



February 4, 2010

The Honorable Steve Cohen
U.S. House of Representatives
House Committee on the Judiciary
Chairman, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

The Honorable Trent Franks
U.S. House of Representatives
House Committee on the Judiciary
Ranking Member, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

Re: State Taxation – The Role of Congress in Defining Nexus

Dear Chairman Cohen and Ranking Member Franks:

The International Franchise Association (IFA) would like to thank you for convening this hearing on “State Taxation – The Role of Congress in Defining Nexus” and express strong support for the *Business Activity Tax Simplification Act* (BATSA) (H.R. 1083). BATSA would address the need for a fair, clear and uniform nexus standard for the imposition of business activity taxes by states and localities.

Who we are:

The International Franchise Association, the world’s oldest and largest organization representing franchising, is the preeminent voice and acknowledged leader for the industry worldwide. The IFA’s mission is to safeguard the business environment for franchising worldwide. The association represents businesses in more than 85 industries, including more than 11,000 franchisee, 1,200 franchisor and 600 supplier members nationwide. According to a 2008 study conducted by PricewaterhouseCoopers, there are more than 900,000 franchised establishments in the U.S. that are responsible for creating 21 million American jobs and generating \$2.3 trillion in economic output.

Why the Franchise Industry Supports BATSA:

While the United States Supreme Court, through its ruling in *Quill Corp. v. North Dakota*, justified the prohibition of states forcing out-of-state corporations to collect certain taxes unless it had established a physical presence in the taxing state, states have in recent years ignored the ruling and begun establishing an economic nexus standard for taxation. This has created tremendous hardships and confusion for businesses that use the franchise business

model to expand their brand, while not necessarily the presence of their corporate entity, across state lines.

Most franchisors own no property in the state in which their franchisees operate, do not maintain offices there and employ no residents of those states. A franchisor's employees may make occasional visits to its franchisee's place of business to assist the franchisee in opening his or her business and to inspect the franchisee's performance and furnish training advice and guidance, but the duration of such visits normally is limited to a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media.

Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on those states. Meanwhile, like any other enterprise domiciled in a state, a franchisee operating there would pay taxes, be involved in supporting community activities and create economic opportunities for employees and suppliers who would directly benefit from the existence of the enterprise.

Enactment of BATSA is important to the franchise industry because of the business relationship between a franchisor and its franchisees. Central to that relationship is a shared trade identity. That shared trade identity is established and maintained by the franchisor's license of its trademark, trade dress and other intellectual property (*i.e.*, intangible property) to each of its franchisees. Thus, each of the hundreds of thousands of franchise relationships that exist in the U.S. involves a license of intangible property. The great majority of those licenses cross state lines.

The franchise relationship evolved over the last half century with the understanding that the franchisor is not subject to state income taxes (other than those imposed by the franchisor's domicile state and any state where it maintains physical presence) on the royalty income paid to the franchisor by franchisees located in a different state. Prior to the late 1980s, with rare exception, states did not seek to tax such income unless the franchisor clearly established a traditional nexus by owning or leasing real estate, operating its own outlets, or maintaining an office or employees in the taxing state.

Franchise brands exist across a multitude of political boundaries in most franchise systems, but the franchisor is often a single entity with a clearly defined corporate residence. Some state revenue officials and, increasingly, legislators view the presence of a franchised outlet of a national or regional brand in their state, intentionally or not, as sufficient for the establishment of economic, rather than physical, nexus of the out-of-state franchisor. It has been incorrectly argued that the mere presence of intangible property in their jurisdiction satisfies the "substantial nexus" requirement under the Commerce Clause for the imposition of state income and related business activity taxes. Such arguments radically expand the classes of persons, relationships and transactions potentially subject to state income taxation, and threaten the livelihoods of hundreds of thousands of entrepreneurs who have chosen franchising as the route to small business ownership.

The issue has enormous implications for the businesses engaged in interstate franchising, a rapidly expanding part of the American economy. If permitted, such assessments would subject licensors of intangible property in interstate commerce to income taxation by every state in which goods or services exploiting the licensed intangible property are sold. If a tax return is not filed, no statute of limitations will limit the period for which taxes, interest and penalties may be due. Such a result would represent a radical departure from the historical understanding of the reach of taxing authority and a significant increase in the tax liability and burden of compliance of thousands of American small businesses.

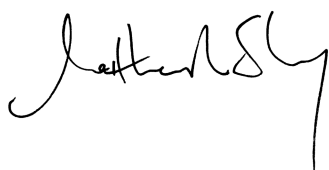
If every state where a franchisor has granted franchises may tax its income attributable to that state, non-resident franchisors will be subject to costly compliance burdens and ever-escalating taxes. Under these circumstances, there is no doubt that franchisors will be forced to consider passing this cost of business on to their franchisees by increasing the royalty fees. Under this scenario the party most harmed is the resident franchisee. Thus, enactment of BATSA is critical for thousands of businesses, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Conclusion:

The IFA appreciates the efforts of the subcommittee in examining discrepancies in the application of nexus standards in state taxation. Unless addressed by Congress, the continuing uncertainty with respect to such issues will impose high costs on companies forced to operate in an environment in which their state tax liabilities are unclear and hinder the growth of small businesses through franchising.

Thank you for considering this written testimony.

Sincerely,

A handwritten signature in black ink, appearing to read "Matthew R. Shay". The signature is fluid and cursive, with a long vertical stroke extending downwards from the end.

Matthew R. Shay
President and CEO