**Franchise Law Alert**

Recent developments in franchise law

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**United States Supreme Court refuses to review Iowa assessment of income taxes on royalty payments made by Iowa franchisees to out-of-state franchisor**

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On October 3, 2011, the United States Supreme Court denied a petition for certiorari in *KFC Corp. v. Iowa Department of Revenue*. As a result, Iowa’s imposition of income taxes on out-of-state franchisors will continue and likely result in other states doing the same. While the implications for franchisors will depend on their particular corporate structures and where their franchisees are located, this could mark an important change in the economic relationship between franchisors and franchisees throughout the United States.

**History of state efforts to collect taxes from out-of-state companies**

In 1967, the U.S. Supreme Court decided the case of *National Bellas Hess, Inc. v. Department of Rev. of Ill.*, 386 U.S. 753, which addressed whether Illinois could require an out-of-state mail order business to collect sales taxes from its Illinois purchasers. Relying upon the Commerce Clause of the United States Constitution, the Court created a bright-line test requiring businesses have a “physical presence” in a state to be subject to any tax obligation. As the mail order business in *National Bellas Hess* had no physical presence in Illinois, it could not be required to collect sales tax from its Illinois customers.

The Supreme Court reaffirmed the physical presence requirement 25 years later in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *Quill* rejected a challenge to the physical presence requirement based on purposeful availment of a state’s market and instead focused on businesses’ “settled expectations” since *National Bellas Hess*. Relying on those settled expectations, the Court once again held that companies could not be subject to a state’s taxes absent a physical presence there.

Following *Quill*, many non-franchise companies established Intangible Holding Companies (“IHC”) for their intellectual property as a means to avoid state taxation. Operating businesses would pay “royalties” to an IHC which generated tax deductions for the operating business while the income received by the IHC was not subject to tax. Many states rejected these constructs and adopted the concept of “economic nexus” to satisfy the physical presence requirement—arguing that actual physical presence was required only in sale and use tax cases.
In 2001, Iowa assessed KFC for three years of unpaid corporate income taxes, interest and penalties based on the royalties KFC received from its Iowa franchisees. This appears to be the first time a state utilized the economic nexus theory to satisfy the physical presence requirement for a franchise system. KFC challenged the assessment, and in 2010, the Iowa Supreme Court approved the application of economic nexus to franchise systems, while “recogniz[ing] that a counterargument could be made that aggressive judicial intervention is required to prevent states from shifting tax burdens onto out-of-state parties who lack political power in the taxing jurisdiction.” 792 N.W.2d 308, 327 (2010). On October 3, 2011, the Supreme Court refused to review the Iowa Supreme Court’s decision.

What will happen next?

State tax authorities will likely interpret the Court’s refusal to review the Iowa Supreme Court’s decision as blessing application of the economic nexus theory to franchise systems. This will lead to more states applying the economic nexus theory to the franchise industry and increased enforcement against franchisors, including assessments and auditing of out-of-state franchisors with in-state franchisees.

What new obligations and costs will this impose on franchisors?

While the immediate consequences of the Supreme Court’s decision are limited to franchisors with franchisees in Iowa, as more states adopt Iowa’s approach, franchisors will be expected to file income tax returns in all states where their franchisees are located. This will likely lead to: (i) increased compliance costs, e.g., tax return preparation costs; (ii) retroactive tax, interest and penalty assessments with no statute of limitations protection; (iii) increases in total state income tax obligations; and (iv) possible double taxation of royalties due to their being taxed twice by different jurisdictions. Franchisors operating through an S corporation or other flow-through entity that are located in states with low income tax rates are also likely not to receive a dollar-for-dollar credit for income taxes paid to other jurisdictions. Franchisors taxed as C corporations could have double tax resulting from the application of formulary apportionment where state rules differ in the sourcing of revenue.

Recommendations for franchise companies

While it will likely take some time for the impact of the Iowa decision to filter through the states, franchisors should consider taking steps now to minimize its impact. First, franchisors may consider retaining counsel well versed in economic nexus and franchising to litigate the issue in states outside of Iowa. Second, franchisors can alone or together lobby the federal government to end the states’ ability to assert the economic nexus theory by adopting the Business Activity Tax Simplification Act or other legislation. Third, franchisors may retain counsel to seek voluntary disclosure or amnesty deals with states to “come clean” and begin filing tax returns prospectively in exchange for limiting exposure to past tax obligations and abatement of penalties. Regardless of which, if any, of these steps franchisors undertake, they should consult with their tax advisors to alert them to this development and consider changing their standard franchise agreement to address this new development.
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Click here to view an online recording of our recent webinar on this subject, entitled “New Developments in Franchisors’ Potential Liability for State Income Taxes.”