PUBLICATION

Spotlight on SALT: Supreme Court of the United States will not Review the KFC Corp. Decision — Ramifications for Franchisors

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The Supreme Court on October 3, 2011, denied the taxpayer's petition for a writ of certiorari in *KFC Corp. v. Iowa Department of Revenue*. This means that the Court will let stand an Iowa Supreme Court decision that found *KFC Corp.*, the franchisor of the Kentucky Fried Chicken restaurant system, had a taxable presence in Iowa based only on the presence in Iowa of its franchisees. The result in *KFC Corp.*, now final with the Supreme Court's refusal to review, is the latest in a trend of state court decisions upholding income tax assessments against corporate taxpayers that have an economic presence, but no physical presence, in a state.

Quill Decision

In 1992 the Supreme Court in *Quill Corp. v. North Dakota* re-affirmed the physical presence standard for tax jurisdiction under the Commerce Clause of the U.S. Constitution, at least for the imposition of sales and use taxes. In *Quill*, the Supreme Court held that North Dakota could not require *Quill*, a mail order seller of office supplies, to collect use tax from its North Dakota customers when *Quill*'s only connections to North Dakota were via common carrier or the U.S. mail. However, states have relied on the Supreme Court's general discussion of state taxation in dicta from the case and argue "concerning other types of taxes," that the Supreme Court has "not adopted a similar bright-line, physical-presence requirement."

Since 1992, states have sought to limit the reach of *Quill* to sales and use taxes. Beginning in 1993 with the South Carolina Supreme Court decision in *Geoffrey, Inc. v. Tax Commission*, at least 15 state high courts have sustained corporate income tax assessments on taxpayers having only an economic, not physical, presence in a state. These decisions have focused on out-of-state licensors of trademarks or other intellectual property, financial institutions – and now franchisors. Further, at least six additional states now assert by statute income tax jurisdiction over taxpayers having no physical presence in the state, but providing services to in-state customers or otherwise making sales above a certain dollar threshold.

The Ramifications for Franchisors

Although the Business Activity Tax Simplification Act (BATSA) remains pending in the U.S. Congress and would require physical presence in a state as a precondition to a state's exercise of income tax jurisdiction, the future of BATSA is uncertain. At the state judicial and statutory level, the trend has and continues to be tax nexus through economic presence alone. The following are just some of the ramifications for franchisors:

1. As has happened for licensing intellectual property and financial services, franchisors should expect other states to use the Iowa KFC Corp. decision as a precedent to assert income taxing jurisdiction over franchisors under their state income tax statutes. The risk is greatest in those states that already have economic presence nexus precedent, but a risk review should not exclude other states that do not have case law supportive of economic presence nexus (the KFC Corp. decision was a case of first impression).
2. Income tax exposure for the franchisor reduces the net revenue from entry into the taxing state, so franchisors need to plan for higher costs or lower yields in the calculus of deciding whether to sell

franchises in the taxing state, and if so, under what terms, conditions and financial commitments from franchisees. A small number of units in the state may not yield sufficient net revenue after income taxes to support the cost of operating in the state and complying with the income tax statute.

3. A franchisor may want to evaluate its risks, tax exposure, and likelihood of success challenging administratively and/or in court the anticipated attempts by key states to impose income tax using the economic presence rationale.
4. Changes to the terms of new franchise agreements may assist in preparing for state economic presence nexus challenges. Alternatively, some franchisors may look at their business direction and decide to mitigate their tax exposure through tax planning consistent with the franchisor's business purposes.
5. A franchisor may determine that it already has significant income tax nexus and exposure risks and should consider negotiations with various states for the purpose of entering voluntary disclosure agreements to obtain a reduced "look-back" period, penalty waiver, and possibly income apportionment relief.

Summary

Although the application of economic presence nexus concepts to out-of-state franchisors is still evolving, mileposts such as the KFC Corp. decision in Iowa clearly portend an expanding tax jurisdiction at the state level. As a result, franchisors should expect income tax assessments from states where they have franchisees based on the economic presence rationale. Franchisors should plan their responses accordingly. If you would like to discuss the issues raised in this Alert, please contact one of the attorneys in the Firm's Tax Department.