Statement of Corey Schroeder
Vice President & CFO, Outdoor Living Brands, Inc.

Before the House Subcommittee on Courts, Commercial and Administrative Law

Hearing on H.R. 1439, the "Business Activity Tax Simplification Act of 2011"

April 13, 2011

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Good afternoon Chairman Coble, Ranking Member Cohen, and members of the subcommittee. My name is Corey Schroeder, and I am grateful for the opportunity to speak today in support of the *Business Activity Tax Simplification Act of 2011*, or "BATSA," and the specific impact the current state income tax reporting environment has on my company, Outdoor Living Brands and on franchise businesses in general.

I am the Vice President and Chief Financial Officer of Outdoor Living Brands, Inc., which is located in Richmond, Virginia and was formed in 2008 to acquire franchise businesses in the outdoor living category. We currently operate three brands representing 181 franchise locations in 34 states. Despite this reach, we are a small business with $4.6 million in revenue and only 28 employees.

During my remarks today, I will highlight why small businesses require a federal solution to bring greater certainty to compliance with state tax laws. I will share with you the experience of our company in navigating the unpredictable nature of state nexus decisions across multiple jurisdictions. Finally, I will provide insight into how the uncertainty of these nexus decisions impact the hundreds of thousands of franchise businesses in the United States.

Our franchise system is an active member of the International Franchise Association (IFA). As the largest and oldest franchising trade group, the IFA's mission is to safeguard the business environment for franchising worldwide. The IFA represents more than 90 industries, including more than 11,000 franchisee, 1,100 franchisor, and 575 supplier members nationwide. According to a study conducted by PwC for the IFA Educational Foundation, there are over 825,000 franchise businesses across 300 different business lines providing for nearly 18 million American jobs and generating over $2.1 trillion to the U.S. economy.

Franchised businesses play an important role in the economic health of the U.S. economy, and they are poised to help lead the economy on the path to recovery. The IFA Educational Foundation report shows that the franchise industry consistently outperforms the non-franchised business sector, creating more jobs and economic activity in local communities across the country. Franchising grew at a faster pace than many other sectors of the economy from 2001 to 2005, expanding by more than 18 percent. During this time, franchise business output increased 40 percent, compared to 26 percent for all businesses.

The franchise model allows companies like Outdoor Living Brands to grow our business concepts in communities across the country by partnering with local entrepreneurs that invest in and operate their own small businesses. As the franchisor we provide a business concept and operating plan, a brand, licensing of intellectual property in the form of trademarks and copy writes, as well as ongoing training and operational support to our franchisees. Our objective is to serve each local community with our services and help our franchisees build successful small businesses that create jobs.

Outdoor Living Brands an Illustration

This legislation would address a significant issue within the franchising community related to state income tax reporting. The primary issue facing franchisors are the confusing and ever changing rules governing the establishment of tax nexus based on business activities in each state.

When nexus is determined to exist, a franchisor is required to file state corporate income taxes based on the apportioned earnings derived from franchisees in that state. Creating a consistent definition of what constitutes nexus would greatly simplify tax reporting obligations for franchise companies and reduce a significant area of confusion, uncertainty and administrative cost.

While Outdoor Living Brands and franchise companies like ours have franchise locations in many states we do not have operations in those states. Outdoor Living Brands is a company incorporated in the Commonwealth of Virginia. Our physical presence, the development of our brand, the development and training of new franchisees, the support of existing franchisees - everything that makes us a franchisor - takes place in Virginia. The only assets we have in the various states are our franchise agreements, the contract that governs the terms of the relationship between us and our franchisees.

Certain states through legislation or recent court rulings have begun to recognize the mere existence of these franchise agreements and the use of our intellectual property or even the physical existence of our training manuals in their states as establishing nexus. I understand the desire of state tax agencies to generate revenue from out of state businesses from the royalty and licensing revenue derived from those states, especially in the current fiscal environment. However, the logical outcome of this view is for a small company such as Outdoor Living Brands, which conducts materially all of its business in the state of Virginia, would pay less than 10% of our state corporate income taxes to Virginia. Add to this the administrative and cost burden of filing 34 state tax returns and more as we expand to new states.

As a franchise business we are already a highly regulated business. Our franchise offering is prepared in accordance with the rules set by the Federal Trade Commission. Further, we must comply with additional rules set in certain states. We currently file a franchise tax return in Texas and we have to report on our franchisees' sales tax activity to the State of New York (a recent development). Finally, due to nexus rules we must file state income tax returns in Virginia, Ohio, North Carolina, Arizona, South Carolina, and Minnesota. The filing fees and expenses for audit, legal, and tax services approaches $100,000 per year. That does not include any allocation of my time or the time of our staff to prepare these various filings each year.

Without reform such as that provided by the *Business Activity Tax Simplification Act* the financial and administrative burden associated with tax compliance will continue to grow. This issue diverts resources vital to our business' ability to grow and support our franchisees.

Outdoor Living Brands provides an illustration of how this issue has grown in complexity in recent years. Our business has growth through the acquisition of our three brands. Through those transactions we acquired operations in Virginia, North Carolina, and Ohio. We have since ceased operations in North Carolina and Ohio but our nexus in those states remains for some reason.

Nexus with Arizona, Minnesota, and South Carolina is established purely through the existence of our franchise locations in those states. Most recently South Carolina in 2007 and Minnesota in 2008 established nexus with us through a questionnaire process. Revenue departments from those states sent Outdoor Living Brands a lengthy business activity questionnaire. After checking 'No' to almost every business activity described in the questionnaire it was determined that the existence of our franchisees was sufficient to establish nexus. We were required to file several years of past due tax returns. If we complied within a specified period of time we could have penalties and interest reduced. The South Carolina questionnaire was driven by a then recent court decision, prior to which our company did not have nexus. I never had any awareness of the nexus with Minnesota until the questionnaire process.

Hopefully, you can see the uncertainty facing franchise businesses surrounding this issue. We do not know with which states we have nexus or why. Further, we have no effective way of determining when those rules change or why.

As a franchise executive I have several ways to manage this issue. The first is to allocate even more of my scarce financial and management resources to proactively determine nexus status with each state. Likely, I would hire a tax consultant to research the remaining twenty-seven states where we have franchisees to explore if our business activity establishes nexus. I expect the states would err on the side of establishing nexus and I will then hire that tax consultant to file tax returns in those states. As you can imagine this is not an attractive approach for a small business like ours. Alternatively, I can take a passive approach and wait until the next business activity questionnaire arrives and start the process with that state, likely adding them to my roster of state income tax filings. The last option which some small business owners have suggested is to ignore the questionnaires and hope that the states are busy enough with larger companies (or those that responded) to overlook them for a couple of years.

Impact on Larger Franchising Business Community

While the United States Supreme Court, through its ruling in *Quill Corp. v. North Dakota*, justified the prohibition of states forcing out-of-state corporations to collect certain taxes unless it had established a physical presence in the taxing state, states have in recent years ignored the ruling and begun establishing an economic nexus standard for taxation. This has created tremendous hardships and confusion for all businesses that use the franchise business model to expand their brand.

Most franchisors own no property in the state in which their franchisees operate, do not maintain offices there, and employ no residents of those states. A franchisor's employees may make occasional visits to its franchisee's place of business to assist the franchisee in opening his or her business and to inspect the franchisee's performance and furnish training advice and guidance, but the duration of such visits normally is limited to a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media.

Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on those states. Meanwhile, like any other enterprise domiciled in a state, a franchisee operating there would pay taxes, be involved in supporting community activities, and create economic opportunities for employees and suppliers who would directly benefit from the existence of the enterprise.

Enactment of BATSA is important to the franchise business community because of the business relationship between a franchisor and its franchisees. Central to that relationship is a shared trade identity. That shared trade identity is established and maintained by the franchisor's license of its trademark, trade dress, and other intellectual property to each of its franchisees. Thus, each of the hundreds of thousands of franchise relationships that exist in the U.S. involves a license of intangible property. The great majority of those licenses cross state lines.

Franchise brands exist across a multitude of political boundaries in most franchise systems, but the franchisor is often a single entity with a clearly defined corporate residence. Some state revenue officials and, increasingly, legislators view the presence of a franchised outlet of a national or regional brand in their state as sufficient for the establishment of an economic, rather than a physical, nexus of the out-of-state franchisor. It has been incorrectly argued that the mere presence of intangible property in their jurisdiction satisfies the "substantial nexus" requirement under the Commerce Clause for the imposition of state income and related business activity taxes.

In December, the Iowa Supreme Court issued a troubling ruling in the case of KFC Corporation v. Iowa Department of Revenue. The ruling held that the U.S. Supreme Court would likely find that the intangibles that KFC licensed to its Iowa franchisees "would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence.'" This functional-equivalency test goes beyond related case law and is of questionable basis. The physical-presence test is a bright-line test that cannot be met through the "presence" of intangible property in a state. It is difficult to reconcile the Iowa Supreme Court's holding with this test, adding another layer of confusion for companies that are trying to properly assess their tax exposure. Such actions at the state level radically expand the classes of persons, relationships, and transactions potentially subject to state income taxation, and threaten the livelihoods of hundreds of thousands of entrepreneurs who have chosen franchising as the route to small business ownership.

The issue has enormous implications for the businesses engaged in franchising. If permitted, such assessments would subject licensors of intangible property in interstate commerce to income taxation by every state in which goods or services exploiting the licensed intangible property are sold. If a tax return is not filed, no statute of limitations will limit the period for which taxes, interest, and penalties may be due. Such a result would represent a radical departure from the historical understanding of the reach of taxing authority and a significant increase in the tax liability and burden of compliance of thousands of American small businesses.

If every state where a franchisor has granted franchises may tax its income attributable to that state, non-resident franchisors will be subject to costly compliance burdens and ever-escalating taxes. Under these circumstances, there is no doubt that franchisors will be forced to consider passing this cost of business on to their franchisees by increasing the royalty fees. Under this scenario the party most harmed is the resident franchisee. Thus, enactment of BATSA is critical for thousands of businesses, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Conclusion

Earlier in my career, as an investment banker, I provided professional services to dozens of small businesses in as many industries with far broader business activities compared to Outdoor Living Brands. Few other businesses face the unique complexity in state tax obligations as faced by franchise businesses due to the current nexus environment. The total cost of complying with the current state income tax environment is burdensome. The rules change frequently creating a great deal of uncertainty. The reforms provided by the proposed legislation would greatly improve these conditions for the franchise industry.

I want to thank the members of the Subcommittee on Courts, Commercial and Administrative Law for the opportunity to participate in today’s important hearing on the *Business Activity Tax Simplification Act*. It is my hope that we can work together to pass this legislation to address the unnecessary hardship that thousands of franchise businesses face across this country when it comes to compliance with state tax laws.

Thank you and I look forward to answering any questions you may have.