STATE AND LOCAL TAXATION: FRANCHISE FEES MUST BE APPORTIONED FOR PURPOSES OF A BUSINESS PRIVILEGE TAX

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In Pennsylvania, the Local Tax Enabling Act authorizes a variety of municipalities to impose a tax "on the privilege of doing business in the jurisdiction of the local taxing authority." 53 P.S. § 6924.301.1(a.1)(1). As with any state or local tax, the tax cannot violate the Commerce Clause; as a consequence, a local business privilege tax may only be imposed "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

On April 13th, the Commonwealth Court ruled that Upper Moreland Township had improperly failed to fairly apportion its business privilege tax in applying it to franchise fees collected from franchisees in Pennsylvania. *Upper Moreland Twp. v. 7 Eleven, Inc.*, No. 144 CD 2016 (Pa. Commw. Apr. 13, 2017).

7 Eleven, the taxpayer, had a regional office for its Northeast Division in Upper Moreland Township, along with a store that it owned; there was also a franchise store in the township. *Id.,* slip op. at 2. The regional office oversaw 7-Eleven stores in Pennsylvania and New England. *Id.* The taxpayer submitted business privilege tax returns that reflected the receipts generated by the store it operated directly in the township, but it did not report the franchise fees that were received from stores that were operated by franchisees in the Northeast Division. *Id.*

In the course of an audit, the township imposed a tax upon the franchise fees. Although the township applied a traditional three-factor apportionment model that focused on payroll, sales, and tangible property, the parties agreed to apply only the sales factor. *Id.* at 3. The parties disagreed on how this factor should be applied, however. The township sought to impose its tax on all franchise fees collected from stores in Pennsylvania, along with an apportioned segment of the franchise fees collected from stores in other states within the Northeast Division, which generated a tax assessment of over 1.7 million dollars. *Id.*

Following the taxpayer's administrative appeal, it sought review in the Montgomery County Court of Common Pleas, which invalidated the assessment, ruling that the tax, as applied to 7 Eleven, was unconstitutional as it did not meet the fair apportionment requirement of *Complete Auto Transit*. *Id.* at 4.

Fair apportionment under the Commerce Clause requires that a tax satisfy two tests: First, it must be internally consistent, which means that if each state adopted an identical tax, the taxpayer would not be subject to a risk of double taxation. *Goldberg v. Sweet*, 488 U.S. 252, 261 (1988). Second, the tax must be externally consistent, a test that "asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed." *Id.* at 262 (citations omitted); *see also Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108, 131 (Pa. 2003).

The trial court concluded that the imposition of the business privilege tax on all of the franchise fees collected from stores based in Pennsylvania violated the external consistency requirement as it failed to account for the fact that the franchise fees that the taxpayer collected from its Pennsylvania franchisees were derived in part from economic activity outside of Pennsylvania. 7 *Eleven,* No. 144 CD 2016, slip op. at 5. On appeal, the Commonwealth Court affirmed.

In the court's view, the record readily demonstrated that the franchise fees were derived in part from activity outside of Pennsylvania. For example, the taxpayer's marketing department was based in Texas and handled all advertising for all 7-Eleven stores in the country, including point-of-sale displays that were changed monthly. *Id.* at 5. Similarly, the taxpayer's IT department was also located in Texas, and IT support for all stores in the Northeast Division was provided by an employee based in Massachusetts. *Id.* at 5-6.

Faced with this record, the township argued that it was incumbent upon the taxpayer to identify the specific portion of the Pennsylvania franchise fees derived from activity outside the state. The Commonwealth Court observed that a taxpayer can show that a local tax is not externally consistent by showing it is disproportionate to its local business, has generated an assessment that is "grossly distorted," or "is inherently arbitrary or produced an unreasonable result." *Id.* at 7 (quoting *Philadelphia Eagles*, 823 A.2d at 132). In the court's view, the trial court had properly concluded that the assessment was disproportionate in light of the evidence that the franchise fees were derived in part through out-of-state activity. *Id.* The court specifically noted that the taxpayer had no obligation to segregate its receipts derived from interstate commerce from those derived from activity in Pennsylvania because it was apportionment that performed that segregation function. *Id.* Accordingly, the Commonwealth Court affirmed the trial court's determination that the township's tax assessment against 7 Eleven violated the Commerce Clause. It reversed the trial court's decision to invalidate the assessment, however, holding that the lower court should have remanded the matter for a recalculation of the assessment. *Id.* at 8.

Local governments in Pennsylvania have become increasingly aggressive in pursuing tax revenue. While they are entitled to collect their fair share, businesses should understand that a local government's view of what is a "fair share" of their revenue may involve overreaching. Courts exist to protect taxpayers from over-aggressive tax collectors, as both the trial court and the Commonwealth Court did here.

The case provides another lesson: In evaluating the scope of a local government's power to tax, think carefully about the economic reality of the taxpayer's business operations; franchise fees are normally calculated, in whole or in part, on the sales from the franchisee's location, making it natural for the local government to view those fees as fair game. By addressing what services the franchisor provided to earn those fees and where it rendered those services, the taxpayer's counsel demonstrated that the township was overreaching.

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