House
Legislative
Analysis
Section

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SBT: FRANCHISE FEES/ ROYALTIES

Senate Bill 486 as passed by the Senate
Sponsor: Sen. Bev Hammerstrom
House Committee: Tax Policy
Senate Committee: Finance

House Bill 5474 as passed by the House
Sponsor: Rep. Gene DeRossett
Committee: Tax Policy

First Analysis (12-11-01)

THE APPARENT PROBLEM:

Public Act 27 of 1985 was an amendment to the Single Business Tax Act that addressed how franchise fees were to be treated under the Single Business Tax Act. Analyses at the time suggest that the aim was to gradually shift franchise fee payments away from the tax base of those who made the payments toward those who received them. As of 1991, the fees were all to be counted in the tax base of the firm receiving the fees. Public Act 27 did not define the term "franchise fee" in the SBT Act; instead it relied on the definition in the Franchise Investment Law. A dispute subsequently arose between the Department of Treasury and Little Caesar Enterprises over how to treat franchise fees and royalties. The firm had been deducting the monthly royalty payments made by its franchisees from its SBT tax base, and the department had disagreed with this practice and billed the company for what it considered tax deficiencies. The Michigan Court of Appeals decided in the company's favor in December of 1997.

In that case, the court distinguished between 1) the one-time payment made by the franchisee to the franchisor and 2) the later regular monthly payments the franchisee makes essentially to maintain the relationship. The court, based on its analysis of both the SBT and the FIL, said the first kind of fee was what the legislature had in mind as a franchise fee to be included in the tax base of the franchisor, while the second kind of payment could be deducted from the franchisor's tax base. This decision had the effect of making the ongoing royalty payments part of the tax base of the franchisees who make the payments. Some people believe this is not the result the legislature had in mind in 1985 when it addressed this subject, and that the SBT Act should be redrafted to clearly include both kinds of payments in the tax base of those who receive the payments (the franchisors) rather than in the tax base of those who make the payments (the franchisers).

THE CONTENT OF THE BILLS:

Senate Bill 486 and House Bill 5474 would both amend the Single Business Tax Act to address the treatment of royalties, fees, and other payments or consideration paid by a franchisee to a franchisor. The effect of Senate Bill 486, generally speaking, would be to include such payments in the tax base of a franchisor and not in the tax base of the franchisee for tax years beginning after December 31, 2000. House Bill 5474 would exclude such payments from the definition of "sale" or "sales" for the purpose of calculating the tax liability of the franchisor. It is tie-barred to Senate Bill 486.

Specifically, Senate Bill 486 would say that 1) a taxpayer would not have to add back to the SBT tax base the kind of payments or consideration described above that had been deducted in arriving at federal taxable income; and 2) a taxpayer could not deduct such payments or consideration from the SBT tax base (as a taxpayer can with some other royalties). The payments or consideration in question would not include payments for the sale or lease of inventory, equipment, fixtures, or real property at fair rental or fair market value.

House Bill 5474 would amend the Single Business Tax Act to specify that the terms "sale" or "sales" would include royalties, fees, or other payments or consideration not deducted from the tax base except for 1) royalties paid to a franchisor as consideration for the use of trade names, trademarks, or similar intangible property; and 2) royalties, fees, or other payments or consideration paid or incurred by a

franchisee to a franchisor to establish or maintain the franchise relationship other than payments for the sale or lease of inventory, equipment, fixtures, or real property at fair rental or fair market value.

MCL 208.7 and 208.9

FISCAL IMPLICATIONS:

The House Fiscal Agency reports that the fiscal impact of Senate Bill 486 should be minimal, and House Bill 5474 would reduce SBT revenues by an indeterminate amount. (Fiscal notes dated 12-4-01)

ARGUMENTS:

For:

Senate Bill 486 would make franchise fees and royalty payments part of the tax base of the companies that receive them (franchisors) rather than those who pay them (franchisees). This, say its supporters, was what the legislature was trying to do in 1985 when it addressed this issue in Public Act 27. Advocates back then argued that Michigan was alone among the states in taxing those who made franchise payments. Some also argued that putting the franchise fees received into the recipient's tax base was more consistent with the concept of a value added tax, which is what the SBT is supposed to be. This treatment of franchise fees and royalties will be beneficial to Michigan-based franchisees, many of which are small businesses.

Response:

Some people believe that the Senate Bill 486 should be retroactive to all tax years after 1997. They argue that since the 1997 court decision, franchisees have been required to pay back taxes resulting from the appeals court decision when audited by the Department of Treasury. These local businesses will be forced to pay several years worth of taxes, even though their interpretation of the SBT law was essentially the same as the department's position in the court case. The legislature could, by providing retroactivity, prevent owners of local franchises from having to pay the taxes on franchise payments made in previous years.

For:

House Bill 5474 is necessary, say supporters, to prevent unintended consequences from the enactment of Senate Bill 486. To put the issue simplistically, the tax liability of multistate companies is calculated based on an apportionment formula, which takes into account the proportion of Michigan sales to total sales, Michigan payroll to total payroll, and Michigan property to total property. The formula is heavily weighted toward sales, with that factor counting 90 percent. If Michigan-based franchisors are required to categorize the franchise and royalty payments they receive as "sales", their tax liability would increase substantially beyond what it would otherwise be by simply adding such fees into the tax base. For example, an official from Domino's testified that while only about two percent of its royalties come from Michigan franchisees, without House Bill 5474, royalties from franchisees in 65 countries would count as Michigan sales. This would increase the ratio of Michigan sales to total sales and thus increase the tax liability of Michigan-based franchisors with out-of-state franchisees. One Michigan-based company, by way of explanation, testified that their calculations suggested they would owe $300,000 with House Bill 5474 but $1.2 million otherwise. Meanwhile, their in-state franchisees would save some $50,000 in taxes.

Response:

Treasury officials say the impact of House Bill 5474 is not yet clear. It would have different effects on differently situated firms. The department is continuing to examine the issue, which they note is complicated. The House bill could have a negative effect on franchisors based outside the state. One representative of such companies has said they are willing to pay the tax on franchise fees rather than have their franchisees pay it, but do not want to see extra taxes added in the process, which could occur under the House bill.

POSITIONS:

The Department of Treasury has no position on the two bills as a package. (12-7-01)

A representative of Domino's testified in support of House Bill 5474 as tie-barred to Senate Bill 486. (12-5-01)

McDonald's Corporation and the Michigan McDonald's Owner-Operators Association support Senate Bill 486 but has questions about House Bill 5474. (12-5-01)

The National Federation of Independent Business (NFIB) has indicated support for Senate Bill 486. (12-5-01)

Analyst: C. Couch

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.