Fox Rothschild LLP
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FOCUS ON FRANCHISING

ALERT

# STATES TAX ROYALTY PAYMENTS ACROSS BORDERS

*NEW LEGISLATION COULD END THIS PRACTICE, BUT CONGRESSIONAL APPROVAL IS FAR FROM CERTAIN*

**By Elizabeth D. Sigety and Owen A. Knopping**

States have found a new way to increase their piece of the tax pie. Several states have begun imposing an income tax or business activity tax on out-of-state businesses whose only activity in the state involves an intangible such as a franchise, trademark, trade name, or service mark in that state. This means that royalties and other income received by the out-of-state business may be subject to tax in that foreign state. The aggressive stance taken by various states can be expected to adversely affect a critical source of income for franchisors and distributors.

In the past decade, a number of state tax cases have considered the legal right of a state to subject an out-of-state company to its income tax or other business activity tax based on the company's *economic* activities in that state. Several state courts have concluded that a company's "economic presence" in their state is sufficient to subject an out-of-state company to such taxes, thus allowing the state to collect income or business activity taxes on royalties received by an out-of-state company from the licenses of a trademark/trade name in the taxing state.

Recently, the United States Supreme Court refused to hear a state income tax case - *Lanco, Inc. v. Director, NJ Division of Taxation*. In *Lanco*, the plaintiff is a Delaware corporation with no physical presence in New Jersey. Lanco licensed its trademarks, trade names, and service marks to an affiliated company (Lane Bryant) with retail stores in New Jersey and numerous other states. The New Jersey Supreme Court determined that the activities in connection with the licensing of intangible property in New Jersey and the receipt of royalties from that activity provided sufficient contacts within the state to obligate Lanco to file New Jersey Corporate Business Tax Returns.

When the United States Supreme Court refused to hear the case, Congress introduced a bill known as the Business Activity Tax Simplification Act of 2007 (BATSA). The bill – which is similar to a House bill that was introduced and defeated in 2005 – was introduced in the Senate early this year. It would set strict criteria for imposing income or business activity taxes upon out-of-state vendors.

Simply put, BATSA would require a "physical presence" in a state in order for a company to be subject to income and other business activity taxes. Said one of BATSA's sponsoring Senators, "businesses should not be punished with double taxation simply because their products reach beyond state borders."

Since the House version of this bill was defeated, BATSA may have an uncertain future. Watch for future *Alerts* from Fox's Franchising & Distribution and Tax Practice Areas for updates on this issue. In the meantime, clients should be aware that out-of-state activities could be subject to income tax or other business activity type taxes. For a more detailed summary of this and other corporate tax developments, visit http://www.foxrothschild.com/nexus.asp.

If you have a question about how royalty tax or other issues could impact your franchising or distribution business, please contact an attorney in our Franchising & Distribution Practice or visit us on the web at www.foxrothschild.com.

**About Fox Rothschild's Franchising & Distribution Practice**

Our experienced team consists of approximately 25 attorneys in eight offices throughout the firm who focus on the many disciplines involved in the business of franchising and distribution. Our clients range from international corporations to entrepreneurial/start-up companies across a variety of industries. As a firm well-versed in this specialized area of law, we are uniquely situated to counsel clients not only because of our significant contacts in the franchising and distribution community, but also because of our breadth of experience with entrepreneurial and growing businesses and the people who work with them.


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