



Franchising
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TO: Corporate Counsel Committee
Legal Legislative Committee
Legislative Action Group

FR: Troy Flanagan
Director, Government Relations

DT: October 5, 2009

RE: California Nonresident Withholding

Recently the California Franchise Tax Board (FTB) has taken an aggressive stance with respect to the responsibilities of nonresident franchisors with resident franchisees. FTB staff members have informed numerous IFA members they must either register as resident corporations or have their California franchisees withhold 7% of royalty payments. § 18662-2 (*Income Subject to Withholding and Requirements for Withholding*) of the tax code is being cited as justification for this interpretation.

On September 24, the FTB issued a memorandum to the American Association of Franchisees & Dealers informing franchisees of a withholding obligation on royalty payments made to franchisors. In light of this reinterpretation of nexus determination, IFA wishes to provide members with guidance in this matter. IFA has consulted with experts in California tax law, who developed a memorandum on the new reporting efforts.

Three key takeaways from the memo are as follows:

- Significant uncertainty exists in the determination of physical, and especially economic, nexus, and therefore franchisors should examine their tax situation carefully and consult with a tax advisor before choosing whether or not to concede a nexus determination. Although case law exists supporting the need for a physical presence for nexus determination, FTB advises its staff that “the case law is still developing in this area” and that “there is no bright-line threshold.” If the franchisor has a California office or physical assets or it has employees regularly present in California, then the franchisor likely will have nexus. If none of these activities occur in California, however, the franchisor may be able to argue that it does not have California nexus and therefore is not subject to tax, despite its obligation to file a California tax return as a result of business qualification.
- Taxpayers may also wish to challenge the FTB’s ability to require either withholding or business qualification. Such a challenge could be based on the court’s holding in *Rainier Brewing*. Taxpayers may assert that they are not subject to withholding because their franchise asset does not have a business situs in California in accordance with *Rainier*. *Rainier’s* rationale is that the situs of intangible property is located at the taxpayer’s domicile or principal place of business.
- If after having made a nexus determination a franchisor chooses to comply with one of the two options being offered by FTB staff, IFA recommends that, given the choice, franchisors should register their business as a California corporation rather than subject their franchisees to the withholding process. Allowing the out-of-state tax obligations to be satisfied by the withholding of 7% of royalties by in-state franchisees reduces the control of a franchisor over its tax liability and has the potential to lead to significant overwithholding. By registering with the state, a nonresident franchisor retains the ability to develop its own tax return position that takes into account nexus and apportionment considerations, without California retaining its funds during this process.