

be less disadvantageous to qualify to do business and subsequently file California tax returns, than to permit California franchisees to become subject to withholding.

II. Business or Taxable Situs in California

A. Business Situs Test No Longer Used to Determine California Taxable Income, But is Still Used to Identify Items Subject to Withholding. A typical symmetry generally exists between items subject to withholding and the inclusion of items in the measure of tax. At one time, the business situs standard was used by California and other states, to identify the jurisdiction that had the right to tax income from certain property (tangible and intangible), assuming the taxpayer had nexus in that jurisdiction. See for instance Section 23040 which provides that “[I]ncome derived from or attributable to sources within [California] includes income from tangible or intangible property located or having a situs” in California. Regulation 23040 further provides that “income from intangible property is income from sources in [California] only if the property has a business situs here.” In 1957, however, the Uniform Division of Income for Tax Purposes Act (“UDITPA”) was adopted by the National Conference of Commissioners on Uniform State Laws. UDITPA provided a formula apportionment method for taxpayers subject to tax in multiple jurisdictions, to divide their income among the jurisdictions in which they could be required to pay tax. UDITPA provisions were thereafter enacted in nearly half the states, including California in 1966. As a result, the direct correlation between business situs and taxability in California tax law became muddled. Thus, property may have a business situs in a particular location, but income from that property will be subject to tax in accordance with the UDITPA apportionment formula and not pursuant to business situs taxation rules. As stated by the California Board of Equalization in an administrative decision in the case of *Appeal of Holiday Inns* (April 9, 1986), “the UDITPA provisions are the exclusive method to be used for apportioning and allocating [a] taxpayer’s business and nonbusiness income.”

What this means is that the FTB’s reliance on the business situs standard in Regulation 18662-2 for purposes of identifying income subject to withholding, may ultimately result in withholding on items of income subsequently determined to be only partially subject to California tax (or not subject to tax at all), since it is the application of California’s apportionment and allocation formulas that ultimately determines the amount of a taxpayer’s California tax liability. This possibility of significant overwithholding is one reason why a franchisor in a given case might prefer to qualify to do business in California instead of acceding to withholding on royalty payments at the rate of 7%.

B. Business Situs Test Satisfied if Intangible Asset is “Employed as Capital” in California or Becomes Localized in Connection with a California Business. Keeping in mind the fact that business situs is now used only to determine if a particular item of income is subject to withholding, it is still necessary to determine whether or not an asset has acquired a business situs in California in order to determine if a nonresident taxpayer is subject to withholding on amounts paid by California taxpayers. Regulation 23040(e) provides additional guidance on the meaning of the phrase “business situs.” That regulation states that “[I]ntangible personal property has a business situs in [California] if it is employed as capital in [California] or the possession and control of the property has been localized in connection with a business, trade or profession in [California] so that its substantial use and value attach to and become an asset of the business, trade or profession in [California].” [Note: Regulation 18662-2 actually makes direct reference to Regulation 17952 for the definition of taxable situs. The definition from Regulation 23040 quoted above, however, is identical to language in Regulation 17952(c). We refer to Regulation 23040 because that regulation was promulgated under statutes contained in Part 11 of the California Revenue and Taxation Code which pertains to the Corporation Tax

Law. Regulation 17952 was promulgated under statutes set forth in Part 10 of the Revenue and Taxation Code pertaining to Personal Income Tax.]

Regulation 23040(e) also provides an example of when property is considered to have a business situs under the aforementioned test. According to the example, stock, bonds or other intangible property pledged in California to secure the payment of indebtedness or taxes incurred in connection with a business conducted in California, is deemed to have a business situs in California. Presumably such property has become localized in connection with a California business because it has been pledged to secure the debts of a business conducted in California. The instructions to California Tax Form 587, Nonresident Withholding Allocation Worksheet, provide additional guidance on the type of royalty payments that are deemed to be attributable to an asset with a California business situs. These instructions provide that “royalties paid to nonresidents for the right to use natural resources located in California,” are subject to withholding. There is nothing surprising, however, about a conclusion that natural resources located in California have a California business situs.

Unfortunately, neither of these examples sheds light on the business situs standards provided by Regulation 23040(e), namely whether the intangible franchise asset is “employed as capital” in California or has become localized with a California business when used by a California franchisee. The FTB could certainly contend that the use of a franchise by a California franchisee automatically creates a California business situs for the franchise asset. In fact this conclusion may well be the unstated premise supporting the FTB’s current efforts directed at nonresident franchisors. As further explained below, however, such a conclusion does not square with historic California case law and more importantly, does not address the issues of nexus and apportionment. By electing to qualify to do business instead of permitting withholding on royalty payments by California franchisees, a nonresident franchisor retains the ability to develop its own tax return position by taking into account nexus and apportionment considerations, without having to do so while California is already in possession of a significant amount of the franchisor’s royalties.

C. California Has Historically Treated Intangible Franchise Assets as Having a Business Situs at the Domicile of the Franchisor. In *Rainier Brewing v. McColgan*, 94 Cal.App.2d 118 (1949), a taxpayer domiciled in California, sold by contract to a third party, “the exclusive right to manufacture and sell in [Washington state] and in the Territory of Alaska, ‘beer, ale, and other alcoholic malt beverages under the trade names, trade marks and labels of ‘Rainier,’ . . .in consideration of the payment to [the taxpayer] of royalties in the sum of 75 cents per barrel.” Under these facts, the California District Court of Appeal concluded that the good will of the taxpayer’s business “which was attached to the trade-mark ‘Rainier’. . .was an element of the general business of [the taxpayer], whose domicile and principal place of business was conceded to be at San Francisco in California. The revenues derived from the transfer of that trade-mark and good will were therefore attributable to the general business which had its situs in California.” The *Rainier* court's rationale, therefore, is that the situs of intangible property is located at the taxpayer’s domicile or principal place of business. In *Rainier* that place of business happened to be California, but the same principle should apply no matter where the franchisor’s domicile and principal place of business is located.

The tax year at issue in *Rainier* (1938), predates the year (1939), that the statute containing the specific business situs language was enacted. Accordingly, the FTB could rightfully contend that the *Rainier* decision was not rendered in connection with a review of the “employed as capital” or localized in connection with a California business, standard. Nevertheless, the business situs statute was in effect by the time the *Rainier* decision was

issued and there is some evidence that the court considered the business situs standard in reaching its conclusions. Moreover, the Board of Equalization applied the principles of *Rainier* and cited that case as controlling in a decision after California's adoption of the business situs standard. See *Appeal of Aetna Plywood & Veneer Company* (April 21, 1959), regarding a loss arising from indebtedness held by a nonresident corporation for which a California corporation was the debtor. The Board of Equalization determined that "it is clear that no loss on the loan to [the California debtor] or on the stock of that company may be attributed to California" by the creditor since the creditor's interest, "whether regarded as that of a creditor or of a stockholder, was an intangible interest which had its situs at [the creditor's] domicile."

Accordingly, it is not at all certain that royalties paid by a California franchisee to a nonresident franchisor leads to the automatic conclusion that the intangible franchise asset has acquired a business situs in California. *Rainier* holds that such property has a business situs at the domicile of the owner and *Rainier* has not been overruled by any California court. Section 25120(b) provides that a taxpayer's commercial domicile is "the principal place from which the trade or business of the taxpayer is directed or managed." It may well be plausible for the FTB to contend that an intangible franchise asset used by a California franchisee has acquired a California business situs based on the language of Regulation 23040(e) that a California situs arises when the asset is employed as capital in California or has otherwise become localized with the conduct of a California business. No California case, ruling, statute or regulation, however, clearly establishes this result.

III. Consequences of Business Qualification

As mentioned above, the FTB is attempting to convince nonresident franchisors to qualify to do business in California under the threat of 7% withholding on royalty payments. Companies qualifying to do business in California become subject, at a minimum, to California's minimum tax of \$800. Section 23153(b)(2) and (d)(1). Business qualification also obligates a taxpayer to file a California tax return. Section 18601. Filing California returns makes withholding unnecessary. See Regulation 18662-13, providing that withholding on items of income from intangibles is required when such items are "paid to corporations which do not have a permanent place of business" in California. A corporation, however, "has a permanent place of business" in California if it is a foreign corporation (i.e., a corporation not formed in California) that "has qualified to transact intrastate business." Thus, by qualifying to do business at the FTB's urging, a taxpayer will not be subject to withholding but the FTB will obtain its objective of having the taxpayer submit a California income tax return.

IV. California Taxation of Franchisors

A. Income Apportionment for Franchisors. As mentioned in Section II.A above, California applies UDITPA principles in determining the California income of taxpayers that are subject to tax in multiple states. Income is apportioned to California by the use of a three factor apportionment formula that includes sales, property and payroll with double weight being applied to the sales factor. Section 25128. (Note: California will begin using the sales factor only for tax years starting January 1, 2011). California also employs a special rule for the income apportionment of franchisors. See Regulation 25137-3. This regulation does not require royalties paid by California franchisees to be included in the franchisor's California sales factor numerator in all cases. As a result, franchisors who license trade marks and trade names to California franchisees but whose other connections with California are negligible, may wish to review their options regarding calculation of the California sales factor. Even if royalties paid by California franchisees are properly included in the California sales factor numerator, franchisors

may obtain a benefit by excluding such receipts from the numerator of the sales factor in their home states.

B. Nexus. The United States Supreme Court requires a physical presence within a state in order for a taxpayer to be required to collect sales and use taxes on sales to customers within the taxing state. See *Quill v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992). The Court, however, has to this point declined to adopt a physical presence standard for income tax nexus purposes. As a result, a number of states have taken the position that a physical presence is not required for income tax nexus and have asserted tax against taxpayers on an "economic nexus" theory. These cases frequently involve the assertion of nexus based on the in-state presence of intangibles.

California has not taken a clear position on the issue of economic nexus. In a 1980 Board of Equalization decision, the Board specifically rejected an economic presence argument to support nexus and instead concluded that there was no barrier to imposition of income tax "so long as the corporation's in-state business activities have some regular, systematic and substantial connection with, and physical presence within, the taxing state." See *Appeal of John H. Grace Company* (October 28, 1980). It is not clear, however, that the FTB would concede that physical presence is a prerequisite for California income tax nexus based on a 1980 administrative decision although the *John H. Grace* decision appears to be the only California authority that speaks directly to the issue of a potential physical presence requirement for income tax nexus. The FTB's current audit manual raises "the possibility that nexus standards may be expanding to the point where nexus can exist for state franchise or income tax purposes in some situations even without the taxpayer having a physical presence within the state." The manual further provides that "the case law is still developing in this area" and that "there is no bright-line threshold." See California Franchise Tax Board Internal Procedures Manual, Multistate Audit Technique Manual Section 1100.

Thus, again it is not definitive whether a taxpayer has nexus in California for income tax purposes merely by having a California franchisee operating in the state. If the franchisor has a California location, office or inventory or sends employees into California, then the franchisor almost certainly 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. Again, a franchisor should examine its tax situation very carefully and consult with its tax advisor before adopting such a position. [We note here that for taxable years beginning January 1, 2011, California will switch to a "factor" nexus test for income tax purposes. Thus, taxpayers will be deemed to be doing business in California for income tax purposes if (i) California sales exceed the lesser of \$500,000 or 25% of total sales, (ii) real property and tangible personal property within California exceed the lesser of \$50,000 or 25% of the taxpayer's total real property and tangible personal property, or (iii) amounts paid for compensation in California exceed \$50,000 or 25% of the taxpayer's total compensation payments. See SBX3 15, new Revenue and Taxation Section 23101(b)(2)-(4).]

C. Property Factor Does Not Include Value of Franchise. Finally, it should be noted that if a franchisor is subject to California tax, it will not be required to include the value of the intangible franchise in the property factor component of California's overall apportionment formula. The property factor only takes into account "real and tangible personal property," not intangible property which is excluded from the apportionment formula. See Section 25129.

V. Business Qualification Likely Preferable to Withholding

Given the foregoing and although not clear in every instance, out of state franchisors are likely to be better off by qualifying to do business in California than risking withholding on royalty payments from franchisees. Withholding is undertaken at the rate of 7% of the royalty payment. California's top corporate tax rate is only 8.84%. If a taxpayer qualifies to do business, it then has time to assess its tax situation to determine if it has income tax nexus in California. We note here that Regulation 25122(b)(1) provides that a taxpayer who "pays a minimal fee for qualification, organization or for the privilege of doing business" in a state, but does not actually engage in business activity or does "actually engage in some business activity, not sufficient for nexus," is not considered to be subject to tax in such state. As a result, the taxpayer will be able to evaluate its position as to whether it can reasonably take a return position that its receipt of royalty payments should be allocated to the state of commercial domicile instead of to California, the location of the franchisee. By qualifying to do business, the taxpayer is able to make these initial determinations without having the state hold possession of the royalty withholding amount.

Even if the franchisor ultimately makes a determination that it is subject to California tax, withholding at the 7% rate may exceed the franchisor's actual California tax liability attributable to the royalty payments to which withholding was applied. This is because the 7% withholding rate is applied to the gross royalty amount and does not take into account deductions that decrease the taxpayer's net income. Moreover, if the taxpayer's California payroll and property factors are negligible, the amount of income actually apportioned to California may create an effective tax rate below 7%. Again, taxpayers should review their own tax situations prior to making these determinations.

In cases where the taxpayer opts for withholding instead of business qualification, the taxpayer is entitled to request a waiver of withholding in whole or in part if the taxpayer can demonstrate to the FTB why such a reduction would be equitable. Regulation 18662-3 and Form 588. The taxpayer can also file a claim for refund for excessive withholding where the taxpayer's ultimate California tax liability exceeds the amounts withheld. Regulation 18662-5.

Finally, 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* described above, and might be made in writing subsequent to the FTB's initial phone call. 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*. Although it is unclear how far one may wish to pursue such a position, initially at least it may prove beneficial to ask the FTB to state its position in writing as to why the principles of *Rainier* do not apply, or to concede that such principles control and that withholding is therefore not required.