PUBLICATION

Spotlight on New York: Amended New York Sales and Use Tax Law Imposes Information Reporting Requirements on Franchisors Regarding Their Franchisees

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Recently enacted New York sales and use tax legislation requires franchisors to submit annual transaction data regarding their New York franchisees to the New York Department of Taxation and Finance (Department). The Department has sent out a number of letter requests to franchisors across the United States requesting franchisee name and address information to "give them the opportunity to apply for New York's Voluntary Compliance Program." New York's franchisee information reporting that is being imposed on franchisors is not only controversial, it is suspect under the constitutional law analysis usually applied to state taxation of interstate commerce.

Franchisor Information Reporting

New York's 2009-2010 Budget Law enacted a new provision (N.Y. Tax Law Section 1136(i)(1)(B)) that requires every franchisor with at least one franchisee in New York State to provide the following information to the Department:

1. Gross sales of the franchisee in New York as reported by the franchisee to the franchisor;
2. Total sales by the franchisor to the franchisee;
3. Income reported to the franchisor by the franchisee;
4. The name, address and the New York certificate of authority or federal taxpayer identification number of the franchisee; and
5. Provide the information reported to the Department to the franchisee.

This data must be reported annually by March 20 and in electronic format as prescribed by the Department. However, the franchisor's initial information return covers the period of March 1, 2009 to August 31, 2009, and must be reported by September 20, 2009.

Subject to a reasonable cause exception, penalties are imposed on franchisors failing to report the information required. A penalty of $500 for up to 10 failures to report and $50 per failure for each additional failure will be imposed. In addition, a penalty of up to $2,000 for each failure to timely report (by March 20 each year) is also imposed. The penalties in aggregate cannot exceed $10,000 for any annual reporting period.

Is New York's Franchisor Information Reporting Requirement Constitutional?

The intent of the New York law is obvious: The Department is seeking the aid of the franchisor to develop the Department's audit trail regarding the franchisee. However, the information reported could also be used for a sales and use tax or franchise (income) tax audit of the franchisor, and it could be exchanged with other states. Still, the Department would likely respond that it is not imposing a tax on the franchisor or a tax collection obligation. Thus, even if the franchisor has no physical presence in New York, the Department would claim it is entitled to the information. Is it?

As an initial matter, franchisors having New York franchisees should carefully consider whether they have nexus in New York for sales and use tax and franchise (income) tax purposes. This is especially true for franchisors operating under master franchise arrangements or that use area representative franchisees or other independent contractors to perform activities, sell equipment or otherwise interact with New York franchisees. Therefore, a franchisor should first evaluate any potential nexus-creating activities and relationships that it may have with New York. To the extent a franchisor may have tax nexus with New York, the Department's ability to obtain the franchisee transaction data is strengthened.

Absent nexus-creating contacts with New York, consideration must be given to questioning the Department's ability to enforce the franchisee information reporting. While a franchisor must consent to service of process in New York to register or obtain the "modest size" exemption from registration under New York franchise law, it may not have the "minimum contacts" necessary to support New York's jurisdiction to enforce the information reporting under the Due Process Clause of the U.S. Constitution. This Spotlight does not address these issues in detail; however, due process only requires an out-of-state franchisor to have purposefully availed itself of the privilege of conducting activities in New York. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Purposeful action, such as designing a product for the New York market, advertising in New York, marketing products or services into New York, and the like could be sufficient to constitute "minimum contacts" with New York. Indeed, the Department would likely argue that entering into a franchise agreement with a New York franchisee is sufficient to establish "minimum contacts" under *Burger King*. Yet, *Burger King* involved the assertion of specific jurisdiction over an out-of-state defendant arising out of an alleged breach of contract. Conversely, New York's information reporting requirement could be viewed as an assertion of general jurisdiction that may not be supported merely by the existence of a New York franchise, since the assertion of jurisdiction should not arise out of a cause of action related to the franchise.

Following the *Quill* decision and the U.S. Supreme Court's reaffirmation that, at least for sales and use tax purposes, a taxpayer must have a physical presence before a state may assert taxing jurisdiction under the Commerce Clause, a number of states sought customer information from mail order sellers. These states argued that, since a direct imposition of a state tax or tax collection obligation was not at issue, the Commerce Clause standard to be applied was that which applied to any regulatory measure. In this context, a balancing test is applied that addresses whether the state has a legitimate interest and, if so, whether the burden imposed on commerce is outweighed by that interest. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). The Department would likely take up this argument: New York has a legitimate interest in enforcing tax compliance of franchisees doing business in New York. However, there appear to be several burdens on the interstate commerce of the franchisor that could outweigh New York's interest in promoting tax compliance, including:

1. The compliance burden on the franchisor with respect to the information reporting;
2. The potential penalty burden on the franchisor;
3. The potential enforcement burden on the franchisor if the information is used by the Department to audit

the franchisor or if it is exchanged with other states;

4. The burden placed on the franchise relationship of the franchisor and franchisee;

5. The burden of requiring the franchisor to provide additional information to the franchisee; and

6. The potential burden that a franchisor will have to correct transaction data originally reported by the franchisee that it may question when it is required to report that data to the Department.

Franchisors that have one or more franchisees in New York should begin now to consider their options in response to New York's franchisee transaction data information reporting. If you would like to discuss the new law or your options, please contact and attorney in the Firm's Tax Department.