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Iowa Corporate Tax - It's Not "Finger-Licking Good"

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Overview

"We're Number One, We're Number One!" While that doesn't apply to the Cyclones, Panthers, Bulldogs or the Hawkeyes, it does apply to Iowa's corporate income tax – it's the highest stated rate in the nation. Now, the Iowa Supreme Court has held that the tax applies to royalties received by a company that has no assets or employees in Iowa.[1] As a result of the Court's decision, the Iowa Department of Revenue (IDOR) has taken an even more aggressive stance against out-of-state businesses.

Facts of KFC

The plaintiff, Kentucky Fried Chicken, is a Delaware corporation with its principal place of business located in Louisville, Kentucky. It licenses the KFC trademark and related systems to franchisees. All KFC stores in Iowa are owned by independent franchisees and KFC has no assets or employees in Iowa. But, KFC did collect royalty income from its Iowa franchisees and the IDOR took the position that the royalty income was subject to Iowa corporate income tax. The IDOR said the royalty income was taxable because it was derived from Iowa customers and was made possible by "Iowa's infrastructure and the legal protection of the Iowa marketplace." The IDOR issued an assessment of $284,658.08 for years 1997-1999. KFC filed a protest, the IDOR answered and the matter went to an Administrative Law Judge, with both sides motioning for summary judgment. The ALJ ruled for the IDOR, stating that a physical presence was not required in Iowa for purposes of the levying of tax on income. As for the situs requirement of Iowa Code §422.33(1), the ALJ reasoned that didn't require a physical situs, only some place in Iowa where something originates in the law. Because the royalty income could be tied to franchisees located in Iowa, the royalty income could be taxed. On further appeal, the IDOR affirmed the ALJ, and the trial court affirmed the IDOR's ruling. KFC pushed the case on to the Iowa Supremes.

IDOR Policy Letter

As we noted on the CALT website in mid-December, the IDOR issued a policy letter stating its position on the matter. In Policy Letter released in late 2010,[2] the IDOR said that a physical presence in Iowa is not required for a corporation to establish a "nexus" with the state for corporate income tax purposes. The LLC at issue was an Idaho LLC, but was registered with the Iowa Secretary of State's Office. All of its employees were located in Idaho, and its business was as a registered agent service that serves process where a process server is unavailable.

Iowa Supreme Court Opinion

Now, the Iowa Supreme Court has agreed with the IDOR's position. That's in spite of a U.S. Supreme Court case that would seem to indicate that KFC should have prevailed. In *Quill v. North Dakota,*[3] the U.S. Supreme Court held that a mail order vendor that had no physical presence in North Dakota was not subject to North Dakota sales and use tax. The Court held, based on a Commerce Clause analysis, that a physical presence by the company in North Dakota was required before the company could be subjected to North Dakota's taxing regime. So, how did the Iowa Supreme Court get around *Quill*? They made broad-sweeping policy arguments, and basically said the U.S. Supreme Court opinion was antiquated (even though it was decided only 18 years ago). Furthermore, the Iowa Supreme Court pontificated that because the U.S. Supreme Court hadn't issued another opinion on the matter since it decided *Quill* in 1992, the U.S. Supreme Court would not decide a similar case the same way today. For example, the Iowa Supreme Court said, "…we think taxation of the income here is most consistent with the now prevailing substance-over-form approach embraced in most of the modern cases decided by the Supreme Court under the dormant Commerce Clause. When a company earns hundreds of thousands of dollars from sales to Iowa customers arising from the licensing of intangibles associated with the fastfood business, we conclude that the Supreme Court would engage in a realistic substance-over-form assessment that would allow a state legislature to require the payment of the company's fair share of taxes without violating the dormant Commerce Clause." The Iowa Court went on to state, "In fact, "physical presence" in today's world is not "a meaningful surrogate for the economic presence sufficient to make a seller the subject of state taxation. "Physical presence" often reflects more the manner in which a company does business rather than the degree to which the company benefits from the provision of government services in the taxing state. Does it really make sense to require Barnes and Noble to collect and remit use taxes, but not impose the same obligation on Amazon.com, based on the difference in their business methods?"

> **Note:** On March 30, 2012, a federal district court permanently enjoined the enforcement of a Colorado statute's sales and use tax notice and reporting requirements.[4] The court noted that while in-state retailers must collect and remit Colorado sales tax, the U.S. Supreme Court's *Quill* decision bars states from imposing the same obligations on out-of-state retailers without a physical presence in Colorado. Doing so, the court reasoned, would discriminate against interstate commerce in violation of the Commerce Clause.

The Iowa Supremes and Tax Policy

That is plainly a policy-based argument. Policy decisions are to be left for elected officials, not the Court. That's particularly the case when there is a U.S. Supreme Court opinion squarely on point to the contrary. But, the Iowa Supreme Court has done this before. Several years ago, the Iowa Supremes were handling a case involving the taxation of racetracks and riverboat casinos, and ruled that there was no "rational basis" for taxing them differently. Before 1994, slot machines were authorized in Iowa only on riverboat casinos, with the casino revenue subject to a 20 percent tax. In 1994, the legislature allowed dog racing tracks to operate slot machines, with the revenues taxed at 36 percent by way of a statutory exception to the taxation of gambling revenues. But, in 2002, the Iowa Supreme Court held that the differential tax rates violated the Fourteenth Amendment's Equal Protection Clause.[5] The U.S. Supreme Court unanimously reversed.[6] The U.S. Supreme Court pointed out that a law only violates the Equal Protection Clause if it has no conceivable rational basis, and that the Iowa legislature's decision to tax casinos and dog tracks differently was rational, and that the Iowa Supreme Court misunderstood and misapplied the Equal Protection Clause. The U.S. Supreme Court specifically noted that it was improper for the Iowa Supremes to rule a law irrational when it fails to pursue only a single purpose. In other words, the Iowa Supremes said the differing tax treatment of dog tracks and casinos violated the Commerce Clause because it put dog tracks at a competitive disadvantage. But, the U.S. Supreme Court unanimously disagreed, and ordered the Iowa Supreme Court to try again and reach a decision that was "not inconsistent" with the U.S. Supreme Court's opinion.

However, the Iowa Supreme Court issued a 5-2 opinion again striking down the casino tax.[7] The second time around, the Iowa Court changed its analysis of such cases and decided it in a way the U.S. Supreme Court could not review. The Iowa Supreme Court stated, "Notwithstanding the broad statement made by this court in its initial opinion that we will apply the same analysis under the state equal protection provision as is applied under the federal Equal Protection Clause, this court has always reserved to itself the ability to employ a different analytical framework under state constitutional provisions." The court then went on to say there was no reasonable basis to tax dog tracks differently from riverboat casinos, so the dog tracks were due a refund of $112 million, plus interest. One of the dissenters said, "The decision of the majority causes great harm to the law, to the concept of federalism, to the doctrine of judicial economy, to the essential reliability of legal principles, and to the balance of power within our government. Perhaps most troubling of all, it also causes a great injustice to the people of Iowa. It is never an easy decision to dissent, but that decision has never been easier than in this case."

> **Note:** On October 5, 2011, the U.S. Supreme Court declined to hear the KFC case.[8]

The *Jack Daniels* Case[9]

In mid-2011, the Iowa Department of Revenue (IDOR) recently issued an administrative decision implementing the legal theory adopted in KFC.[10] The case involved the IDOR's attempt to recover taxes from two subsidiaries of alcohol distributors for the royalty income earned from the licensure of trademarks or trade names where the only connection that the subsidiaries had with the state involved the sale of liquor to the state's wholesale liquor monopoly.

Facts of the case. Brown-Forman Corporation [Brown] is a Delaware corporation with its principal offices located in Louisville, Kentucky. Brown produces and markets Jack Daniel's and Southern Comfort whiskeys. All production and marketing of Jack Daniel's products are done through Brown and two other corporate entities, Jack Daniel's Distillery, Inc. is a Tennessee corporation that produces a "distillate" that it sells to Brown. JD Properties owns all of Jack Daniel's intellectual property and entered into an exclusive agreement with Jack Daniel's Distillery to use intellectual property, including the trademark. Jack Daniel's Distillery was authorized by JD Properties to grant Brown an exclusive nontransferable license to use the intellectual properties for marketing of the product. Likewise, Southern Comfort Properties, Inc. is a subsidiary of Brown that owns all the intellectual property rights of the brand. It entered into a trademark license agreement with Brown for the marketing of the brand.

Administrative Law Judge's decision. In applying the holding of the KFC case, the ALJ found no distinction between the franchisees paying royalties to KFC for the right to use trademarks because they know the name and trademarks will attract customers and the royalties Brown pays to Southern Comfort Properties for the right to sell the product to retailers in Iowa. The ALJ did not find significance in the fact that no Iowa business remitted royalty payments to Southern Comfort Properties. Indeed, the ALJ stated that IDOR's regulations were consistent with the Iowa Supreme Court's interpretation of the statute insomuch as the regulations defined "intangible property located or having a situs in this state" to include intangible property that "has become an integral part of some business activity occurring regularly in Iowa."[11]

But, those regulations conflict with federal law (the Interstate Income Act (IIA)[12]) which bars states from taxing corporations that merely ship goods into the state from another state. The IIA bars states from subjecting to income tax sales within its borders if the orders for tangible personal property are filled or shipped outside of the state.

The ALJ found the JD Properties scenario was not distinguishable from the KFC decision with the only difference being there were three companies involved instead of two. Consequently, the ALJ upheld IDOR's assessment and the penalties for the failure to file and underpayment of estimated tax. The ALJ held that for waiver of penalties, the corporations were required to identify the substantial authority and legal position upon which they would rely at the time the return was originally due.

The ALJ's decision was appealed to the trial court, but apparently a settlement was reached before the court rendered a decision.

Conclusion

Unfortunately, the Iowa Supreme Court has a history of ignoring U.S. Supreme Court precedent when that precedent doesn't allow the court to produce the result that it wants[13] and, in this instance, the IDOR has written regulations consistent with the Iowa Supreme Court decision.

From a policy standpoint, there are numerous products, franchises, and services with nationally-recognized trademarks and brands that are being offered and sold throughout Iowa currently. The extent of this long-arm taxing strategy can only dampen corporate investment in Iowa and make it more difficult for local businesses to negotiate sales and use agreements with national companies.

The Iowa legislature may want to address the issue along with an overhaul of the state's corporate tax structure. Unfortunately, they appear to be doing just the opposite.[14]

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[1] KFC Corporation v. Iowa Department of Revenue, 792 N.W.2d 308 (Iowa 2010).
[2] IDOR Policy Ltr. No. 10240041 (Dec. 16, 2010).
[3] 504 U.S. 298 (1992).
[4] The Direct Marketing Association v. Huber, No. 10-CV-01546-REB-CBS (D. Colo. Mar. 30, 2012).
[5] Racing Association of Central Iowa, *et al*. v. Fitzgerald, 648 N.W.2d 555 (Iowa 2002).
[6] Fitzgerald v. Racing Association of Central Iowa, *et al.*, 539 U.S. 103 (2003).
[7] Racing Association of Central Iowa, *et al.* v. Fitzgerald, 675 N.W.2d 1 (Iowa 2004).
[8] 132 S. Ct. 97 (2011).
[9] In re Jack Daniels Properties, Inc., No. 09DORFC002, 004 (Iowa Dept. of Inspections and Appeals, Jul. 28, 2011).
[10] *Id.*
[11] 701 Iowa Adm. Code 52.1(1)(d), 52.1(4).
[12] 15 U.S.C. §§381-384.
[13] See notes 4-6 *supra*.
[14] SF 2330, 2012 Session.