West Coast Warning: California Targets Nonresident Franchisors

October 12, 2009

It appears that California has joined New York in targeting nonresident franchisors. The California Franchise Tax Board (FTB) has taken the position that nonresident franchisors not qualified to conduct business in California are subject to California withholding. The FTB website states when a nonresident payee – in this case, a franchisor – is not qualified with the California Secretary of State to do business in California, and does not maintain a permanent place of business in California, the payor must withhold 7% from all California source income payments that exceed $1,500 in a calendar year. The FTB website further states that California source income includes payment of royalties.

California law exempts nonresidents from 7% withholding if the nonresident is qualified to do business in California. But the nonresident will be subject to California income taxes. Even more troubling is Section 17952(a) of the California Code of Regulations (CCR), which provides:

Income of nonresidents from rentals or royalties for the use of, or for the privilege of using in this State, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises, and other like property is taxable, if such intangible property has a business situs in this State within the meaning of [Section 17592](c).

Section 17952(c) of the CCR provides:

Intangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State.

If the nonresident's intangible personal property is "employed as capital" in California, the nonresident's effective tax rate will likely be increased. Although this tax approach was undoubtedly directed at the entertainment industry exiles who fled the Golden State for lower tax jurisdictions, its plain language covers franchise royalties.

By way of an example, let's assume that the Franchisor (nonresident, but qualified to do business in California) has $1 million in gross revenues, derives $300,000 of its revenues as royalties from California and has taxable income equal to $200,000. In addition, assume that Franchisor has no payroll in California and employs no capital in California. Using California's allocation formula, the tax on the income is $2,652.

Now assume the following: (i) the value of this same Franchisor is $5 million; (ii) 70% of that value is represented by its trademark and goodwill; (iii) Franchisor's business in California of licensing its intellectual property constitutes the "employing of capital"; and (iv) that such capital employed are deemed to be in the same percentage as revenues earned (i.e., 30%). California's allocation formula then produces a tax due of $3,580.

It gets even worse. Let's now assume that our sample Franchisor is actually a nonresident who is not qualified to do business in California. Under California's new allocation formula, the Franchisor's tax liability then soars to $21,000, resulting in an effective tax rate of 10.5%.

Franchisors receiving California source income from their franchisees should contact their tax advisor immediately to determine whether it makes sense to become qualified to conduct business in California. Because franchise registration under the California Franchise Investment Law requires consent to service of process as a condition to franchising in California, a major reason for not undertaking qualification may be absent for franchisors.