

BLOGS

State Taxation

Iowa Supreme Court Upholds District Court's Decision That Iowa May Access Income Taxes on Out-of-State Franchisors

On December 30, 2010, the Iowa Supreme Court affirmed the Iowa Department of Revenue's imposition of income taxes on royalties an out-of-state franchisor, KFC Corporation, received from its Iowa franchisees. *KFC Corporation v. Iowa Department of Revenue*, No. 09-1032 (Iowa S. Ct. Dec. 30, 2010). As background, in *Quill v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court had reaffirmed an interpretation of the Commerce Clause that prevents states from imposing *sales or use* taxes on any business without a "physical presence" in the state. The U.S. Supreme Court, however, has been far less clear regarding nexus between a state and a foreign business when looking to impose *income* taxes on profits from the state. As support for its conclusion, the Iowa Supreme Court noted that the U.S. Supreme Court "has emphasized a flexible approach based on economic reality and the nature of the activity giving rise to the income that the state seeks to tax."

The Iowa Supreme Court, after a very lengthy analysis of the U.S. Supreme Court's state income taxation cases, found that the "intangibles owned by KFC, but utilized in a fast-food business by its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence,'" and thus allow Iowa to impose income taxes on the royalties collected. Alternatively, the Iowa justices expressed the belief that the U.S. Supreme Court would not extend the sales and use tax "physical presence" requirement to income taxes, and would instead use a more flexible, economic analysis. In the end, the Iowa Supreme Court found that "by licensing franchises within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes that otherwise meet the requirements of the dormant Commerce Clause."

As noted repeatedly in the Court's decision, the lack of clarity by the U.S. Supreme Court in applying the "physical presence" test has led to a myriad of state laws and regulations to collect taxes from foreign businesses. Beginning in 2009, several members of Congress, supported by the International Franchise Association (IFA) and many in the franchise community, proposed legislation that would require a "physical presence" in any state before the state can impose sales, use, or income taxes on the business. The legislation has been stalled for the last several years, but may garner more support in the coming months as the 112th Congress gets underway.

Impact on Franchisors with Franchisees in Iowa. KFC has 90 days to appeal the Iowa Supreme Court's decision to the U.S. Supreme Court, which has not yet taken up the issue of states assessing state income taxes on foreign corporations without a "physical presence" in the state. Iowa's decision is only the latest example, however, of states looking to tax out-of-state businesses. We understand that slightly more than half the states take the position that licensing of intangibles or granting of franchises in the state constitutes sufficient nexus with the state to allow for income taxation, whether or not there is a physical presence there.

It is likely that the Iowa Department of Revenue will begin organizing more extensive collection proceedings against other out-of-state franchisors with Iowa franchisees. Iowa does have a Voluntary Disclosure Program under which its Department of Revenue may be willing to work with franchisors to settle back taxes and negotiate lesser penalties. The



Voluntary Disclosure Program, however, is only available to franchisors who contact the state before receiving a notice from the Department. For more information on this program, visit http://www.iowa.gov/tax/business/voluntary_disclosure.html.

We recommend that franchisors get in touch with their tax advisors and discuss the implications of this recent decision and whether or not to make the first contact with Iowa's Department of Revenue.