Armstrong Teasdale

Client Alert

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IOWA SUPREME COURT ORDERS OUT-OF-STATE FRANCHISOR TO PAY TAX ON ROYALTY INCOME

Last week, in the case *KFC Corp. v. Iowa Department of Revenue* the Iowa Supreme Court issued a ruling that will require out-of-state franchisors to pay tax on income earned through royalties earned from Iowa-based franchisees. With this decision, Iowa joins the increasing list of states that have determined that franchise royalty income is taxable as in-state income, regardless of whether the franchisor has any physical operations located in Iowa. The decision also has implications for any business that derives income from intangible assets (through licensing or otherwise) located in another state.

In the lawsuit, KFC challenged an income tax assessment imposed by the Iowa Department of Revenue on the royalty revenue earned by KFC from its franchisees in the state. KFC - which does not own any restaurants or have any employees in Iowa - argued that under the Commerce Clause of the U.S. Constitution, a corporation must be physically present in the state before that state can impose a tax on the company's income. It also claimed that under the relevant Iowa statute, the company could not be taxed because it did not have property "located or having a situs in the state."

The Iowa Supreme Court disagreed. Instead, the Court found that the *intangible* property that KFC owned within the state – the company's goodwill and the right to license its trademarks and system to Iowa franchisees - created a sufficient connection to the state to justify taxation on revenue generated within the state. After conducting a detailed analysis of relevant United States Supreme Court cases, the Court held that "physical presence is not required under the dormant Commerce Clause of the United States Constitution in order for the Iowa legislature to impose an income tax on revenue earned by an out-of-state corporation arising from the use of its intangibles by franchisees located within the State of Iowa." The Court also found that physical presence is not required to constitute "situs" within the meaning of the Iowa statute.

In determining that physical presence is not required to create taxable nexus, the Iowa Supreme Court adds its name to a growing list of states that have begun taxing franchisors on royalty income earned from in-state franchisees. Franchisors and other companies should be aware of this growing trend that would require them to pay income taxes on income they receive from states where they have intangible assets.

For more information, please contact a franchise attorney in the Franchising, Distribution and Antitrust Practice Group.

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