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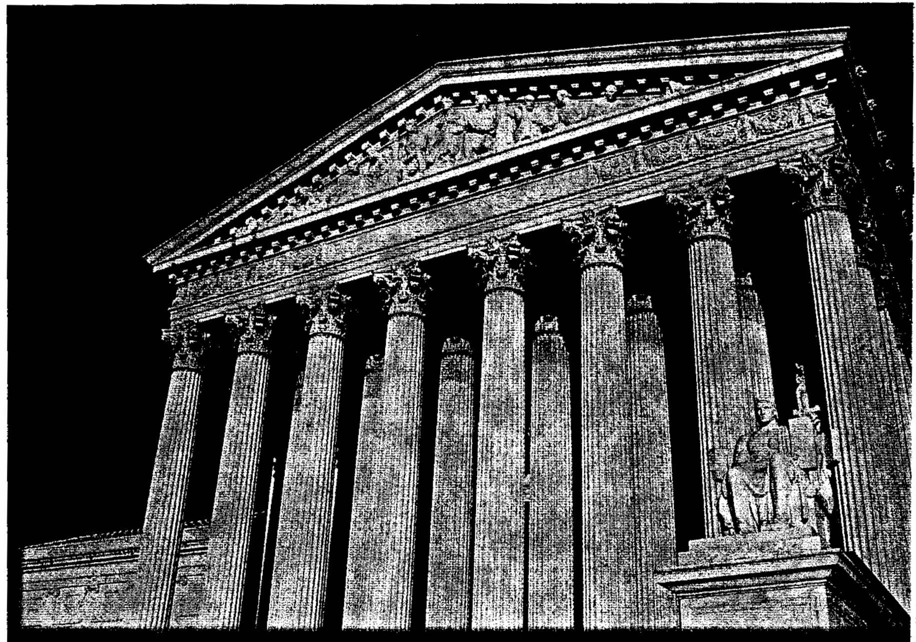
Nexus Goes to Washington

As this edition of *Franchising World* went to press, the International Franchise Association filed an amicus (friend of the court) brief in support of Supreme Court review in A&F Trademarks v. State of North Carolina as cited in this article.

By Bruce S. Schaeffer



Victoria's Secret wants to appear before the U.S. Supreme Court to strip off its tax liability. As reported by publisher CCH Inc., on June 2, 2005, Limited Brands, the owner of Abercrombie & Fitch and Victoria's Secret, filed a petition for certiorari in A&F Trademark.

The question presented: "Whether Quill Corp. v. North Dakota's Commerce Clause nexus test forbidding taxation in the absence of physical presence applies to all state taxes...or...whether the rule only applies to State sales and use taxes."

Two issues may affect tax costs to franchisors and licensors: whether or not the operation of a franchisee in a particular state constitutes tax "nexus" for the franchisor; and whether or not royalties paid by company-owned units can be deducted for state and local tax purposes.

The nexus issue is of overwhelming importance to state and local tax authorities because of the size of the revenue loss. The state of Louisiana recently argued that "similar tax schemes are robbing the state of 42 percent of its corporate income tax base."

Every licensor and franchisor that derives out-of-state revenues should address the problem prospectively. And, because the statute of limitations does not begin to run until a tax return is filed, some non-filers could be liable for many prior years with interest and penalties.

Methods

Here are three recently challenged nexus structures.

Geoffrey Method

This structure was described by one angry judge as follows:

First, a corporation creates a separate person in a state that does not tax that person's income. Second, the [taxpayer] assigns the patent or trademark to the new person, essentially for free. Third, the [taxpayer] agrees to pay the new "person" royalties for use of the patent or trademark.

This new "person"—which received the patent or trademark rights for free—then claims that it has no connection with [the taxing state] and owes [the taxing state] no tax on the income it derived from [its] sales in [the taxing state]....This certainly is clever, but [the result] is absurd.

In both Geoffrey and the A&F case, the intangibles were incorporated in Delaware, a "phantom tax" state, i.e. one with no income tax. Then royalties were deducted by the South Carolina and North Carolina entities for state and local income tax purposes.

Kmart Method

In a 2000 New Mexico case involving Kmart, the Geoffrey mechanics were used but the licensing company was incorporated in Michigan, a state which had an income tax. However, the Michigan levy exempted royalties and interest from out-of-state sources. So, even though the royalties were paid to an entity in an ostensibly taxing jurisdiction, it really worked out to be another "nowhere tax" state. New Mexico ruled the royalties were subject to both income and gross receipts tax.

Autozone Method

Another strategy was disallowed in Louisiana v. Autozone Properties in 2005. The taxpayer, Autozone, used three entities: Stores, which

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Impact of "Allocation," "Employment of Capital" and Royalty Add Back Statutes

The four ways of treating an out-of-state franchisor's royalty income are each more onerous than the next.

New York has a Corporate Franchise Tax of 8 percent on "allocated entire net income" (substantially the same as taxable income). The allocation formula, like most state allocation formulae, takes into account three elements—payroll, capital and revenues. In New York revenues are given double weight.

Example: X, a successful out-of-state franchisor, has gross revenues for the year of $10 million. X derives $3 million of its revenues from New York. X has deductions of $4 million and, therefore, taxable income equal to $6 million. X has no payroll in New York and (arguably) employs no capital in New York.

The Four Possibilities

1. **No tax liability because no nexus.**
   Tax Due = $0

2. **File with only an income allocation.**
   Here's how the tax works.

   The allocation percentage is computed by determining:
   - a payroll percentage (in this instance, 0 percent),
   - a capital percentage (in this instance, 0 percent), and
   - a revenue percentage (in this instance, 30 percent).

   Then add the various percentages (with the revenue percentage included twice) and dividing the sum by 4. In this case, 0 percent + 0 percent + 30 percent + 30 percent = 60 percent, divided by 4 = 15 percent. Thus, net income ($6,000,000) X allocation percentage (15 percent) X tax rate (8 percent). Tax due = $72,000.

3. **File with an "income" and an "employment of capital" allocation.**
   If the net worth of X is $5 million of which one-half is the value of its trademarks and goodwill, and that is deemed the "employing of capital" in the same percentage as revenues earned (i.e., 30 percent), then the tax due would be: payroll percentage = 0 percent, capital percentage is 30 percent X one–half (capital allocated to intangibles) = 15 percent; revenue doubled 30 percent X 2 = 60 percent; allocation percentage = 75 percent divided by 4 = 18.75 percent.

   Thus, net income ($6,000,000) X allocation percentage (18.75 percent) X tax rate (8 percent). Tax due = $90,000.

4. **"Royalty Add Back" statute**
   Some states have responded by modifying their tax laws with "royalty add back" statutes because there can be no nexus attack made by licensees actually operating within the jurisdiction. The results are punitive to the local operating entities.

   To illustrate the effect, under the same set of facts, assume (as in fact happened) that New York amended its corporate income tax to include a "royalty add back" provision.

   This requires the New York taxpayer (such as a company-owned franchise), which pays royalties, to take its federal taxable income (on which royalties have been deducted) and add back the royalties paid to a "related party" and then apply the full applicable rate to the adjusted taxable income.

   The result: (1) makes the licensee pay tax on the licensor's income, and (2) causes the tax to be paid at an effective rate equal to the state's maximum effective rate without the benefit of the "allocation" formula. Thus, income increase = $3,000,000 X tax rate 8 percent. Tax due = $240,000.

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operated the retail stores and paid a percentage rent to Development, which was a real estate investment trust and Properties, which was the sole shareholder of Development.

Stores filed Louisiana tax returns but avoided Louisiana income taxes by taking rent deductions which wiped out its income. Development also filed tax returns in Louisiana and included all the rental income from Stores but took a dividends paid deduction (available to REITs) to the extent of all of its income. The dividends were received by Properties, a Nevada corporation which did not file Louisiana tax returns and argued that they were not physically present in Louisiana and therefore, owed the state no taxes. Their position was rejected by the Supreme Court of Louisiana.

A&F's Request for Certiorari

A&F's petition makes several legal arguments. The headings and the language in quotes are taken from the certiorari petition.

1. **Decisions in conflict in various states re constitutional limits on imposition of "franchise and income" taxes (i.e. income)**
   a. States disagree on physical

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presence requirement

A&F argues that the Supreme Court should take the case to resolve the dispute because of the volume of "costly time-consuming litigation which, given the high financial stakes, will continue unabated," and because decisions in six States have held that Quill prohibits corporate income taxes on entities that do not have a "presence" while decisions in eight other states have agreed with North Carolina.

b. Disagreement disrupts "predictability" of interstate commerce

A&F also argues that the issue is too significant for "predictability and clarity to be absent" saying that "the clarity provided by Quill" should be restored to the country's business community and tax agencies.

2. North Carolina court's decision "can not be reconciled" with Supreme Court's decisions

A&F argues that "physical presence" should be a sine qua non for income tax liability because a higher (not lower) jurisdictional threshold "should exist for the direct imposition of tax, such as income and franchise taxes, than for collection of use taxes."

3. States have become emboldened by Supreme Court's failure to intercede on this issue

a. States' growing disregard for limitations set by Quill

This is the "power to tax involves the power to destroy" argument. A&F argues, "The result is precisely the evil with which the framers of the Constitution were concerned—the shifting of tax burdens from citizens to non-citizens at the expense of interstate commerce."

A&F argues that "the State provides no benefits (fire or police protection or the like)" to these intangible licensing companies.

b. Adverse consequences for owners of intangible property

This A&F argument has been made since the Geoffrey decision which, it was argued, would jeopardize the license revenues of Walt Disney, Mickey Mouse and Michael Jordan.

A Practitioner's Advice: Reach a Settlement

The Problems of "Allocation," "Employing Capital" and "Royalty Add Back" Statutes

There is a good chance that A&F will not prevail. Franchisors that have been avoiding state and local taxes on franchisee operations (or company-owned sites) should consider setting aside reserves for potential liability. They should also consider making a deal with the tax authorities and taking half-a-loaf instead of risking all the bread.

A good deal from the point of view of both sides would seem to be one that:

- accepts income tax nexus in exchange for an omnibus settlement agreement,
- limits or eliminates liability for prior years,
- waives interest and penalties, and
- includes a stipulation that licensed trademarks within the jurisdiction is not the "employing of capital."

In light of the possible outcomes, an "income" only allocation seems safe. The element of "employing capital" is doubly pernicious because it:

1) establishes tax liability as an independently sufficient tax nexus; and

2) increases tax liability (see sidebar).

With publicly-traded multi-billion dollar companies valuing goodwill and intangibles more than their entire net worth (e.g. and Tyco), it is arguable that licensing their intangibles is the "employment of capital."

Moreover, in the franchise context, it is difficult to argue that the franchisor has no "physical presence" if there is a confidential operating manual, which distinctly states it is the property of the franchisor, in the possession of a franchisee within the jurisdiction.

If licensing trademarks is held to be the "employment of capital," the cost of annual valuations and revaluations of the intangibles (under FASB 141) could be more expensive than the taxes.

Alternative Tax Liabilities

So, as can be seen from the following chart, the franchisor-licensor's alternative tax liabilities on the exact same amount of income are:

1) $0 (no nexus),
2) $72,000 (only "income"),
3) $90,000 ("income" and "employment of capital"), or
4) $240,000 (royalty add back).

The states have made three basic arguments against the A&F certiorari position:

- The Carolinas' argument, that physical presence is established by the licensing of intangibles in the jurisdiction (economic nexus), or

- New Mexico's argument, that physical presence can be attributed to the licensor by virtue of the activities within the jurisdiction of the licensee (attributional nexus), or

- The commonly understood reading of Quill that "physical presence" is not a nexus requirement for state and local income taxes.

Because the Supreme Court may well side with any or all of the propositions which have been argued against A&F's position, franchisors and licensors should definitely consider setting aside reserves and explore making an omnibus deal with the state and local authorities. It defies good sense and logic to refuse to recognize that, unlike tangible property, intangible property can be used simultaneously in more than one place—and thus be subject to tax in more than one place. ■

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