



One Minute Memo®

Franchisor With “Economic Presence” In Iowa, But No Physical Presence, Is Held Liable For Iowa Income Tax On Franchise Fees

The Supreme Court of Iowa recently upheld the State Department of Revenue's assessment of \$285,000 in corporate income tax, penalties and interest against franchisor KFC Corporation, even though KFC has no corporately-owned stores, no real or personal property, and no employees in Iowa, and *neither does any KFC corporate affiliate*. The taxable income consisted of royalty and license payments sent by franchisees in Iowa to KFC out of the State. *KFC Corp. v. Iowa Dep't of Rev.*, No. 09-1032 (Iowa Sup. Ct., Dec. 30, 2010). The Iowa Court's decision appears to be the first case upholding a state tax levy on revenue derived from intangible property used in a place where neither the recipient nor any corporate family member maintains a place of business.

Kentucky-based KFC has franchise agreements with 3,400 restaurant owners nationwide. Franchisees pay franchise fees and allow KFC to control the nature and quality of products sold under trademarks as well as menus, advertising and physical facilities. The company also owns more than 1,000 stores throughout the U.S. but none in Iowa. The Iowa Supreme Court held that Iowa may tax franchise fees paid by Iowa franchisees to the out-of-state franchisor despite KFC's contention that the tax violated the U.S. Constitution's Due Process and dormant Interstate Commerce Clauses. The Court determined that Due Process was not offended because KFC's trademarks and trade name are used in the course of regular business activity in Iowa, and KFC benefits from the State's economic climate. Further, the Court said that there was no undue burden on interstate commerce since the tax was based on the in-state use of KFC's intangible property (an Iowa statute expressly provides for taxation of income resulting from “intangible property . . . having a situs in the state”).

The Court distinguished *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which invalidated North Dakota's assessment of a use tax, a close relative of the sales tax, against a corporation that had intellectual property but no physical presence in the State. *Quill* was said to be inapposite because it involved assessment of a tax imposed on each retail transaction with a customer. The Iowa Court deemed sales and use taxes to be markedly different from an income tax which is assessed on revenue belonging to the recipient.

The Iowa Supreme Court found persuasive the ruling of its South Carolina counterpart in *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993). In *Geoffrey*, the Court rejected Due Process and Interstate Commerce clause challenges to the imposition of South Carolina corporate income tax on royalty payments made by Toys R Us, Inc. to its second-tier subsidiary, Geoffrey, Inc. Geoffrey, Inc., a Delaware corporation that owned the Toys R Us trademark and trade name, had no physical presence in South Carolina, but its Toys R Us, Inc. corporate affiliate owned and operated many stores there. The South Carolina Court reasoned that, despite the absence of a physical presence, Geoffrey Inc.'s intangible property acquired a “business situs” in South Carolina where local businesses affiliated with Geoffrey, Inc. regularly

engaged in exploitation of South Carolina markets. The Court was also influenced by the fact that Delaware -- Geoffrey, Inc.'s home state -- has no corporate income tax and, therefore, South Carolina is the only State where royalty payments made to Geoffrey, Inc. might be subject to such a tax. Relying on *Geoffrey*, the *KFC* Court apparently was unimpressed with the facts that Geoffrey Inc.'s licensees in South Carolina were corporate affiliates of the licensor, whereas *KFC's franchisees in Iowa had no corporate affiliation with the franchisor*. The *KFC* Court did not say whether Kentucky taxes corporate income.

A number of other decisions feature at least some similar facts to, and reached the same result as in, *Geoffrey*. These include cases from Louisiana (also taxing Geoffrey, Inc.'s royalty income); Maryland (imposing state corporate income tax on royalty payments made by Talbots, owner-operator of retail stores in Maryland and elsewhere, to its wholly-owned Delaware subsidiary -- which had no place of business in Maryland -- in exchange for a license to use the Talbots trade name and trademarks; the same court announced the same decision as *Geoffrey* and *KFC* in a case involving an out-of-state wholly-owned subsidiary of Maryland retailer Syms); Massachusetts (disallowance of tax deductions taken for Syms' royalty income payments to an out-of-state wholly owned subsidiary); New Jersey (corporate business tax imposed on a Delaware corporation that licensed the Lane Bryant trademarks and trade name to its affiliate operating retail stores in New Jersey); North Carolina (a similar scenario involving imposition of corporate franchise and income taxes on The Limited's out-of-state affiliated holding companies which licensed The Limited's operation of 130 retail stores in North Carolina); New Mexico (income tax imposed on K-Mart's wholly-owned Michigan subsidiary which licensed the parent company to operate stores in New Mexico); and Oklahoma (also taxing Geoffrey, Inc.'s royalty income). Certiorari petitions to the U.S. Supreme Court were denied in a number of these cases, but the Court might accept the Iowa decision for review, if asked, because of its extended and seemingly unprecedented reach.

A result similar to the one in Iowa and the other decisions noted above was reached by a Washington appellate court which upheld the City of Seattle's imposition of a gross receipts tax on wholesale automobile sales by General Motors and Chrysler to car dealers in Seattle even though neither manufacturer had physical assets in the city. However, the automobile manufacturers personnel made regular trips to Seattle.

An appellate court in Tennessee struck down as unconstitutional the imposition of franchise and excise taxes on fees and interest received from Tennessee holders of Visa and MasterCard credit cards by an out-of-state bank without a physical presence in the State. Subsequently, however, Indiana and West Virginia appellate courts reached the opposite result on similar facts.

As governmental bodies (cities as well as states) scramble to find new sources of revenue, franchisors like KFC and other licensors of intellectual property receiving fees and royalties probably can expect income tax assessments regardless of whether the franchisors or licensors have tangible assets or employees in the jurisdiction imposing the taxes. If the income tax assessments are challenged, state courts -- which tend to be favorably inclined toward their states' taxing bodies -- are most likely to approve taxation, especially where there is a corporate affiliation between the payor and the recipient and/or where the recipient has benefitted from extensive and regular business activities within the taxing jurisdiction.

Franchisors (and licensors) need to consider the likely impact of the *KFC* decision and reasoning on their operations in Iowa and, potentially, in other states.

Please contact members of Seyfarth Shaw's Franchise Law team -- Lou Chronowski, Andrea Okun, and Paul Freehling -- if you have any questions about this or any other franchise law issue.

Note - The following are citations to cases mentioned above but without cites given:

A & F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005)

Bridges v. Geoffrey, Inc., 984 So.2d 115 (La. Ct. App. 2008)

Classics Chicago, Inc. v. Comptroller of the Treasury, 189 Md. App. 695, 985 A.2d 593 (2010)

Comptroller of the Treasury v. Syl, Inc., 375 Md. 78, 825 A.2d 399, *cert. denied*, 540 U.S. 984 (2003)

General Motors Corp. v. City of Seattle, 107 Wash. App. 42, 251 P.3d 1022 (2001)

Geoffrey, Inc. v. Commissioner of Rev., 453 Mass. 17, 898 N.E.2d 87 (2009)

Geoffrey, Inc. v. Oklahoma Tax Comm'n, 2006 Ok. Civ. App. 27, 132 P.3d 632 (2006)

J.C. Penney Nat. Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000)

KMart v. New Mex. Tax. & Rev. Dep't, 189 N.Mex. 177, 131 P.3d 27 (2001)

Lanco, Inc. v. Director, Div. of Tax., 379 N.J. Super. 562, 879 A.2d 1234 (2005), *aff'd*, 188 N.J. 380, 908 A.2d 176 (2006), *cert. denied*, 127 S.Ct. 2974 (2007)

MBNA Amer. Bank, N.A. v. Indiana Dep't of State Rev., 895 N.E.2d 140 (Ind. Tax Court 2008)

Syms Corp. v. Commissioner of Rev., 436 Mass. 505, 765 N.E.2d 758 (2002)

Tax Comm'r v. MBNA Amer. Bank, N.A., 220 W.Va. 163, 640 S.E.2d 226, *cert. denied sub nom.*

FIA Card Services N.A. v. Tax Comm'r, 551 U.S. 1141 (2007)



Breadth. Depth. **Results.**

www.seyfarth.com