State Income Tax Liability Surprises Some Multi-State Franchisors

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Scenario: A franchisor is physically located in Maryland, has payroll only in Maryland and pays taxes on tangible property only in Maryland. This franchisor sells franchises to franchisees in five other states and provides the typical franchisor services (advertising and marketing support, training, and supplier management)—all from its Maryland office. The franchisor collects its franchise fees and royalties from each franchisee, in accordance with the franchise agreement.

Question: Does the franchisor owe state income taxes in Maryland only or does it owe taxes in each of the states where its franchisees are located?

Answer: In most cases, the franchisor will owe income tax to its home state, but will also owe taxes in states in which franchisees are located (on a proportionate basis).

In the landmark 1993 case of Geoffrey Inc., v South Carolina Tax Commission, the South Carolina Supreme Court ruled a licensor's physical presence in a state is not constitutionally required in order for the state to impose income taxes on the licensor. The rationale for this is that the licensee's use of the licensor's trademarks within the state establishes an "economic nexus" between the state and the licensor; since the licensor derives income (royalties) from the licensee's state, the income should be taxable to the licensor. The U.S. Supreme Court refused to consider an appeal of that ruling, and in the last few years several states' appeals courts have issued opinions following *Geoffrey* and the Supreme Court also refused to consider appeals to any of those rulings.

The *Geoffrey* ruling and the more recent state appeals court decisions each involved retailers in which the licensor was a Delaware trademark holding company and the licensees were affiliates that operated the trademarked stores. Such arrangements are easily characterized as schemes to avoid state corporate income tax, since Delaware (famously) does not have one.

However, the taxing authorities in Florida, Hawaii, Iowa, Louisiana, Massachusetts, New Jersey, North Carolina, Oregon, Pennsylvania, South Carolina, and Wisconsin have all taken the position that franchisors must pay income tax on franchise-fee revenue received from franchisees in their state – despite the fact that the franchisors and franchisees are, by definition, not related entities, and the franchisors are not located in income tax advantageous states. In their zeal to collect revenue other states are likely to follow suit. To make matters worse, in some cases, the states are not only demanding payment for current income taxes, but also taxes, interest, and penalties for prior years.

While constitutional constraints prohibit multiple states from each taxing 100% of the income of a multi-state business, that business is not entitled to tax credits in their home state for taxes paid to another state on the same income. Moreover, there is no forum available for these multi-state businesses in which they can join multiple states for a comprehensive resolution.

On a bright note, some states have tax rules that prevent them from collecting taxes from an out-of-state company, even if a business activity nexus is established. For example, in states applying the "cost-of-performance" test as an all-or-nothing determinant of whether an out-of-state business' income is taxable to that state, none of the franchise fees paid to the franchisor would be subject to income tax. The exception to this is if the franchisor, due to the actions of its agents in the franchisee's state, incurs the majority of its cost of performing the services associated with the franchise fee in that state. However, since many other states do not apply the "cost of performance" test, it certainly does not eliminate the *Geoffrey* conundrum.

An alternative is to pass state income tax on to the franchisee(s) in that state on a pro rata basis. The downside to this, however, is that the franchisors would need to disclose to their franchisees their own federal income tax returns. And more fundamentally, the reimbursement of the taxes from the franchisees would really constitute more income for the franchisee, which would only exacerbate the franchisor's tax situation in each state with franchisees.

Summary: Clearly, the Geoffrey rule (and individual state rules) has significant implications for accountants with clients who are multi-state franchisors. Not only must you understand taxation laws for your franchisor-client's home state, but also the applicable tax laws in all states where its franchisees are located so you can calculate their taxes (revenue less expenses) on a per-state basis. Finally, if you have franchisor clients that may already be in a position of owing penalties and interest, now is the time to research the availability of amnesty periods or negotiate pay-offs with those franchisees' states in an effort to minimize the tax hit on your client.