State and Local Taxation of Franchisor Income: They Are Out to Get You!

Although federal levies may be going down, the state and local authorities are becoming very aggressive. *Caveat franchisor.*

By Bruce S. Schaeffer

Franchisors selling company-owned units, or thinking of expanding into new jurisdictions, and even those who are not changing anything, had better be wary. State and local governments, in this time of deficits, are constantly looking for ways to increase their revenues by broadening the scope of their taxes. For example, to escape the issue of what constitutes "income," for tax purposes, New Mexico simply taxes "gross receipts."

South Carolina and many other states following the Geoffrey case have disallowed the deductibility of royalty payments to a licensor and even claimed taxable presence when a company's trademark is used in the taxing jurisdiction. And the sales tax area is getting increasing attention.

Here are some dangers to be aware of:

Nexus: This legal requirement for income taxation by state and local jurisdictions has been expanding. And as ReMax's12-year battle showed, even the best of cases (a subfranchise arrangement with no ReMax personnel in the jurisdiction) may not be worth it. ReMax (and the International Franchise Association) spent plenty of treasure, and provided an overwhelmingly persuasive legal argument, showing why New Jersey shouldn't be taxing ReMax's income. But the state refused to concede and the amount of tax was very small. And when it was taken as a credit against other state and local levies and used as a deduction federally, its cost became very, very small.

So, after 12 years of unrelenting legal fees ReMax accepted tax nexus and "paid the two dollars" as Groucho Marx used to say.

A lesson from the ReMax situation: it all started with a "Nexus Questionnaire." Franchisors should think carefully before responding to a "Nexus Questionnaire."

The franchisor has sufficient nexus for income tax purposes.

Tax Traps for the Unwary

Example 1: The Unknowing Sales Tax Vendor

A franchisor has an office in New York and four company-owned facilities in New York City. It is selling all four stores to one developer and subleasing the sites to the franchisee including "furniture, appliances, and lighting fixtures." Additionally, they are leasing machines to the franchisee.

There is no question that the franchisor has sufficient nexus for income tax purposes. The questions arise with respect to whether or not the transactions are subject to sales tax.

Two New York cases, U-Need-A-Roll Off Corp. and Waste Management of New York, hold that if the tangible personal property is provided without separately stated charges, then it is included in the rental of real property (which is exempt). Therefore, the franchisor could not claim an exemption from N.Y. sales tax on purchase claiming it was for resale and the franchisee owed no sales tax on the lease of the "furniture, appliances, and lighting

fixtures" unless it was separately stated.

However, the machinery is a different matter. The general rule is that an equipment lease is subject to a sales tax. The exception lies for "Machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property..." In the case of Burger King, the company sustained their burden, arguing that the grills they provided to franchisees produced "tangible personal property," i.e. the food. The opposite was found with respect to a car-wash machine which produced a service.

Example 2: West Virginia

A franchisor with franchises in West Virginia requires that franchisees pay a royalty of 6 percent of gross sales. In standard fashion, the franchisee is granted a non-exclusive license to the franchisor's marks, and the franchisor is obligated to provide certain services and instruction.

The West Virginia sales tax agency has recently asserted that the services provided by the franchisor are subject to the state's sales tax. The issue turns on whether the payment is a royalty or a payment for services. The West Virginia sales tax law taxes sales of "tangible" personal property. License fees for the use of a trademark are payments for "intangible" personal property. Accordingly, they are exempt from the West Virginia sales tax. However, lately the West Virginia sales tax authorities have confronted some West Virginia franchisees with the position that "royalty" payments are really one-half (or some other allocation) payments for services rendered by the franchisor. So, West Virginia argues, the payment for these services is subject to the sales and use tax.

The issue of "compensation for services" vs. "royalty income" turns on the facts and the specific terms of the agreement. But franchisors must be wary and consider the possibility of jurisdictions making these assertions. Greater attention to the language of the franchise agreement is strongly suggested. A case to be reviewed is U.S. Universal Joints v. Commissioner, where the court made specific findings with respect to how much of a royalty was for passive patent rights and how much was for "compensation for services" despite the characterization in the contract solely as "royalty." (For a full discussion of this issue see Schaeffer, 559 BNA Tax Management Portfolio, *Tax Aspects of Franchising*.)

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A Late Note

Two additional state tax problems have recently come to light:

The Oregon Dept. of Revenue issued an administrative rule, Rule 150-318.202(2), effective July 31, 2003, saying that franchisors who are "doing business" (e.g. by inspection or training of franchisees) in Oregon, who receive royalty payments, franchise fees, or income from the transfer of tangible personal property, pursuant to a franchise agreement, are liable for the corporate tax. This is another example of expanded nexus to increase the revenues of a financially desperate state.

In New York there are bills before the assembly and the senate that would effectively codify the results of the Geoffrey decision. The bills would require an "add-back" of monies paid to related parties (related being defined as ownership of 30 percent or more), for royalties or other payments (defined to encompass payments denominated asset sales and the interest paid on them), to the New York taxable income. This would effectively prohibit the deduction and require income tax on the royalties be paid to New York with respect to company owned stores primarily.

Caveat franchisor

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