



State of California
Franchise Tax Board
Legal Division MS A390
PO Box 2229
Sacramento, CA 95812-2229

05.11.10

CHIEF COUNSEL RULING 2010-2

Subject: Request for Chief Counsel Ruling for ***.**

Dear *****:

You requested by letter dated October 30, 2008, a chief counsel ruling concerning whether the regulation governing the allocation and apportionment of income for franchisors (Cal. Code Regs., tit. 18, § 25137-3) applies to the allocation and apportionment of income your client earned from licensing activity. You also requested a chief counsel ruling advising whether income from the business of franchising, paid by foreign affiliates of your client, to your client, is treated as paid by third parties when your client elects to report its income and apportionment factors on a water's-edge basis.

FACTS

***** (hereafter Company) designs, markets, and distributes *****. Company's ***** are marketed under numerous trademarks including "*****," "*****," "*****," and "*****."

Company designs, manufactures, and sells its products in company-owned retail stores. Company also manufactures and sells products at wholesale to department stores and boutiques.

Company enters into the following types of licensing agreements in return for royalty payments and trademark fees:

- (1) Company licenses the right to unrelated third parties to operate retail stores outside the United States. All stores inside the United States that bear Company's trademark are owned and operated by Company.
- (2) Company licenses to foreign affiliates both the right to manufacture products bearing Company's trade name, and the right to distribute the manufactured products to wholesale customers outside the United States.
- (3) Company licenses to unrelated foreign and domestic third parties the right to manufacture ***** , *****

bearing Company's trademarked logo. These third parties sell the manufactured products in geographic regions defined by specific licensing agreements. Some licensing agreements allow the third parties to sell manufactured products worldwide.

Licensees remit franchise and royalty payments to Company. Franchise payments are a minimal fee for use of Company's trademark logo, while royalty payments are generally a percentage of licensed-product sales. Licensees usually pay Company the greater of a percentage of net sales of licensed products or a guaranteed annual minimum royalty that increases during the term of the agreement.

A licensee is generally granted the right to use specific trademarks in connection with the manufacture of products at places approved by Company. A licensee also has the right to use the trademarks in the distribution and advertising of manufactured products.

Licensing agreement by Company usually require licensees to obtain prior approval from Company if a subcontractor will be used to manufacture products. The licensing agreements usually determine whether licensees can distribute at the wholesale level, retail level, or both levels. Company must approve wholesale customers.

Licensee advertising is generally limited to specific geographic regions. Licensees generally must spend a percentage of their net sales of licensed products on advertising and promotion. Company's licensing agreements usually require Company approval of the content and manner of licensee advertising.

Company Licensing Department personnel actively monitor and direct licensee compliance with the methods and procedures prescribed by Company in the licensing agreements for the marketing or use of products under Company's trademark. Company licensing personnel meet regularly with licensees to ensure consistency with Company's overall merchandising and design strategies and to supervise quality control. Company licensing staff members approve, in advance, all licensed products, advertising, promotional and packaging materials. Company's licensing personnel also monitor the use of Company's trademarks worldwide to protect the trademark from counterfeit and other unauthorized use.

Company Licensing Department employees visit retail licensees to review store locations, store layouts and placement of display fixtures, communicate with licensees about store issues, and report to Company headquarters about the presentation of Company licensed products. Company licensing employees also develop relationships with licensee retailer visual design personnel to facilitate a retail location's visual needs, including sign placement and special signage needs. Company licensing employees monitor licensee retail stores for compliance with Company directives on visual displays of merchandise to ensure uniformity among retail stores.

Licensing Department employees also meet with licensee distributors to present seasonal product lines for licensee distribution under the licensing agreement, and

review licensee sales and marketing information. Licensing Department staff also works with licensees to promote product lines.

Company made a water's-edge election under Revenue and Taxation Code sections 25110 and 25113 and reports its apportionment and allocation of income accordingly. But for Company's water's-edge election, franchise fees and royalty payments received from Company's foreign affiliates, based on the licensing agreements would have been eliminated as intercompany transactions (royalty payments by subsidiary, royalty receipts by Company).

ISSUES

1. Whether the special regulation for the allocation and apportionment of income of franchisors (Cal. Code Regs., tit. 18, § 25137-3) applies to a taxpayer that receives income from licensees that manufacture and/or distribute, and sell products bearing the taxpayer's licensed trademarks at wholesale and/or retail?
2. Whether royalty and franchise payments by Company's foreign subsidiaries are treated as payments by third-party licensees when Company elects to allocate and apportion its income on a water's-edge basis?

APPLICABLE LAW

Regulation section 25137-3 provides an industry regulation for taxpayers who are in the business of franchising. The business of franchising is defined in the regulation as “a trade or business which includes the granting of a license by a taxpayer (franchisor) of a trademark, trade name or service mark, to market or use a product or service under such trademark, trade name or service mark in accordance with methods and procedures prescribed by the taxpayer.” (Cal. Code Reg., tit. 18, § 25137-3, subd. (a).) (Hereafter Franchisor Regulation or Regulation section 25137-3.)

Regulation section 25137-3 does not define the term “franchise” by referencing definitions contained in the Business and Professions Code or the Corporations Code.¹ Therefore, those definitions are not applicable in determining the scope of the regulation. There are no other indications that Regulation section 25137-3 relies on sources outside the Revenue and Taxation Code to shape its meaning and the scope of the regulation's application.

Generally, when a taxpayer makes a water's-edge election, the taxpayer excludes from its California combined report the income and factors of entities that are not

¹ (Bus. & Prof. Code, § 20001 and Corp. Code, § 31005.)

subject to taxation in the United States. (Rev. & Tax. Code §§ 25110; 25113.) Such entities are treated as third parties to the extent that they are excluded from a combined report by a water's-edge election. (See Legal Ruling 2006-02.)

DISCUSSION

A. Company's licensing activity is within the Franchisor Regulation's meaning of the "business of franchising" for the allocation and apportionment of franchisor income.

The special regulation defines the business of franchising as a trade or business "which includes the granting of a license" by the taxpayer of a trademark to market or use a product under such trademark in accordance with methods and procedures prescribed by the taxpayer. (Regulation section 25137-3(a).) Company is a trade or business engaged in numerous aspects of designing, manufacturing and selling ***** and merchandise.

Company's trade or business includes granting licenses for the use of Company's trademark to licensees who market products bearing Company's trademark. Some licensees operate retail stores bearing Company's trademark. Another type of licensee manufactures goods bearing Company's trademark, then markets the products to wholesale and/or retail customers. Therefore, Company meets the requirement of 25137(a) that the taxpayer must "grant a license" for a "trademark, trade name or service mark, to market or use a product or service under such trademark, trade name or service mark".

Company's licensing agreements prescribe methods and procedures licensees must follow when marketing products bearing Company's trademark. Company actively directs and monitors licensee compliance with methods and procedures prescribed in the licensing agreements. Company Licensing Department employees regularly meet with licensees, visit licensed retail stores to review locations, layouts and product displays. Company licensing employees meet with licensees to promote seasonal product lines, and direct marketing strategies. Company licensing employees also inspect licensee-manufactured products before licensed products are put on the market. Company must approve subcontractors of licensee manufacturers. Company must approve the extent and content of advertising and marketing. These activities meet the requirement in 25137(a) that the licensee utilize the license "in accordance with methods and procedures prescribed by the taxpayer."

Company's licensing activity – granting licenses of its trademark to licensees that market products under the trademark in accordance to methods and procedures prescribed by Company – is within Regulation section 25137-3's definition of the business of franchising. Company's receipts from its licensing activity should therefore be apportioned in accordance with Regulation section 25137-3.

B. Royalty payments received from entities excluded from Company's combined report by Company's water's-edge election should be treated by Company as royalty payments from third parties.

Company foreign affiliates remit royalty and franchise fee payments to Company pursuant to licensing agreements. Company elects to file its combined report on a water's-edge basis to exclude the factors and income of the foreign affiliates from Company's combined report.

The income and apportionment factors of Company's foreign affiliates making the royalty payments to Company would be included in Company's combined group report but for Company's water's-edge election. If Company had not elected to file on a water's-edge basis, royalty and franchise fee payments by these overseas affiliates to Company would be eliminated from Company's combined report as intercompany transactions.

However, Company elected to file on a water's-edge basis. Company's foreign affiliates are treated as third parties. Therefore, royalty and franchise fee payments to Company by its foreign affiliates are included in Company's combined report the same as payments from an unrelated third party and the receipts received by Company pursuant to its licensing agreements should be assigned utilizing the rules contained in Regulation section 25137-3.

DETERMINATION

1. Because Company's licensing activity is within the meaning of the "business of franchising" contained in Regulation section 25137-3(a), the provisions of Regulation section 25137-3 apply to the apportionment of the income derived from that activity.
2. Entities excluded from a combined report because of a water's-edge election are treated as third parties for combined reporting purposes. Company's income from overseas affiliates is treated as income from unrelated third parties because of Company's water's-edge election.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and

Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Brian C. Miller
Tax Counsel III