



Department of Revenue

State Income Taxation of Intangibles

KFC Corp. v. Iowa Department of Revenue

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Overview

- Iowa Supreme Court Ruling
 - Physical Presence
- Director's Opinion
 - KFC's activities
 - Director's Analysis



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KFC Corp. v. Iowa Department of Revenue,
792 N.W.2d 308 (Iowa 2010)

Relevance

- 2010 State Supreme Court Decision
 - 2001 Assessment
 - 1997, 1998, 1999 tax years

Relevance

- Basic physical presence arguments
- What kind of non-physical presence is enough?
- Lower court decisions not readily available



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Legal Opinion

Physical Presence Not Required

Statement of the Case

“... whether the State of Iowa may impose an income tax on revenue received by a foreign corporation that has no tangible physical presence within the state but receives revenues from the use of the corporation's intangible property within the state.

- *KFC Corp. v. Iowa Department of Revenue*, 792 N.W.2d 308, 310 (Iowa 2010)

Iowa Supreme Court Analysis

- Focused on federal constitutional analysis
 - What would the US Supreme Court do?
- Good summaries of:
 - *Bellas Hess*
 - *Quill*
 - *Geoffrey*
- Deference Question
 - “even if deference were not afforded, we conclude . . . that IDOR correctly interpreted the applicable statutes.”

Quill

- Physical presence requirement satisfied
 - Compare the extent to which KFC’s intangibles were used in the state to the “few floppy diskettes” referenced in *Quill*
 - Find that the extent of KFC’s IP licensed in Iowa amounted to the “functional equivalent” of physical presence under *Quill*
- *Quill* based on *stare decisis* and a fear of retroactive applicability
 - No such reliance issues here

Physical Presence

- “physical presence” in today's world is not “a meaningful surrogate for the economic presence sufficient to make a seller the subject of state taxation.”
- “Physical presence” often reflects more the manner in which a company does business rather than the degree to which the company benefits from the provision of government services in the taxing state.

U.S. Supreme Court

- Cert denied October 3, 2011
 - 132 S.Ct. 97



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Physical Presence Not Required

What was KFC's actual presence?

Iowa Protest/Appeals Process

- Notice of Assessment issued
- Taxpayer has 60 days to file an appeal
 - Attempt at informal resolution
- Administrative Law Judge (ALJ)
 - Facts Established
 - Facts were undisputed in this case
- Director Hearing
- Appeal to District Court
- Appeal to Iowa Supreme Court

Iowa Supreme Court's Statement of the Case

“... whether the State of Iowa may impose an income tax on revenue received by a foreign corporation that has no tangible physical presence within the state but receives revenues from the use of the corporation's intangible property within the state.

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Director's Statement of the Case

“Whether KFC has sufficient nexus with Iowa to be subject to Iowa corporation income tax?”



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KFC's Activities

KFC Corporation

- Owned “the intellectual property of Kentucky Fried Chicken Corporation, including the KFC trademarks and trade names as well as all other aspects of a unique system for preparing and marketing fried chicken and other food products pursuant to trade secrets, standards, and specification designed to maintain a uniform high quality of product, service and national image.”

KFC's Business

- KFC owned, managed, protected, and licensed the KFC Marks and related System
- Licensed intangible intellectual property in the form of Marks and the related KFC

System to non-affiliate franchisees

- Marks: trademarks, trade names, and service marks
- System: KFC's unique system for preparing and marketing fried chicken and other food products pursuant to trade secrets, standards, and specifications designed to maintain a uniform high quality of product, service, and national image.

KFC's Iowa Activity

- KFC has licensed its valuable intellectual property for use within the geographic boundaries of the State of Iowa to produce income.
 - Did not own or operate any stores in Iowa
 - No offices or other real property in the state
 - No employees in the state
 - No services performed in the state

License Agreement

- Licensed intangible intellectual property in the form of Marks and the related KFC System to non-affiliate franchisees
 - Iowa restaurants were granted the right to use KFC's Marks and System at the franchisees' outlets to prepare and market approved products and provide services meeting KFC's quality standards
 - Iowa restaurants paid royalties to KFC at the rate of four percent of gross revenues for each month, with a minimum monthly royalty amount

License Agreement- Control

- KFC had the right to control the use of its Marks by franchisees with locations in Iowa and the right to control the nature and quality of goods sold by franchisees
- Franchise agreement placed detailed obligations on the Iowa franchisees which included strict adherence to KFC's requirements regarding menu items, advertising, marketing, and physical facilities.
 - Use only signs and menu boards, advertising and promotional materials, equipment, supplies, uniforms, paper goods, packaging, furnishing, fixtures, recipes, and food ingredients which met KFC's standards
 - Purchase the equipment, supplies, trademarked paper goods, and other products required by KFC, only from KFC-approved manufacturers and distributors.

Instructions

- The Confidential Operating Manual delivered by KFC to its franchisees consisted of six volumes, in ring binders, which set forth KFC's instructions and requirements related to: (1) Products; (2) Equipment and facilities; (3) Safety, security, sanitation, and employee relations; (4) Merit (computer system) procedures; (5) Merit records and troubleshooting; and (6) Hospitality, quality, service, and cleanliness.

License Agreement- Control

- KFC's Franchise Department included tracking the compliance of the KFC franchisees. KFC's Franchise Department determined whether and which disciplinary actions (ranging from warnings to default notices to termination of the franchise agreement) were required
- Upon termination or expiration of a franchisee's franchise agreement, the franchisee had to immediately discontinue use of KFC's Marks and System and had to return all operating manuals and other confidential materials to KFC.

Indirect Connections

- The franchise agreement set forth the continuing services that might be performed by KFC or an affiliate of KFC, including:
 - operating advice and training,
 - informing franchisees of proven methods of quality control,
 - such other services as KFC deemed necessary or advisable

KFC's Iowa Receipts

- Received royalty and/or license income from franchisees with restaurants that were located in Iowa, for the use of KFC's Marks and System.
 - 1997 (short period): \$380,589
 - 1998: \$1,777,913
 - 1999: \$986,541



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Director's Analysis

Complete Auto Analysis

- The tax:
 - is applied to an activity with substantial nexus with the taxing state,
 - is fairly apportioned, (not in dispute)
 - does not discriminate against interstate commerce, and
 - is fairly related to the services provided by the state.

Income Tax is Not Discriminatory

- The tax can be fairly apportioned and/or deducted in the computation of other income
- Consistent with other foreign corporations doing business in the state and Iowa corporations doing business in the state

Fairly related to the services provided by the state

- Related to the governmental functions that all Iowa businesses enjoy
- KFC is enjoying all of the rights and privileges of business in Iowa
- There is no duplication of the taxes by other jurisdictions

Complete Auto Analysis

- The tax:
 - is applied to an activity with substantial nexus with the taxing state,
 - ~~is fairly apportioned, (not in dispute)~~
 - ~~does not discriminate against interstate commerce, and~~
 - ~~is fairly related to the services provided by the state~~

Doing Business

- “every corporation doing business within Iowa, or deriving income from sources consisting of . . . intangible property located or having a situs within Iowa, shall file a true and accurate return of its income or loss for the taxable period.”

Royalty Income Derived from Business in Iowa

- Royalty payment is based on Iowa locations' gross revenues
- When a customer purchases from a KFC franchisee in Iowa, the franchisee is obligated to send part of the gross receipts to KFC
- KFC knows the amount of income from each franchised location in the state

Intangible Franchise Rights have Their Situs in Iowa

- “The term “intangible property located or having a situs within Iowa” means generally that . . . the intangible property has become an integral part of some business activity occurring regularly in Iowa.”
 - Iowa Admin. Code r. 701-501.1(1)(d)
- intangible franchise rights are enforceable
- with every Iowa purchase at a franchisee’s Iowa location, the franchisee is obligated to pay KFC based on the gross revenue

Summary

- ★ Iowa Supreme Court's 2010 *KFC* ruling provides good overviews of pre-*Wayfair* nexus case law as well as arguments for why physical presence should not be required.
- ★ In the absence of a brightline standard nexus through the presence of intangibles was established through
 - Connection between in state activity and royalty income
 - Control of the in-state use of the intangibles by the licensor
 - Benefits and protections to licensor from the state



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Questions?