BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	**)**	**DECISION OF HEARING OFFICER**
[REDACTED]	**)**	
F.E.I.N. [REDACTED]	**)**	**Case No. 200700083-C**

A hearing was held on November 19, 2007 in the matter of the protest of [REDACTED] (Taxpayer) to the denial of a refund by the Corporate Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax years ended December 31, 1998 through December 31, 2003 (Audit Period). The record in this matter was left open until March 3, 2008 to allow for post-hearing memoranda. Taxpayer's opening post-hearing memorandum was timely filed by postmark dated December 21, 2007. The Section timely filed its response post-hearing memorandum on February 7, 2008. Taxpayer timely filed its reply post-hearing memorandum by postmark dated March 3, 2008. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

The evidence and the parties' joint listing of facts establish the following. Taxpayer is a [REDACTED] company, operated primarily through franchises, that is headquartered [OUT OF STATE]. Taxpayer owns the service mark for [REDACTED]®. Taxpayer entered into Franchise Agreements with four Franchisees located in Arizona during the Audit Period. Those Franchisees were located in Glendale North, Mesa, Scottsdale, and Tempe, Arizona (collectively referred to herein as the "Franchisees").

Taxpayer granted Franchisees a license to use the service mark [REDACTED], and all other service marks Taxpayer adopted for use in conjunction with the business. Taxpayer collected royalty income based on a percentage of Franchisees' sales in Arizona.

Taxpayer also provided Franchisees a license for Taxpayer's computer software to assist the Franchisee in the operation of its business. Under the Franchise Agreement, Franchisees were required to utilize the software and to allow Taxpayer to have access to Franchisees' software and computer equipment. Taxpayer also provided Franchisees with operations manuals, as well as training and promotional aids to assist Franchisees in their businesses. However, Taxpayer retained ownership of such items, and Franchisees were required to return the items upon termination of the Franchise Agreement.

Under the Franchise Agreement, Franchisees were subject to reasonable inspections by Taxpayer during normal business hours. Franchisees were also required to maintain complete and accurate books and records of its business and operations. Taxpayer, or its authorized agent, was given the right to examine Franchisees' books, records, and tax returns during normal business hours, and were allowed to copy such documents.

Taxpayer assigned an employee to act as a liaison between Taxpayer and the Franchisees, known as a Franchise Business Consultant (FBC). According to the FBC's job description, the FBC was to assist Franchisees in such areas as: "marketing, financials, financial matters, employee recruitment and retention, protecting the brand, and continuous growth." The

FBC also conducted inspections of Franchisees, and offered recommendations and assistance to help Franchises to grow their business. The FBC was required to "visit each franchise location as needed (at least once per year)," to "track franchise performance in the four 'key result areas', and contact all franchises on a regular basis." The parties stipulated that the FBC physically visited each Arizona Franchisee at least once per year.

On December 10, 2004, Taxpayer filed Arizona corporate income tax returns for the Audit Period. Taxpayer paid $[REDACTED] in Arizona corporate income taxes, under protest, for the Audit Period. On February 10, 2005, Taxpayer filed amended Arizona corporate income tax returns for the Audit Period requesting a refund in the amount of $[REDACTED] for all taxes previously paid during the Audit Period. On March 29, 2005, the Section denied Taxpayer's refund claim. Taxpayer timely protested the Section's refund denial via protest letter dated May 19, 2005. Taxpayer also requested a formal hearing via letter dated August 25, 2005.

The Department, in Publication 623, acknowledges that in order to impose a tax on a potential taxpayer, that taxpayer must have nexus with the state of Arizona. At issue is whether Arizona has sufficient nexus to tax income from an out-of-state franchisor that receives license and royalty fees from franchisees within the state of Arizona.

CONCLUSIONS OF LAW

The State of Arizona imposes a net income tax on the Arizona taxable income of foreign corporations with business activity in this state. *See* A.R.S. Title 43, Chapter 11. Royalty and licensing fees are considered business income and are subject to tax in Arizona. *See* A.A.C. R15-2D-506.

Taxpayer argues that the Due Process Clause and the Commerce Clause of the United States Constitution limit Arizona's power to levy taxes, and that a state can only tax those persons, activities, transactions, and property that have sufficient nexus with that state. Taxpayer further argues that because Taxpayer does not have sufficient nexus in Arizona, it is not subject to income tax in Arizona.

Commerce Clause

With respect to the Commerce Clause, both parties agree that the appropriate test is found in *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977). In that case, the United States Supreme Court provided a four-part test to determine whether a tax can withstand a Commerce Clause challenge by requiring that the "tax [1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Id*. at 279. Neither party argues that the tax at issue runs afoul to the second, third, or fourth prong of the four-part test. Rather, both parties seem to agree that, with respect to the Commerce Clause issue, the crux of the matter is whether or not Taxpayer

had substantial nexus with Arizona. However, the parties disagree as to what constitutes substantial nexus.

Taxpayer argues that the United States Supreme Court, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), requires that a taxpayer must be physically present in the state in order to meet the substantial nexus requirement. The Section argues that the physical presence requirement articulated in *Quill* applies to sales and use tax cases, but does not apply to income tax cases. In *Quill*, the Supreme Court upheld its ruling set forth in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, (1967), a sales and use tax case which held that "a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Quill*, 504 U.S. at 311.

However, since *Quill*, a number of states have found that its holding is limited to sales and use taxes. For example, the New Jersey Supreme Court recently held that it did "not believe that the Supreme Court intended to create a universal physical-presence requirement for state taxation under the Commerce Clause," and that "the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes." *Lanco, Inc. v. Director*, 908 A.2d 176, 177 (N.J. 2006). The Supreme Court of Appeals of West Virginia declared as follows:

> **After careful consideration of the parties' arguments, the relevant legal authority, and the Court's reasoning in *Quill*, we conclude that *Quill*'s physical-presence requirement for showing a substantial Commerce Clause**

> nexus applies only to use and sales taxes and not to . . . corporation net income taxes.

Tax Comm'r of West Virginia v. MBNA America Bank, N.A., 640 S.E.2d 226, 232 (W.Va. 2006). The South Carolina Supreme Court held as follows:

> The U.S. Supreme Court recently revisited [in *Quill*] the physical presence requirement of *Bellas Hess* and, while reaffirming its vitality as to sales and use taxes, noted that the physical presence requirement had not been extended to other types of taxes.

Geoffrey, Inc. v. South Carolina Tax Com'n, 437 S.E.2d 13, 18 n. 4 (S.C. 1993). In a similar case, involving the same taxpayer, the Oklahoma Court of Civil Appeals also found that "the physical presence requirement applicable to use and sales taxes is not applicable to income tax." *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632, 638 (Okla. Ct. App. 2005) (herein "*Geoffrey Oklahoma*").

The Hearing Office agrees with the above mentioned states, and others, that the physical presence test articulated in *Quill* is limited to sales and use tax cases. While *Quill* upheld the precedent set forth in *Bellas Hess* that physical-presence was necessary to establish nexus in a sales and use tax case, the *Quill* opinion itself acknowledges that the Supreme Court has not extended the physical-presence test to other types of taxes. In *Quill*, the Court stated:

> In sum, although in our cases subsequent to *Bellas Hess* and <u>concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement</u>, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess*

> **established in the area of sales and use taxes.**

***Quill*, 504 U.S. at 317 (emphasis added). *Bellas Hess* was a mail-order sales and use tax case, as was *Quill*. By upholding *Bellas Hess*, the *Quill* court was only upholding the rule as it applied to sales and use tax cases.**

Further, there are significant differences between an income tax and a sales or use tax. These differences, as some courts have pointed out, may make the test used in sales and use tax cases inapplicable to income tax cases. For instance, the North Carolina Court of Appeals stated as follows:

> **"[T]here are important distinctions between sales and use taxes and income and franchise taxes "that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test." "The use tax collection cases were based on the vendor's activities in the state, whereas" the income and franchise taxes in the instant case are based solely on "the use of [the taxpayer's] property in th[is] state by the licensee[s]" and not on any activity by the taxpayers in this State. . . . Since the tax at issue in this case is not based on the taxpayers' activity in North Carolina, but rather on the taxpayers' receipt of income from the use of the taxpayers' property in this State by a commonly-owned third party, "it would [be] inappropriate and, indeed, anomalous . . . [to determine] nexus by [the taxpayers'] activities or [their] physical presence" in North Carolina.**

***A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194-95 (N.C. Ct. App. 2004) (citations omitted) (quoting Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 State Tax Notes, 671, 676 (1995)). *Accord Lanco, Inc. v. Director*, 879 A.2d 1234, 1238-40 (N.J. Super. Ct. App. Div. 2006); *Geoffrey Oklahoma*, 132 P.3d at 637-38.**

The Arizona Court of Appeals has recently addressed the issue of substantial nexus. *See Ariz. Dep't of Revenue v. Care Computer Systems, Inc.*, 197 Ariz. 414, 4 P.3d 469 (App. 2000); *Ariz. Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears*, 192 Ariz. 200, 963 P.2d 279 (App. 1997). However, both cases were in the context of the transaction privilege tax, and neither case extends its holding to cases involving corporate income tax. *See O'Connor*, 192 Ariz. at 205, 963 P.2d at 284 n. 6 (noting their refusal to address the nexus threshold of another type of tax "because the nexus is at issue here only with respect to the transaction privilege tax"); *Care*, 197 Ariz. at 416, 4 P.3d at 471 ("We now decide whether a sufficient nexus existed between Care's business activities and Arizona to subject Care to Arizona's retail transaction privilege tax.") (emphasis added).

Because the Arizona cases were based upon the transaction privilege tax, the Court looked at the taxpayers' activities performed in Arizona. However, where the tax at issue is a corporate income tax, the relevance of physical presence and activities is less significant than the taxpayer's "receipt of income from the use of the taxpayer['s] property in this State" by another party. *A&F Trademark,* 605 S.E.2d at 195. Therefore, the Hearing Office holds that the standards for determining nexus found in *O'Connor* and *Care* are limited to cases involving the transaction privilege tax.[1]

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[1]It is significant to note, however, that in both Arizona cases, the Arizona Court of Appeals seemed to diminish the importance

The South Carolina Supreme Court recently addressed the very issues addressed in the case at hand. *See Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (1993). While the South Carolina case is not binding on Arizona, because it is directly on point, it is very persuasive. In that case, taxpayer (Geoffrey) was an out-of-state company that owned "several valuable trademarks and trade names, including 'Toys R Us.'" *Id*. at 15. Geoffrey entered into license agreements with Toys R Us that allowed Toys R Us to use its trade names and trademarks, as well as the "right to use Geoffrey's merchandising skills, techniques, and 'know-how' in connection with marketing, promotion, advertising, and the sale of products covered by the Agreement." *Id*. In return, Geoffrey received a percentage of the sales "of the Licensed Products sold or the Licensed Services rendered under the Licensed Mark." *Id*.

In that case, the South Carolina Supreme Court held as follows:

> **It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus. . . . We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a "substantial nexus" with South Carolina.**

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of the amount of physical presence in establishing nexus, even in transaction privilege tax cases. *See Care*, 197 Ariz. at 417, 4 P.3d at 472 (noting that "[a]lthough Care's Arizona activity was of relatively low volume, 'the volume of local activity is less significant than the nature of its function on the out-of-state taxpayer's behalf'") (quoting *O'Connor*, 192 Ariz. at 208, 963 P.2d at 287).

_Id._ at 23-24. The taxpayer appealed the decision to the United States Supreme Court, but was denied certiorari. _See_ 510 U.S. 992 (1993).

In the case at hand, Taxpayer entered into Franchise Agreements with four Franchisees located in Arizona during the Audit Period. Taxpayer granted the Franchisees a license to use the service mark "[REDACTED]," and all other service marks that Taxpayer adopted for use in conjunction with the business. In return, Taxpayer collected royalty income and advertising fees based on a percentage of the Arizona Franchisees' gross receipts from sales and services.

Taxpayer provided Franchisees a license for, and required its Franchisees to utilize, Taxpayer's computer software to assist the Franchisee in the operation of its business. Franchisees were required to allow Taxpayer to have access to Franchisees' computer equipment and software. Taxpayer also provided Franchisees with operations manuals, as well as training and promotional aids to assist Franchisees in their businesses. However, Taxpayer retained ownership of such items, and Franchisees were required to return the items upon termination of the Franchise Agreement.

Finally, Taxpayer assigned an FBC to act as a liaison between Taxpayer and the Franchisees. The FBC's job was to assist Franchisee in areas such as: "marketing, financials, financial matters, employee recruitment and retention, protecting the brand, and continuous growth." The FBC also conducted inspections of Franchisees, and offered

recommendations and assistance to help Franchises to grow their business. The FBC was required to "visit each franchise location as needed (at least once per year)," to "track franchise performance in the four 'key result areas', and contact all franchises on a regular basis." While the exact number of contacts that Taxpayer's FBC made with the Arizona Franchisees is not known, the parties stipulated that the FBC physically visited each Arizona Franchisee at least once per year.

Based on these facts, the Hearing Office finds that Taxpayer had "substantial nexus" with Arizona, as required under *Complete Auto*'s four-part test. *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977). Therefore, Arizona is not prohibited by the Commerce Clause to impose a corporate income tax upon Taxpayer for the royalty and licensing fees received from its Arizona Franchisees.

In its Post-Hearing Memoranda, Taxpayer argued that "with the exception of *MBNA*, the remaining 'authority' utilized by the [Section] all involve a parent company with subsidiaries operating in the respective states." Taxpayer then noted that, conversely, Taxpayer is a franchisor of the four Franchisees located in Arizona. Taxpayer asserts that the cases cited by the Section are not persuasive because a parent-subsidiary relationship is different than a franchisor-franchisee relationship in that a parent corporation controls its subsidiary, while a franchisor does not control its franchisee.

However, neither *Geoffrey*, nor the other cases that follow its reasoning, attach any significant relevance to the issue of control in their rulings. In addition, while *Geoffrey* involved a parent-subsidiary relationship, Geoffrey (the out-of-state company) was not the parent corporation. Rather, Geoffrey, as the licensor, was a "second-tier subsidiary of Toys R Us, Inc.," the licensee. *Geoffrey*, 437 S.E.2d at 15. Consequently, Geoffrey had no structural control over the operations of the in-state company from which it received royalty fees. In the case at hand, the Franchise Agreement allowed Taxpayer a significant amount of control over how and where the Franchisees conducted their business. Taxpayer also had the right to audit Franchisees' books at any "reasonable time" and had the authority to shut down a Franchisee if Taxpayer believed it was conducting its business adversely to Taxpayer's operations. Thus, although *Geoffrey* and its progeny do not seem to place significant relevance on the issue of control, to the extent control has any relevance, Taxpayer in this case had much more control over its Franchisees than did the taxpayer in *Geoffrey*.

<u>Due Process</u>

Taxpayer also asserts that the Due Process clause of the United States Constitution prohibits Arizona from assessing taxes against the Taxpayer. The Supreme Court acknowledged, in *Quill*, that it has "sometimes stated that the '*Complete Auto* test, while responsive to Commerce Clause dictates, encompasses as well ... due process requirement[s]'" and that "such comments might suggest that every tax that passes contemporary Commerce

Clause analysis is also valid under the Due Process Clause." *Quill*, 504 U.S. at 313 n. 7 (quoting *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 373 (1991)). Therefore, because the Section's assessment of tax in this case is valid under the Commerce Clause, it is also likely valid under the Due Process Clause.

However, the Supreme Court also stated, in *Quill*, that while the Commerce Clause and the Due Process clauses are "closely related," they are also "analytically distinct" and "reflect different constitutional concerns." 504 U.S. at 305. Because the issues were addressed separately in *Quill*, and Taxpayer has raised the Due Process argument as a separate issue, the issue will be addressed here.

In *Quill*, the Court noted as follows:

> **The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that the "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'"**

***Id*. at 306 (citations omitted). However, the Supreme Court also abandoned any physical-presence requirement to establish nexus for purposes of the Due Process Clause. *Id*. at 307-08. Rather, in *Quill*, the Court made it clear that "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State," or "purposefully directed" its efforts "toward residents of another state," then the Due Process requirement is met. *Id*.**

Using the criteria set forth in *Quill*, the South Carolina Supreme Court held that "by electing to license its trademarks and trade names for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states." *Geoffrey*, 437 S.E.2d at 16. The *Geoffrey* court further held that "by providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement." *Id*. at 18.

In this case, Taxpayer licensed its trademarks, trade names, manuals, and software to its Franchisees in Arizona. Taxpayer received royalties based upon a percentage of the Franchisees' gross receipts from the Arizona market. It is rational to assume that the purpose of Taxpayer's contacts, inspections, training, manuals, software, etc. was to increase the Franchisees' gross receipts in Arizona in order to increase its own royalty income from such Franchisees. Thus, Taxpayer's efforts were "purposefully directed" toward the residents of Arizona. *Quill*, 504 U.S. at 308.

Like the taxpayers in *Geoffrey*, by licensing its trade names and trademarks to the Arizona Franchisees, Taxpayer "contemplated and purposefully sought the benefit of economic contact" with Arizona. *Geoffrey*, 437 S.E.2d at 16. In addition, Arizona provided "an orderly society" for which the Franchisees could conduct business, and thereby "make it possible for [Taxpayer] to earn income pursuant to the [franchise] agreement." *Id*. at 18. Therefore, the Hearing

Office finds that the Due Process Clause does not prohibit Arizona from taxing the income at issue in this case.

Based on the foregoing, the Section properly denied Taxpayer's request for refund. Therefore, Taxpayer's protest is denied.

DATED this 27th day of March, 2008.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by
certified mail to:

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