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Iowa Tax Case Could Cost Nation's Franchises

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Franchisors should also expect the impact of the decision in KFC Corp. to extend beyond Iowa.

By Bruce A. Ackerman and Adam B. Thimmesch

The Iowa Supreme Court in late May heard oral arguments in *KFC Corp. vs. Iowa Department of Revenue*, a case that could have a substantial financial impact on franchisors across the nation.

Iowa asserted that KFC is subject to the state's corporate income tax based solely on the fact that it received royalties from franchisees in Iowa. The state cited *Geoffrey v. South Carolina Tax Commission* and related cases in support of its position. However, a victory by the state would represent an extension of those cases because KFC involves licensing agreements between unrelated parties.

The KFC case could result in a landmark decision for states attempting to impose income tax on out-of-state franchisors and other similarly situated taxpayers.

Background on State Tax Nexus

Historically, many franchisors have reported and paid income taxes only in states in which they have a physical presence. This practice is based on a 1992 U.S. Supreme Court case, *Quill Corp. v. North Dakota*, which held that the Commerce Clause of the United States Constitution barred states from imposing a use-tax collection obligation on out-of-state corporations that had no physical presence in the taxing state. The court held that such corporations did not have the "substantial nexus" with the state that was required under the Commerce Clause.

Since *Quill*, many state taxing authorities have argued that the physical-presence requirement enunciated in that case applied only to state sales and use taxes. Taxpayers, on the other hand, have read *Quill* to apply to state income taxes as well.

The first major case to address these conflicting interpretations was *Geoffrey*, which was decided by the S. C. Supreme Court in 1993, shortly after the *Quill* decision. In *Geoffrey*, the S. C. high court sided with the state in a case involving the licensing of trademarks by a licensor to a related licensee. The *Geoffrey* court held that the U.S. Constitution did not prevent the state from imposing income tax on an out-of-state licensor whose only connection with the state was the receipt of royalties from its subsidiary for use of its intangible property in the state.

A number of state courts have decided cases that are similar to *Geoffrey* since 1993, including several in recent years. The vast majority of those cases have been decided in favor of the state taxing authorities, and the U.S. Supreme Court has repeatedly declined taxpayer requests to review those decisions. This, in turn, has led state taxing authorities to become increasingly

aggressive in asserting nexus over out-of-state entities.

KFC Corp. v. Iowa Department of Revenue

In June 2009, an Iowa District Court upheld the state's imposition of tax on KFC based on its receipt of royalties from franchisees in the state. The court held that the Commerce Clause of the U.S. Constitution did not require a taxpayer to have a physical presence in Iowa to establish a "substantial nexus" in the state for purposes of corporate income tax. The district court cited to the Geoffrey line of cases to support its decision. KFC appealed the district court's decision to the Iowa Supreme Court, which, following the submission of briefs by KFC and the state, heard oral arguments in the case in May.

The overall tone of the Iowa Supreme Court in the oral arguments was one of skepticism as to KFC's claim that Quill should control its analysis. The court specifically highlighted Quill's less-than-enthusiastic adoption of the physical-presence test. In turn, KFC pointed out that the Quill court did evaluate and affirm the adoption of that test and that Quill is the U.S. Supreme Court's latest ruling on this topic.

The court stated that it struggled with the notion that the Commerce Clause protected KFC from taxation in the state even though KFC earned significant income in Iowa that was dependent upon the state's provision of protections and benefits to its franchisees (e.g., roads, courts, etc.). KFC responded by arguing that those indirect benefits were received by many out-of-state (or out-of-country) entities whose products or customers happened to be sold or located in Iowa. According to KFC, if the court applied that type of indirect-benefit analysis, "everyone would be taxable everywhere."

Throughout its arguments, KFC forcefully argued that Quill should apply to Iowa's corporate income tax and that the Geoffrey line of cases had been improperly decided. KFC thus urged the court to follow the pragmatic result reached in Quill and to reverse the decision below.

During the state's argument, the court asked it to respond to KFC's assertions that a ruling in the state's favor would require a wide range of out-of-state entities and individuals with little or no connection to Iowa to pay taxes in the state. The state responded merely by commenting that other potential applications of the decision were not before the court and declined to opine as to how far it could assert nexus under its reading of the Commerce Clause. The state appeared content to rely on the Geoffrey line of cases during its argument.

It is difficult to determine how the court will decide the case based solely on the oral arguments. The court seemed hesitant to accept that KFC could be exempt from Iowa tax merely because it did not have a physical presence in the state. However, KFC continually reminded the court of the immense difficulties that abandoning Quill could create for taxpayers across the nation.

What's next for Franchisors?

The Iowa Supreme Court's determination in the KFC case will significantly affect franchisors (and other taxpayers) across the nation regardless of its result. If the case is decided adversely to KFC, franchisors with franchisees in Iowa may face aggressive enforcement actions by the state to collect income taxes (including interest and penalties) from the franchisors for prior years. If a

franchisor has not been filing returns in the state, it could be liable for taxes going back as many years as it has had franchisees located in the state. The Department of Revenue could also adopt a shorter look-back period, but that is unknown at this time.

Franchisors should also expect the impact of the decision in *KFC Corp.* to extend beyond Iowa. Other states will likely aggressively pursue collection actions against franchisors—if they are not already doing so—if Iowa is successful with this case. Franchisors should consider how they will handle such actions and whether they wish to be proactive in reaching out to state taxing authorities before they are contacted. Many states have voluntary disclosure programs pursuant to which taxpayers can limit the number of years of exposure and potentially limit interest and penalties on any underpayments tax.

On the other hand, if *KFC Corp.* is decided favorably for the company, the case may discourage actions by other states against out-of-state franchisors. The *Geoffrey* line of cases would then be easily distinguishable by franchisors and states may be reluctant to take an aggressive stance in light of that decision. Franchisors should keep in mind, however, that other states will not be bound by *KFC Corp.* and other state taxing authorities may attempt to obtain a more favorable ruling in their state courts. Further, states with *Geoffrey* decisions already on the books will likely view *KFC Corp.* as immaterial to their own taxing authority.

Practice Tips

- This issue is not going away. States across the nation are facing budget shortfalls and are looking for ways to increase revenue without raising tax rates. Franchisors should consider whether they should be proactive in addressing this issue with states (and potentially limiting their liability) or waiting to see if and when states approach them.

- States may approach this issue in different ways. *KFC* involved an attempt by the State of Iowa to collect tax directly from a franchisor. Other states may take different approaches. For example, California has been pursuing the collection of taxes it claims are owed by out-of-state franchisors by requiring their California franchisees to withhold the tax from the license fee payments that they make.

- Consider availability of state tax credits. Franchisors that are structured as sole proprietorships, partnerships, LLCs or S corporations may have less exposure than C corporations to double taxation of their license royalty fee income. The owners of those types of entities may be eligible to receive a credit in their home state for taxes (but not interest and penalties, if any) that they paid to other states. (In the case of C corporations, similar credits are generally not available.) Franchisors should determine the existence of such a credit when evaluating whether to make a voluntary disclosure to a state about paying any back-taxes that they might owe. This factor may be especially important if the taxing state's "look-back" period is approximately the same as the number of years for which a home-state credit is available.

- Consider adding tax gross-up language to franchise agreements. A tax gross-up provision is one that is structured to compensate a franchisor, in whole or in part, for the taxes that it pays in states in which its franchisees are located. In effect, the gross-up language states that the franchisee is responsible for paying a higher license royalty payment to compensate the

franchisor for the taxes that it must pay to the state(s) in which the licensee operates.

- The complexity of state-tax issues and the lack of conformity among states on those issues can make the area of state taxation a particularly difficult area to navigate. However, with expanding tax enforcement, state taxes could have a material impact on a franchisor system's bottom line. Addressing those issues proactively through planning (e.g., implementing gross-up provisions, evaluating voluntary disclosures, evaluating nexus positions, etc.) can help bring some certainty, allowing franchisors to get back to the business of franchising.

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