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Out-of-state licensing company not subject to Oklahoma tax - would offend due process

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In Brief

An out-of-state insurance company was not liable for Oklahoma income tax on payments it indirectly received for the use of intellectual property by restaurants operating in the state.

In *Scioto Ins. Co. v. Oklahoma Tax Comm'n*,¹ the **Oklahoma Supreme Court** found persuasive that Scioto Insurance Company's intercompany licensing arrangement was not made in Oklahoma and that no part of it was performed in the state. Furthermore, the intangibles were used in Oklahoma by sub-licensors unrelated to any action of Scioto. The court distinguished this matter from the state's *Geoffrey* decision by highlighting that Scioto was not a shell entity and that the licensing agreement was not a sham transaction.

The court summarized its decision as follows:

due process is offended by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . who has a bona fide obligation to do so under a contract not made in Oklahoma. (emphasis added)

¹ 2012 OK 41 (Ok. May 1, 2012).

Facts and Scioto's intangible license structure

Scioto Insurance Company (Scioto) is a Vermont company that was established by Wendy's International Inc. (Wendy's) to insure various risks of Wendy's and its affiliates. In establishing Scioto, Wendy's transferred intellectual property to Oldemark, a disregarded single member limited liability company wholly owned by Scioto, to meet capitalization requirements of the state of Vermont for an insurance business. Scioto did not provide insurance to any entity or person in Oklahoma.

Pursuant to a license agreement, Oldemark granted the right to use and sub-license its intellectual property to Wendy's. Wendy's paid Oldemark a license fee equal to 3% of restaurant gross sales.

Wendy's sublicensed the intellectual property rights to franchisees for a fee equal to 4% of the franchisees' gross sales and reported such income to Oklahoma. Wendy's, in turn, paid an amount equal to 3% of such gross sales to Scioto under the licensing agreement and deducted this amount on its Oklahoma tax return.

For tax years 2001 to 2005, the Oklahoma Tax Commission (OTC) assessed Scioto corporate income taxes based on payments it indirectly received from Oklahoma franchisees for the in-state use of Scioto's intangible property.

Oklahoma Supreme Court: Due process "offended"

The court found that Oklahoma has no connection to, or power to regulate, the license agreement between Scioto and Wendy's. The court offered several facts to support its decision, including:

- The license between Scioto and Wendy's was not made in Oklahoma;
- No part of the license was to be performed in Oklahoma;
- The sub-license of intangibles with restaurants in Oklahoma was the **legal act and sole responsibility of Wendy's**, not Scioto; and

Wendy's obligation to pay Scioto was not dependent on the Oklahoma franchisees actually paying Wendy's.

The court contrasted its decision with that of Oklahoma's appellate court in [*Geoffrey Inc. v. Oklahoma Tax Comm'n*](#),² which held that Oklahoma had nexus with an out-of-state company (that otherwise had no contacts with Oklahoma) when it licensed intangibles to licensees in the state. The *Scioto* court found that Scioto's license agreement: (1) created a bona fide obligation for Wendy's to pay; and (2) created a revenue stream for Scioto's insurance business, none of which is carried on in Oklahoma. Accordingly, the court found that, unlike the taxpayer in *Geoffrey*, Scioto was **not a shell entity** and the license agreement between Scioto and Wendy's was **not a sham obligation** to support a deduction under Oklahoma law.

The court found that "**due process is offended**" by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving

² 132 P.3d 632 (Ok. App. Ct. 2006).

payments from an Oklahoma taxpayer (Wendy's International) who has a bona fide obligation to do so under a contract not made in Oklahoma." (emphasis added)

PwC Observes

William Essay, SALT Partner with PwC in Houston, notes that "nexus determinations regarding intangible license agreements are generally decided under a Commerce Clause analysis. It is rare for such a decision to be made under Due process grounds."

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