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June 24, 2008

The Honorable Linda Sánchez
U.S. House of Representatives
House Committee on the Judiciary
Chairwoman, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

The Honorable Chris Cannon
U.S. House of Representatives
House Committee on the Judiciary
Ranking Member, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act (H.R. 5267)

Dear Chairwoman Sánchez and Ranking Member Cannon:

The International Franchise Association (IFA) would like to express strong support for the Business Activity Tax Simplification Act ("BATSA") (H.R. 5267). BATSA would answer the need for a fair, clear and uniform nexus standard for the imposition of business activity taxes by states and localities.

Who we are:

The International Franchise Association, the world's oldest and largest organization representing franchising, is the preeminent voice and acknowledged leader for the industry worldwide. Approaching a half-century of service with a growing membership of more than 1,300 franchise systems, 10,000-plus franchisees and more than 500 firms that supply goods and services to the industry, IFA protects, enhances and promotes franchising by advancing the values of integrity, respect, trust, commitment to excellence, honesty and diversity. According to a 2008 study by PricewaterhouseCoopers, there are more than 900,000 franchise establishments in the U.S. that are responsible for creating 21 million American jobs and generating an annual economic output of \$2.3 trillion. The great majority of the approximately 2,500 franchisors operating in the U.S. are small businesses, with fewer than 50 franchised outlets.

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Why the Franchise Industry Supports BATSA:

Enactment of BATSA is important to the franchise industry 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 (*i.e.*, intangible 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.

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 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.

The franchise relationship evolved over the last half century with the understanding that the franchisor is not subject to state income taxes (other than those imposed by the franchisor's domicile state) on the royalty income paid to the franchisor by franchisees located in a different state. Prior to the late 1980s, with rare exception, the states did not seek to tax such income, unless the franchisor clearly established a traditional nexus by owning or leasing real estate, operating its own outlets, or maintaining an office or employees in the taxing state.

Recently, however, some state revenue departments have 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. Such arguments radically expand the classes of persons, relationships and transactions potentially subject to state income taxation.

To illustrate this point Mr. Stephen Joost, Chief Financial Officer of Firehouse Subs, Jacksonville, Florida, testified on February 14 of this year before the House Small Business Committee. According to Mr. Joost, "The way states are imposing burdensome rules, and changing them every year—first it is an unfair tax on intellectual property and secondly it has created a subsidy for lawyers and accountants." Added Mr. Joost, "The fact that I merely step foot in a state creates a taxing event is incredulous."

Illustrating the aggressive and arbitrary nature of state nexus audits on franchise companies, Mr. Joost's own testimony before Congress has been referenced in ongoing tax disputes with state departments of revenue. For that reason, many members of the IFA are hesitant to share their stories publicly for fear of further retribution. By way of example, the following situation was provided anonymously by an IFA member headquartered in a Western U.S. state:

Franchisor Company, Inc. ("FCI") is a franchise company headquartered in State A. FCI files and pay taxes in State A, as this is where they have a material physical presence. They maintain no other offices and their only "physical presence" in other states relates to short training and visits with franchisees in other states. Over the past 5-6 years four regionally varied states have contacted FCI, and as a result of "economic benefit/presence" they have required FCI to file and report in their states. This practice always begins with a self nexus audit.

Over the years FCI has spent over \$50,000 on accountants, consultants and other costs in reviewing these states' claims of nexus as well as trying to support their objections in light of no material physical presence in these states. FCI has also paid over \$100,000 in back amounts to settle with these states for periods prior to their contact with the respective state revenue departments.

As a result, FCI has considered eliminating onsite trainings, franchisee meetings, and other support activity that benefits franchisees, truly the core of the concept of franchising. Ultimately, FCI chose to settle as the states offer no due process or appeals process and the costs to litigate this issue against a state is unrealistic for a small franchise company.

The issue has enormous implications for the many thousands of businesses engaged in interstate franchising and licensing of intangible property, a rapidly expanding part of the American economy. 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. Unless addressed, the continuing uncertainty with respect to such issues will impose high costs on companies forced to operate in an environment in which their state tax liabilities are unclear.

The Honorable Sánchez and Cannon
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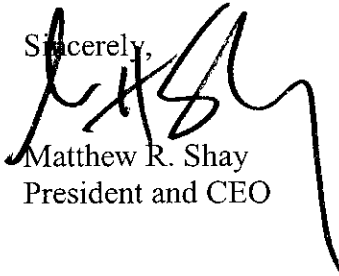
Conclusion:

As you can see from the examples provided, which are indicative of many IFA member companies, the franchising business model is at risk if aggressive nexus audits continue to threaten the ongoing relationship between franchisors and franchisees. While the two are separate entities, the steps necessary to maintain the shared brand do not constitute a presence in every state when that brand appears. The cost associated with compliance and preparation of the returns is a major financial burden for smaller franchisors and in many cases eclipses the taxes being paid.

If every state where a franchisor has granted franchises may tax its income attributable to that state, franchisors will be subject to costly compliance burdens and overlapping taxes. 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.

Thank you for considering this written testimony.

Sincerely,

A handwritten signature in black ink, appearing to read 'M. R. Shay', with a long, sweeping underline that extends to the right.

Matthew R. Shay
President and CEO