

PUBLICATION

Spotlight on SALT: What Happens When a Deer Meets a Giraffe? Sub-Licensing and Economic Presence Nexus

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The Scioto River runs through central and southern Ohio and was the home for many Native American cultures. "Scioto" is a Native American word for "deer." The State of Oklahoma has its own very important Native American history -- and is also one of approximately 18 states that follow economic presence nexus as a result of *Geoffrey, Inc. v. Okla. Tax Comm'n*, the "giraffe." However, in *Scioto Insurance Co. v. Okla. Tax Comm'n*, the Oklahoma Supreme Court has just provided business taxpayers with a glimmer of hope in the battle against states asserting economic presence nexus.

Background

In Oklahoma's *Geoffrey* case, the Oklahoma Supreme Court followed the courts of a number of other states in holding that the Due Process and Commerce Clauses of the U.S. Constitution did not forbid Oklahoma from asserting income tax jurisdiction over an out-of-state intangible holding company that licensed the "Geoffrey the Giraffe" and other trademarks to affiliated Toys"R"Us retail stores in that and other states. In so doing, the Oklahoma Court held that the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota* did not extend the physical presence nexus requirement for sales and use taxes to income taxes. However, in *Scioto Insurance*, the Oklahoma Supreme Court has allowed a deer to jump over the giraffe.

Scioto Insurance Co. v. Okla. Tax Comm'n

Wendy's International, Inc. (Wendy's), the parent company of the Wendy's restaurant chain, formed a captive insurance company in Vermont to insure the various risks of Wendy's and its affiliates. The captive, Scioto Insurance Co. (Scioto), was capitalized with Wendy's trademarks and other intellectual property. The intellectual property was actually owned by Oldemark, LLC, a single member limited liability company (disregarded for federal and Oklahoma tax purposes) whose sole member was Scioto. The trademarks were licensed to Wendy's in return for a royalty measured by three percent of Wendy's gross sales. Wendy's was provided the exclusive right to sub-license the marks and it did so with Wendy's restaurants in Oklahoma. Those restaurants paid Wendy's a royalty equal to four percent of their gross sales.

Wendy's was clearly subject to Oklahoma's tax jurisdiction as a result of the *Geoffrey* case, and included such royalty income in its Oklahoma taxable income and filed an Oklahoma tax return. However, the court held that this sub-licensing arrangement was sufficient to cut off Oklahoma tax jurisdiction at Wendy's, the sub-licensor, and that such jurisdiction did not extend to Scioto, the licensor. The Oklahoma Supreme Court noted that Scioto was formed pursuant to legitimate business purposes, was a substantive entity, and the license between Scioto and Wendy's was bona fide. On this basis, the court distinguished its *Geoffrey* decision.

While the result in *Scioto Insurance* is encouraging, the fact that Scioto did not insure any Oklahoma person or entity is likely very significant. In fact, a more interesting question in the case that was not squarely addressed centers on the Due Process Clause. While most of the contentions surrounding economic presence nexus deal with the Commerce Clause and whether its physical presence requirement (per *Quill*) applies outside of sales and use taxes, insurance companies are not protected by the Commerce Clause based on the federal McCarran-Ferguson Act. As an insurance company, the question of whether *Quill*'s physical presence

requirement applied to Scioto was irrelevant. As a result, *Scioto Insurance* may be even more important than just encouraging. Under facts similar to those in this case, a sub-licensor may serve as a "blocker entity" against a state asserting economic presence nexus under the Commerce and Due Process Clauses.

If you would like to discuss the *Scioto Insurance* case or have other questions involving state tax jurisdiction, please contact any attorney in the Firm's Tax Department.