27 *Id.*

28 *Id.*


30 *Id.* at 234.

31 *Id.* at 235.

32 *Id.* at 236.
presence. For instance, the Ohio Commercial Activity Tax ("CAT") became effective July 1, 2005. CAT nexus results if, among other things, the taxpayer has during the calendar year taxable gross receipts of at least five hundred thousand dollars ($500,000). Ohio openly acknowledges that CAT nexus standards do not even purport to satisfy Quill's physical presence standard. Similarly, the Michigan Business Tax ("MBT") became effective on January 1, 2008. An out-of-state business has nexus with Michigan and is subject to MBT if: 1) the taxpayer has a physical presence in Michigan for more than 1 day during the tax year (the "physical presence test"), or 2) the taxpayer actively solicits sales in Michigan and has gross receipts of $350,000 or more sourced to Michigan (the "economic nexus test"). Finally, under Washington's 2010 legislation, nexus is created for a recipient of royalties if among other things, the out of state royalty recipient has more than either $50,000 of property in Washington, $50,000 of payroll in Washington or $250,000 of annual receipts from Washington payors, or at least 25% of its total property, payroll or receipts are from Washington sources.

Given the foregoing, it is clear that physical presence is not required for income tax nexus purposes. As a result, franchisors should understand that a lack of physical presence is unlikely to provide protection from a state's ability to impose income or gross receipts taxes when income is derived from in-state franchisees.

IV. SIGNIFICANT STATE ISSUES IN TAXATION OF OUT-OF-STATE FRANCHISORS

Approximately 29 states consider the licensing of trademarks or other intangible property in the state or the granting of a franchise in the state with no physical presence in the state to be an adequate basis for establishing tax nexus. Of course, the degree to which each of these states is actually pursuing out-of-state franchisors to collect taxes based on franchise fees generated from franchisees in the state varies, but, as noted above, there has been a marked increase in the aggressiveness of a number of states in this regard in recent years. The state of affairs with respect to taxation of out-of-state franchisors among the states is in constant flux, but the general direction of the states is clear--and it is not a positive direction for multi-state franchisors.

Discussed below are some significant state developments (some recent and some not so recent) with respect to taxation of out-of-state franchisors as well as the approach taken by some of the states that play a prominent role in franchising in the United States.

A. California

34 See OHIO REV. CODE § 5751.01(I)(3) (2009).
35 See Information Release, Ohio Department of Taxation, CAT 2005-02 - Commercial Activity Tax: Nexus Standards (September 2005), http://www.tax.ohio.gov/divisions/communications/information_releases/CAT/CAT200502.stm (providing that "the Supreme Court has never applied the physical presence standard to other taxes, such as income, franchise, and gross receipt taxes. Therefore, Quill's physical presence requirement does not explicitly apply to a business privilege tax such as the CAT.").
38 See S.B. 6143, supra note 2, at §§ 103 and 104(1)(c).
California imposes a franchise tax generally on corporations “doing business” in California.\(^39\) For entities whose activities do not rise to the level of “doing business” in California but which have net income derived from sources within California, California imposes a corporate income tax.\(^40\) These two taxes are mutually exclusive.

To date, California courts and the California Franchise Tax Board have not published official guidance asserting that *Quill*'s physical presence rule does not apply to franchise or corporate income tax. Nevertheless, within the past year, California has become more aggressive in seeking to impose corporate income tax on out-of-state franchisors based on revenue they receive from franchisees within the state of California.

In fact, California tax authorities have begun sending notices to franchisees of out-of-state franchisors who are not qualified to do business in California advising them that they must withhold California income tax from their payments to their franchisors. Additionally, non-resident franchisors have been advised by the California Franchise Tax Board that they must either qualify to do business in California (at which point, the franchisor's income derived from California sources would be subject to the franchise tax) or have their California franchisees withhold 7% of amounts payable to the franchisor for "personal services" and royalties. California takes the position that the first $1,500 of annual payments is not subject to the 7% withholding tax, but anything over $1,500 is subject to withholding.\(^41\)

Notwithstanding the position taken by the California tax authorities, the issue of whether the California tax law requires this withholding is not clear-cut. Out-of-state franchisors' receipts are only subject to withholding if they are “derived from sources within this state.”\(^42\) California generally adheres to the doctrine of “mobilia sequuntur personam” (i.e., “movables follow the person”), and therefore sources income from intangibles to California only if the owner is a California corporation or a foreign corporation with a California commercial domicile.\(^43\) As an exception to this general rule, however, the tax law provides that, “income from sources within this state includes . . . income from intangible personal property having a business situs in the State.”\(^44\) In other words, if an item of intangible property gains a business situs, for sourcing purposes, the business situs trumps the owner’s location.

Regulations for determining whether intangible personal property (e.g., the rights licensed under a franchise arrangement) has a business situs in California provide as follows:

Intangible personal property has a business situs in this State

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\(^{39}\) See *CAL. REV. & TAX CODE* § 23151(a).

\(^{40}\) See *CAL. REV. & TAX CODE* § 23501(a).

\(^{41}\) *CAL. CODE REGS.* tit. 18, § 18662-2.

\(^{42}\) *CAL. CODE REGS.* tit. 18, § 18662-11.

\(^{43}\) See *CAL. CODE REGS.* tit. 18, § 23040(c); *Rainier Brewing Co. v. McColgan*, 94 Cal. App. 2d 118, 123 (Cal. Ct. App. 1949).

\(^{44}\) *CAL. CODE REGS.* tit. 18, § 23040(a) (emphasis added); see also *CAL. CODE REGS.* tit. 18, § 23040(c) (2010) (treating as non-California source income receipts from intangibles by a California corporation where the intangible gains a business situs elsewhere).
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. For example, if a corporation pledges stocks, bonds or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here. Again, if a corporation maintains a branch office here and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in this State, the bank account has a business situs here.45

There is not much meaningful guidance on applying this standard. Because the answer to the question of whether an out-of-state franchisor’s intangible personal property has acquired a California business situs is unclear, its franchisees should not be required to withhold based on a California Franchise Tax Board publication, which provides that “[d]etermining business situs is a difficult area where bright-line tests have not been developed. If the withholding agent is certain that an intangible asset has acquired a California business situs, withholding is required. If the status is not clear, the withholding agent is not required to withhold”.46

Effective for tax years beginning January 1, 2011, California’s definition of “doing business” for corporate income and franchise tax purposes will be expanded to incorporate the Multistate Tax Commission’s “factor presence” nexus guidelines. Pursuant to these guidelines, a taxpayer will have nexus in California if the taxpayer (i) has sales for the tax year, including sales made by an agent or independent contractor, that exceed the lesser of $500,000 or 25% of the taxpayer’s total sales, (ii) has real property or tangible personal property in California that exceed the lesser of $50,000 or 25% of the taxpayer’s total real property and tangible personal property, or (iii) pays compensation in California in an amount that exceeds the lesser of $50,000 or 25% of the total compensation paid by the taxpayer.47 For this purpose, “compensation” means “wages, salaries, commissions and any other from of remuneration paid to employees for personal services.”48

B. New York

To date, New York has not actively sought to tax the revenue of franchisors with no physical presence in the state with respect to franchise fees paid by New York franchisees. This is likely because of a conclusion by the New York Division of Tax Appeals that the

45 CAL. CODE REGS. tit. 18, § 23040(e).
47 AB 15, Approved by the Governor February 20, 2009. California Revenue and Taxation Code Section 23101(b)(2)-(4).
48 California Revenue and Taxation Code Sections 23101(b)(4) and 25120(c).
principles of *Quill*’s physical presence requirement for sales and use nexus as discussed in Section III.A.1 above, can be extended to income tax nexus.\(^49\)

As a part of the 2009-2010 Education, Labor and Family Assistance Budget Bill, New York enacted a requirement that franchisors with at least one New York franchisee that must be a registered New York state sales tax vendor must file an annual informational return with the New York Department of Taxation and Finance.\(^50\)

The stated purpose of the requirement is to permit the Department to use information provided by franchisors to determine the accuracy of income and sales tax returns filed by franchisees. Currently, the Department is notifying New York-based franchisees of their franchisors’ new reporting obligation and is reminding those who may “have filed false or inaccurate returns, or failed to file returns” that they can avoid penalties by participating in the Department’s Voluntary Disclosure and Compliance Program.

Detailed information regarding each franchisee, including its legal name, contact information, Federal Employee Identification Number (or Social Security Number if the franchisee is an individual), and the franchisee’s New York State Sales Tax Certificate of Authority number must be reported by the franchisor. Franchisors are also required to report:

- The beginning date of each franchise;
- The physical address of each franchised location and, if different, the mailing address of each franchised location;
- The gross sales in New York for each franchised location as reported by the franchisee to the franchisor for the period covered by the return and, if different, the gross sales in New York for each franchised location as audited by the franchisor. Representatives of the Department have said the state wants all revenue information the franchisor has, even if the franchisor does not charge a fee on certain revenues;
- If known, the amount of New York state and local sales tax collected at each franchised location by each franchisee for the period covered by the return;
- The amount of royalty payments, if any, for each franchised location made to the franchisor and, where applicable, for each franchised location the royalty percentage of gross sales reported. If royalties are based on a computation other than percentage of gross sales, the franchisor must give details of the alternative computation;

\(^49\) See Petition of Wascana Energy Marketing, DTA No. 817866 at n. 6, N.Y. Tax App. Tribunal (August 8, 2002) (concluding that the holding in *Quill* "explicitly relies on and reaffirms the vitality of the substantial nexus requirement expressed in *Complete Auto*, which is applicable to franchise and income taxes" (emphasis added)), available at http://www.nysdta.org/Determinations/817866.det.htm.

\(^50\) Subpart G of Part V-1 of Chapter 57 of the Laws of 2009.
• The total amount of sales made to each franchised location by the franchisor, by companies affiliated with the franchisor, and by any supplier designated by the franchisor.  

Interestingly, franchisors of some service-based businesses may not have to file this informational return. If the franchisee is exempt from having a Sales Tax Certificate of Authority number, because, for example, it only sells services to its customers and not tangible products, the filing is not required, and, in fact, is not possible since the reporting form cannot be completed without a Sales Tax Certificate of Authority number.

The first return was due on or before September 20, 2009 (covering the period from March 1, 2009 through August 31, 2009), and the second return was due on or before March 20, 2010 (covering the period from September 1, 2009 to February 28, 2010). Subsequent returns must be filed annually on or before March 20 and must cover the period from March 1 of the previous year through February 28 or 29 of the current year. Returns must be filed electronically at http://www.tax.state.ny.us/online/bus.htm.

In addition, on or before March 20 of each year, the franchisor must give each franchisee included on the return a statement showing the same information reported for that franchisee in the information return. The statement can be in summary form, but must include the identifying information pertaining to the franchisee along with the gross sales of each franchised location, and royalty payments made to the franchisor for each franchised location, as reported on the franchisor’s informational return. Franchisors can use any form for the statement as long as the Department can verify that the statement was sent to each franchisee in a proper and timely manner.

Given the tide of states rushing to tax non-resident franchisors, this New York reporting requirement may well be the first step of the Empire State’s efforts to jump on that bandwagon and mine another source of tax revenue.

C. New Mexico

In what appeared to be a significant win for franchisors, in the 2006 decision of Sonic Industries, Inc. v. State (“Sonic II”), the New Mexico Supreme Court held that New Mexico’s gross receipts tax (GRT), which is a form of income tax, was not applicable to franchise fees paid under a franchise agreement for a New Mexico location that was entered into outside of New Mexico with a non-New Mexico franchisor.  

The New Mexico Supreme Court reasoned that the 1991 version of the New Mexico Gross Receipts and Compensating Tax Act (the “New Mexico Act”) required that the licensing of franchise rights must actually occur within the borders of New Mexico in order for fees paid under the franchise agreement to be subject to the GRT.

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51 The text of the bill states that the franchisor must also report “any income reported to the franchisor by the franchisee”. However, there is no definition of “income” in the bill and no reference to it in the explanatory bulletin published by the Department on July 7, 2009. When asked about this, representatives of the Department referred us to the bulletin. Representatives of the Department have said that the sales information applies only to the sale of tangible personal property, not fees charged for use of the trademarks, training or other services.

52 141 P.3d 1266 (N.M. 2006).
Any comfort taken by franchisors in the Sonic II holding was short-lived. Shortly after the Sonic II opinion was issued, the New Mexico Legislature amended and broadened the New Mexico Act to provide that the GRT applies to receipts from “leasing or licensing property employed in New Mexico.” Based on the 2006 amendment to the New Mexico Act, the GRT appears to clearly apply to franchise fees paid under franchise agreements for outlets located in New Mexico, regardless of where the franchisor is located or where the franchise agreement is actually entered into. The New Mexico Taxation and Revenue Department actively pursues out-of-state franchisors with respect to payment of the GRT on franchise revenues.

D. Texas

Entities that are doing business in Texas are required to pay a corporate franchise tax. The Texas Administrative Code lists certain activities that constitute “doing business in Texas.” That list includes the following:

(8) franchisors: entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which:

(A) the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; and

(B) the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate;

Texas has a practice of sending “nexus questionnaires” to out-of-state franchisors with franchisees in Texas in an effort to determine whether these franchisors (as well as other non-resident companies) are paying required franchise taxes. Although there have been efforts in the past to expand the definition of “doing business in Texas” to include licensing of intangibles in Texas, those efforts have, so far, failed. However, given the specific language regarding the applicability of the franchise tax to franchisors with no apparent limitation to franchisors that have a physical presence in the state, the lack of a broader “licensing nexus” component in the Texas law is of little comfort to non-resident franchisors with franchisees in Texas, particularly in the post-Geoffrey environment.

E. Florida

Florida’s rules regarding corporate income tax nexus were amended in 1994 and now provide that “[s]elling or licensing the use of intangible property [including trademarks or trade names] in Florida for taxable years beginning on or after January 1, 1994” constitutes “doing business” in Florida and will subject the licensor to Florida’s corporate income tax, regardless of where the licensor is based. In addition, companies that licensed the use of

54 34 Tex. Admin. Code § 3.546(c)(8); see also 34 Tex. Admin. Code § 3.554(d)(20).
trademarks to an entity in Florida and provided “management services,” including purchases of supplies, on-site inspections, and training seminars in Florida, are subject to Florida corporate income tax for all years the services were performed, even prior to 1994. Finally, the rules go on to specifically provide that “[c]onducting management training courses for franchises or affiliated corporations in the state” and “[r]egularly or systematically visiting franchisees or affiliated corporations in the state in order to advise on business matters” constitute “conducting business” in the state for tax nexus purposes.\(^{56}\)

These broad nexus rules position Florida to pursue out-of-state franchisors for corporate income taxes up to the constitutional limits.

F. South Dakota

South Dakota extends its sales and use tax to services.\(^{57}\) As a result, South Dakota is particularly aggressive about imposing sales tax on franchisors performing in-state services, which provides nexus, and the payment of royalties is not separately stated from the payment of service fees.\(^{58}\)

G. Hawaii

The Hawaii General Excise Tax (“GET”) is a privilege tax imposed “against persons on account of their business and other activities” in Hawaii. The GET is calculated by applying the tax rate to a taxpayer's "gross proceeds of sale, or gross income."\(^{59}\) For this purpose, gross income includes amounts received "from the sale of tangible personal property, or service, or both, and all receipts, actual or accrued . . . including interest, discount, rentals, royalties, fees, or other emoluments."\(^{60}\) Accordingly, the GET has a broader scope than most state sales and use taxes and extends to goods, services and other business activities (including royalties) that are not always taxed in other states.\(^{61}\)

The GET is intended to apply to payments made by Hawaii purchasers. In Tax Appeal of Baker & Taylor, Inc. v. Kawafuchi,\(^{62}\) an out-of-state corporation challenged the Hawaii

\(^{56}\) Id. at 12C-1.011(1)(r).

\(^{57}\) S.D. CODIFIED LAWS § 10-45-4.

\(^{58}\) See South Dakota Department of Revenue and Regulation, Franchise Operations, Tax Facts #165 (July 2007) (providing that "royalties or service fees paid by a franchisee strictly for the privilege of engaging in business using the franchiser’s name are not subject to sales or use tax. However, royalty fees are taxable if the franchiser provides services or tangible personal property with the payment of the royalty fee. When taxable services are included within the royalty fee, and not separately stated, the entire royalty payment is subject to South Dakota sales or use tax. Examples of taxable items that may be included with the royalty fee are training, accounting, and software."), available at http://www.state.sd.us/drr2/businesssax/publications/taxfacts/franchise.pdf.

\(^{59}\) HAW. REV. STAT. § 237-13.

\(^{60}\) See HAW. REV. STAT. § 237-3(a).

\(^{61}\) See Subway Real Estate Corp. v. Dir. of Taxation, 129 P.3d 528 (Haw. 2006) (noting that the tax "applies at all levels of economic activity . . .and to virtually all goods and services," and that in "enacting . . .(the GET), the legislature cast a wide and tight net").

\(^{62}\) 82 P.3d 804 (Haw. 2004).
Department of Taxation’s assessment of GET on the seller’s sale of books to the Hawaii state library. The seller claimed that title to the books transferred on the mainland and that, therefore, it was not subject to the GET. The court upheld imposition of the GET on the seller, noting that the GET is intended to apply to “sale proceeds that originate from purchasers in [Hawaii] regardless of whether the seller is an in-state or out-of-state company.”

However, nexus is still required to impose the GET on an out-of-state seller. Even though Hawaii asserts that the GET should apply to transactions that include a Hawaiian purchaser, Hawaii cannot disregard federal nexus constitutional principles that require a connection between the seller and the state of Hawaii in order to impose the tax on out-of-state sellers. (See discussion in Section III. above.) Hawaii’s GET nexus provisions are not clearly defined, but are sprinkled among various statutes and have been interpreted by numerous cases. For instance, HRS Section 237-13(9) provides that the GET applies to "every person engaging or continuing within [Hawaii] in any business, trade, activity, occupation or calling." HRS Section 237-2 further provides that business "includes all activities . . .engaged in with the object of gain or economic benefit."

In *In re Heftel Broadcasting Honolulu, Inc.*, the Hawaii Supreme Court examined the nexus issue as applied to an out-of-state licensor of films and telecast rights where the licensor had no physical presence in Hawaii. The court concluded that the presence and rental of the films in Hawaii constituted economic activity that was sufficient to meet Hawaii’s in-state business activity requirement. The court observed that such economic activity in Hawaii was evidenced by the fact that the intangible telecast rights "were wholly consumable and only consumable in Hawaii" and that therefore the licensing represented "the type of activity contemplated in the definition of 'Business'" in the Hawaii statute.

*Heftel* is of significant relevance to franchisors because it indicates that the Hawaii Supreme Court considers the presence of intangibles in Hawaii as a nexus creating activity, even where the licensor itself is outside of the state. The 1976 *Heftel* conclusion was rendered prior to the United State’s Supreme Court *Quill* decision in 1992. Since *Quill* made physical presence a prerequisite for nexus (at least with regard to nexus for sales and use tax purposes), a state revenue agency claiming nexus today against an out-of-state taxpayer based solely on the in-state presence of the taxpayer’s intangibles, would be highly questionable.

The *Baker & Taylor* decision, however, clearly establishes that the presence of in-state representatives will support a state’s nexus claim. In *Baker & Taylor*, the out-of-state seller in question was determined to have sufficient nexus with Hawaii for GET purposes. The seller had no office in Hawaii, but was active with regard to its in-state sales efforts and contacts with its Hawaii customers. The seller provided software (which it continued to own) and software training to its customers to assist the customers in purchasing the seller’s products. In addition, over a five year period, between one and four of the seller’s employees made eleven separate visits to Hawaii to meet with customer representatives. The court found this level of solicitation activity to be sufficient to establish nexus with Hawaii and subject the seller to GET.

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63 *Id.* at 816.

64 554 P.2d 242 (Haw. 1976).

65 *Id.* at 246-47.

66 *Supra* note 56.
on its gross receipts from sales to Hawaii purchasers. Accordingly, franchisors should be mindful that even the temporary presence of employees or independent contractors in Hawaii acting on the franchisor’s behalf, could create GET liability.

H. Washington

Washington recently enacted legislation that makes the taxation of royalties received by an out-of-state recipient from a Washington payor, more likely.67 Under prior law for Washington Business and Occupations (“B&O”) Tax purposes, royalties in the form of license fees were allocated to the state of the licensor’s commercial domicile. This meant that royalties paid by a Washington franchisee to an out-of-state franchisor were not subject to Washington B&O tax.

The new legislation, however, requires the royalties to be allocated to the state where the customer used the taxpayer’s intangible property that generates the royalty.68 Accordingly, income from royalties become subject to the B&O tax as of June 1, 2010, to the extent that (i) the royalties are paid by a Washington franchisee for the rights to use intangible property in Washington, and (ii) the licensor has Washington nexus.69 The royalty tax rate of .484% remains unchanged from prior law.70

I. Other States Pursuing Non-Resident Franchisors

A number of other states have been particularly aggressive in their tax collection efforts with respect to non-resident franchisors and licensors and their nexus definitions. For example, for many years Massachusetts’s Department of Revenue has actively enforced its corporate income tax laws against out-of-state companies. The corporate nexus rule in the state is so broad that it arguably covers virtually every franchisor that has franchised outlets in Massachusetts by providing that “[s]upervising the operations of a franchisee or similar party” will be considered engaging in business in the state, unless such activity is de minimis.71

New Jersey subjects companies that are either “doing business, [or] employing or owning capital or property . . . in this State” to the Corporation Business Tax.72 The New Jersey courts have been particularly active in interpreting the nexus provisions of the New Jersey corporate tax statute. In the seminal Lanco case discussed in Section III.B.1 above, the New Jersey Supreme Court affirmed the appellate court’s decision that companies with no physical presence in the state may be subject to the Corporation Business Tax if they derive

67 See S.B. 6143, supra note 2.
68 See id. at § 105(3)(b)(i).
69 See id. at § 1702. Nexus is created in Washington if among other things, the out-of-state royalty recipient has more than either $50,000 of property in Washington, $50,000 of payroll in Washington or $250,000 of annual receipts from Washington payors, or at least 25% of its total property, payroll or receipts are from Washington sources. Although the new royalty allocation rules are effective as of June 1, 2010, the nexus thresholds for purposes of determining the treatment of receipts on June 1, 2010, and thereafter are measured by taking into account property, payroll and sales for all of 2010. See §§ 103 and 104(1)(c).
70 See WASH. REV. CODE § 82.04.2907.
71 830 MASS. CODE REGS. 63.39.1(5)(d)16.
income from licensing intangible property to entities in the state. Accordingly, the court effectively adopted an economic presence nexus standard for New Jersey.\textsuperscript{73} Lanco and subsequent New Jersey cases that follow Lanco’s lead open a wide door for New Jersey tax collectors to pursue non-resident franchisors.

Finally, West Virginia has followed New Jersey in rejecting a physical presence standard and adopting an economic presence standard with respect to the application of corporate income tax to out-of-state companies.\textsuperscript{74} In a lengthy decision issued by the West Virginia Office of Tax Appeals in early 2010, the Office of Tax Appeals followed Geoffrey and its progeny by holding that the application of the state’s franchise and corporate income tax to a non-resident entity that licensed the use of its trademarks to an entity in West Virginia, which then sold the trademarked products to customers in West Virginia, does not violate the Due Process Clause of the U.S. Constitution because the licensor “has minimum contacts with the State of West Virginia and the tax is rationally related to values connected with the taxing State” and does not violate the Commerce Clause of the U.S. Constitution since the taxpayer has a “substantial nexus” with the state, the “tax is fairly apportioned to the State of West Virginia, the “tax does not discriminate against interstate commerce”, and the “tax is fairly related to the benefits provided by the State.”\textsuperscript{75}

V. WHAT DOES THIS MEAN TO A FRANCHISE SYSTEM AND WHAT CAN BE DONE ABOUT IT?

The trend is clear: spurred by budget woes, pro-tax court rulings and the silence of the U.S. Supreme Court on important nexus issues, the states have become emboldened and are reaching as far as (what they view are) the constitutional limits to impose taxes on companies that have any degree of economic contact with the state. What this means to franchise systems is that, without significant judicial or legislative intervention to reverse the course of many state taxing authorities, franchisors will inevitably be faced with greater state tax burdens going forward. The question of what can be done does not have a straightforward answer.

A. Become Educated and Don’t Ignore this “New Reality”

First and foremost, franchisors must recognize and account for these new (and expanding) state tax liabilities in their day-to-day operations and strategic planning. Understanding (i) the state tax landscape in the states in which the franchisor has franchisees or in which it intends to expand, (ii) whether changes to the franchisor’s methods of operation can eliminate or minimize tax liability in particular states, and, ultimately, (iii) how state taxes affect the bottom-line, are all critical aspects of the franchise relationship.

Ignoring these issues and/or failing to respond to state tax authorities’ inquiries, including nexus questionnaires, will only result in bigger problems in the future, including accumulating tax liabilities and interest and penalties on those amounts or state action against the franchisor, such as the imposition by state tax authorities of levies on the franchisor’s bank accounts.


Having competent tax and legal advisors (internally and/or externally) is an important aspect of planning and implementing franchisors’ state tax strategy and is critical in the context of resolving issues and disputes with the states when they arise.

B. Contract Modifications and Business Solutions

Many modern franchise agreements contain a little-used provision commonly referred to as a “tax gross-up” clause which requires the franchisee to “gross-up” payments to the franchisor so that the franchisor receives the full amount that it was entitled to receive under the franchise agreement, before taxes. The inclusion and enforcement of this type of provision may effectively shift the tax liability imposed by the states back to the franchisee. As taxation of out-of-state franchisors becomes more prevalent, tax gross-up provisions will likely be an increasingly important tool for franchisors to use in order to preserve the economics of the franchise system.

Another potential approach is for franchisors to marginally increase the royalty rate payable by franchisees located in states that impose taxes on out-of-state franchisors or include a royalty “escalator” clause that is triggered in the event that the state in which the franchisee is located begins taxing payments by the franchisee to the franchisor.

Other potential remedies may be state specific. For example, a franchisor risks increasing its Washington tax burden to the extent it negotiates and pays for third party services for its Washington franchisees and is then reimbursed for the cost of such services from the franchisees. Since Washington’s B&O tax is based on gross receipts, such reimbursement could be included in the franchisor’s taxable base although the service is actually performed for the franchisee. A potential approach to minimize the adverse tax consequences of such an arrangement requires careful consideration of Washington’s agency laws and perhaps the corresponding inclusion of specific provisions in the governing documents to indicate that the franchisor’s role in procuring the service is that of an agent on behalf of the franchisees.

Obviously, although the approaches discussed above may preserve the economics of the franchisor’s business, shifting the tax liability to the franchisee will affect the franchisee’s bottom line. It is for that reason that some franchisors elect to take on the responsibility of paying state taxes in order to protect unit economics, while other franchisors may agree to “share the pain” with its franchisees by implementing a limited tax gross-up requirement or an increase in royalty rates which cover only a portion of the state tax liability.

Of course, in the states that take a more conservative approach to taxing out-of-state companies by applying the more traditional physical presence standard with respect to nexus questions, franchisors may avoid creating a tax nexus by carefully managing their activities within those states’ borders. For example, the franchisor may implement procedures whereby all pre-sale activities (e.g., “discovery days”), all franchise agreements are executed, and all training and ongoing consultation is provided outside of the relevant state. This is, however, very likely easier said than done in most franchise systems.

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76 An example of a simple tax gross-up provision follows: “If any amount to be paid or reimbursed under this Agreement to Franchisor, or any of its Affiliates, is subject to state gross receipts or other state income tax, then Franchisee must pay or reimburse an additional amount to Franchisor or to such Franchisor Affiliate, as the case may be, so that the amount actually received by Franchisor or its Affiliates after such deduction, payment or withholding will equal the full amount stated to be payable or reimbursable under this Agreement.”
While the franchisor of a home-based internet consulting business in which training can be provided and franchisee performance can be measured remotely online, for example, may find limiting its physical presence in its franchisees’ home states feasible, a restaurant, hotel, or retail store franchisor may find limiting its physical presence in states other than its own almost impossible. In fact, many franchisors’ franchise agreements require them to provide on-site support to their franchisees and the failure to do so could constitute a breach of the franchise agreement. Even if the franchise agreement does not require on-site visits, most franchisors must, at a minimum, visit franchisee locations on a regular basis to conduct inspections and evaluate franchisees’ performance as part of quality assurance efforts.

C. Negotiation with States

1. Participation in Regulation Drafting and Interpretation

Although the die appears to be cast in a number of states with respect to their implementation of a liberal economic presence nexus standard, there are still many states that are not as far down this road . . . yet. Therefore, front-end efforts by industry leaders and trade organizations to influence tax policy and regulations adopted by state tax authorities can reap real and lasting benefits to franchisors.

Involvement in these activities can range from participation in regulation drafting by providing formal comments and suggested changes on proposed regulations to state tax regulators during public comment periods to more informal opportunities to educate tax authorities on the impact of policies, such as serving on committees in which state tax regulators may be involved or drafting papers or speaking on panels at tax law and industry conferences with state regulators. The key to having a positive impact on rule-making processes and interpretation is to develop strong professional relationships (and build credibility) with state tax authorities so that the concerns expressed are taken into account and, hopefully, addressed.

The International Franchise Association is a good example of a trade organization that has been actively working to effect fair and pro-business tax policy at the state level.

2. Conferences with Revenue Agency Staff

Legal staff at state revenue agencies are oftentimes very helpful when a question of interpretation of a particular provision of a state tax code or related regulations or policy statements are raised. Maintaining good relationships with revenue agency staff members can lead to productive dialogue and, ultimately, positive resolution of questions of interpretation of particular provisions. Even if the staff member takes a position that is inconsistent with the taxpayer’s/franchisor’s position, it can be very helpful to understand the position and rationale of the taxing authority on a particular issue from the perspective of staff since that perspective is often not available through public sources.

If a specific issue related to a franchisor’s tax liability arises, staff are oftentimes empowered to negotiate an acceptable resolution to the matter. Examples of negotiated resolutions include limiting the “look-back” period for calculating tax liability or waiving or reducing accrued penalties and/or interest. Obviously, the history of the franchisor with respect to compliance with tax and other laws of the state, the amount of tax liability and the particular circumstances resulting in the tax liability, the credibility of the individual
3. **Voluntary Disclosure Agreements**

Many states make available to taxpayers (including out-of-state franchisors) the opportunity to enter into agreements under which accrued tax liabilities are settled if the taxpayer voluntarily discloses income from the state. Under these voluntary disclosure agreements, the state may agree to reduce or waive penalties and interest in consideration of the voluntary disclosure, full payment of the accrued taxes, and an agreement by the taxpayer to pay applicable taxes in the state on a timely basis going forward.

The obvious policy underlying these types of settlements is to maximize tax revenue by encouraging delinquent taxpayers to come forward while reducing the tax agency’s expenses to collect the taxes. In the current environment of state budgets being cut to the bone and the dire need to raise revenue, there is strong incentive for state tax agencies to enter into tax settlements of this nature. Franchisors that know (or suspect) that they have state tax liability may be well-advised to consider “coming clean” with states and seek a favorable settlement of accrued taxes.

4. **Tax Amnesty**

Another method in a state’s multi-pronged arsenal of generating immediate revenue is through an amnesty program. Such programs have become popular in recent years. In 2009, tax amnesty was offered in one form or another in Alabama, Arizona, Connecticut, Delaware, Hawaii, Louisiana, Maine, Maryland, Massachusetts, New Jersey, North Carolina, Oregon, Tennessee, Vermont and Virginia. The District of Columbia, Massachusetts, Florida, New Mexico, Nevada, New York and Pennsylvania featured tax amnesty programs in 2010. Amnesty terms vary from state to state but generally feature some sort of penalty and/or interest abatement for taxpayers who voluntarily come forward and declare prior unreported tax liabilities.

**VI. WHAT’S NEXT? BATSA AND FEDERAL RESPONSE**

Legislation which would clarify the states’ rights with respect to taxation of out-of-state companies has been introduced for several years. Most recently, Representative Rick Boucher (D-VA) introduced the Business Activity Tax Simplification Act of 2009 (H.R. 1083) on February 13, 2009. H.R. 1083 is co-sponsored by a bi-partisan group of 25 representatives and is similar to legislation introduced in previous Congresses.

If passed, H.R. 1083 would define nexus as a physical presence in the state and would prohibit states imposing net income and other business activity taxes on an out-of-state company unless that company has a physical presence in the state. The bill defines physical presence to include the following (and only the following): (a) being an individual physically in, or assigning one or more employees to be in, the state; (b) using the services of an agent (excluding an employee) to establish or maintain the market in the state, if the agent does not perform business services in the state for any other person during the relevant taxing year; or (c) leasing or owning of tangible personal (excluding leasing or licensing of computer software) or real property in the state. Being physically present in the state for less than 15 days in a
taxable year or presence in the state to conduct limited or transient business activity is considered *de minimis* physical presence, and, therefore, does not constitute “physical presence” for purposes of the bill.

In June 2006 the House Judiciary Committee sent a previous bill that was similar to H.R. 1083 to the House floor for debate. That bill was summarily removed from floor consideration after a number of state governors voiced opposition to the measure citing estimates of foregone revenue that would result if the bill became law. As a result of several high-profile legislative priorities during the 111th Congress, including, economic recovery legislation in 2009 and health care and financial reform in 2010, H.R. 1083 has, similarly, seen little action. The last major action on the bill was in March 2009 when it was referred to the House subcommittee on Commercial and Administrative Law. It is highly unlikely that H.R. 1083 will advance any further given that the 111th Congress ends on January 3, 2011 and Congress appears to have its plate full.

Legislation like H.R. 1083 would encourage fairness in state taxation of interstate commerce and provide franchisors with consistency and predictability on these matters which can have a significant effect on the bottom line of franchisors and franchisees alike. Therefore, the passage of such legislation at the federal level should be a priority of the franchise community.

**VII. CONCLUSION**

Franchisors must acknowledge the states’ continuing efforts to expand their reach outside of their own borders in an effort to increase revenue, and franchisors must also understand the impact of potential additional state tax liabilities on their own businesses and the businesses of their franchisees. Complying with current state tax law, while, at the same time, working to promote fair (and constitutional) state tax policies are important aspects of any franchisor’s strategy to address aggressive forms of state taxation.
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