The Key Tax Issues in International Franchise Transactions

William Edwards
EGS LLC
Irvine, California 92612

Frank Robinson
Cassels Brock & Blackwell LLP
Toronto, Ontario M5H 3C2

Kenneth S. Levinson
Faegre Baker Daniels LLP
Minneapolis, MN 55402
The Key Tax Issues in International Franchise Transactions

Frank Robinson
Bill Edwards
Ken Levinson

Introduction.

Almost 80% of the franchisor members of the IFA have reported that they intend to expand their franchise systems outside of the countries in which they were developed at some point during the lifecycle of their respective brands, and more than half of those members have already done so. Clearly, international franchise expansion is both an established and growing means by which franchisors expand the markets for their products and services and for the franchise operations which make them available.

A number of factors contribute to the growing trend toward international franchise expansion, including reducing dependence on domestic or regional markets, leveraging existing technology, systems and intellectual property, tapping into expanding middle classes in foreign and emerging markets, and of course, adding additional revenue sources.

While it is increasingly the goal of franchisors to expand beyond home borders, international expansion requires perhaps more education, planning, and resources than domestic expansion. Addressing one of the primary issues relating to international franchising, this paper will concentrate on the tax issues associated with such expansion methods. As noted above, the quest for additional revenue from international sources will trigger the risk, in fact the reality, of being exposed to new and very different types of taxation on those new revenues. Understanding the issues and definitions that other governments, and additionally the international network of tax treaties, apply when assessing what income is subject to local tax, and why, is a key element in expanding internationally.

However, as noted, the tax issues regarding international franchise expansion are only one of the key touchstones to evaluate. Clearly, there are other critical areas of consideration, including the local market opportunities and demographics for the brand, the effective ability of the brand and standard marketing to translate properly into the local culture, the availability of resources and capital requirements of franchisee candidates, the general climate relating to governmental regulation applicable to the market and the products, services or ingredients essential to making the brand successful. And while each of those, and other, issues are of significant importance

---

1 While we will focus generally on US “outbound” franchising expansion, many of the legal principles and issues discussed are reciprocally applicable to “inbound” franchising, that is, non-US franchisors who wish to expand into the United States and non-US franchisors expanding into other countries.
when planning for and implementing international expansion transactions, the purpose of this paper is to focus on the tax and related issues associated with such transactions.

Part 1: Structuring Issues

International franchising involves a number of corporate structuring and tax issues that are similar to other international business expansion transactions. Many of the initial strategy or structuring questions, however, are unique to the franchise area; others are not. However, before advisors can sensibly help with the structuring and contracts for international franchising, a number of questions should be addressed.

- Will the franchisor operate "remotely" (strictly from its home country) or have an actual “presence” in the foreign country or market?
- Will the franchisor have services obligations abroad to its franchisees or Area/Master Developers, and if so are those best performed by the franchisor’s employees or by qualified, local independent contractors?
- What effects will the local performance of such services have on tax issues relating to the franchisor?
- Since the franchisor is also licensing technology, know-how, trademarks, copyrights, patents, etc., abroad, how – and where – does the applicable IP get registered and protected abroad?
- What is the business need for, and most tax efficient use of, the profits earned abroad?
- What are the differences in these types of business and tax decisions, and how does the client and its advisors know what is best for the franchisor?

Once these questions, and others, are addressed, the structuring and tax advice can more sensibly be tailored to the franchisor’s actual situation, business needs, and anticipated expansion opportunities. The rest of this paper will help put the significance of these types of questions into their tax and structuring context.

---

2 When franchising abroad, other key issues are important, such as the practical questions of the country-specific required FDD documentation, required local country registration (if any), licensing rights, trademark registrations, royalty and up-front payment processes (including tax withholdings or reporting (if required), and other related contractual obligations or arrangements are, or at least may be, subordinated to making sure your confidential intellectual property (IP) is protected. The franchisor’s proprietary know how, systems, technology, trademarks/brand, copyrights, trade secrets/formulas, patents, etc., all need protection in the local market beyond the rigorous contract protections in a franchise agreement. In addition, once the closing has occurred, there are myriad additional legal and business issues, as well as regulatory filings, to be addressed. For a comprehensive discussion, see Brimer, de Chatellus, Forseth, and Maher, After the Agreements are Signed: Post-Closing Legal and Business Matters in International Franchise Transactions, IFA 46th Annual Legal Symposium (2013).
There are no easy answers to these and the myriad other related international business expansion questions. Not only do they vary from business to business, but also they vary from market to market, and from time to time as the international operations initially expand, grow, and then mature. The business objectives and cash needs will also vary over time, between or among markets, and even between or among brands (for the multi-brand structures). In other words, “no one size fits all” in the world of international franchising…

As a general overview of some common international franchising structures, consider the following concepts:

1. US franchisor directly franchises into a foreign country (often involving multiple local, unrelated franchisees who will then have specific territory or market constraints in their separate agreements);³

2. US franchisor licenses its own subsidiary in the foreign country, which in turn sub-licenses to unrelated franchisees;

3. US franchisor licenses an unrelated Area/Master Developer who, in turn, sub-licenses to unrelated franchisees (whether owned by or unrelated to that Area/Master Developer);

4. US franchisor licenses an unrelated Area Representative⁴ who markets franchises on behalf of US franchisor so that the US franchisor can then enter into direct franchise contracts with franchisees; the Area Representative is paid a commission upon success.

Let’s look at some of the various issues associated with these alternatives. We will identify some key non-tax issues but focus principally on the tax implications of these various structures. So as not to disturb the flow, we are including in Part II a brief discussion of the benefits and detriments of tax treaties, and their potential applicability in the context of international franchising. A number of tax treaty concepts, even specific provisions or withholding rates, are referenced throughout the paper inasmuch as international franchising, whether inbound or outbound, can hardly ignore—nor should it ignore—the applicability of a tax treaty.

1. Direct Franchising Abroad.

Generally, direct franchising abroad is the least frequent form of international franchising, especially when the target international market is geographically distant and

---
³ Direct, company-owned franchises in a foreign country are something of a rarity in international franchising given the absence of limited liability protection for the franchisor and the exposure to direct taxation (and other nexus issues) locally for the franchisor.

⁴ This version of the term “Area Representative” is defined here to be an international franchise broker or agent, to distinguish this general category of relationship from that described in paragraph 3 just above. The latter category is meant to include those principals who are franchisees with rights to sub-franchise themselves, rather than simply agents (as in the fourth paragraph) whose function is to help find franchisees/Area/Master Developers.
different in terms of practical operating requirements. Indeed, in such scenarios the franchisor is solely responsible for all activities, contractual relationships and accounting/reconciliation/tax issues with respect to that country. In one scenario, the franchisor directly contracts with several specific franchises under separate arrangements. A variation is sometimes known as the McDonald’s or YUM model where the very large franchisor enters a new country, without separate franchisor licenses, and builds, owns and operates the units. Generally, those forms of expansion provide the possibility of the highest potential returns to and the most control by the franchisor, but it also involves far more “hands on” attention and costs.5

As respects the tax issues related to direct franchising, some principal questions are:

(1) whether the US franchisor may be seen locally as being engaged in trade or business in the foreign country with sufficient “nexus” (sometimes referred to as having a “permanent establishment” or PE in tax treaty parlance) so as to be required to file local (i.e., foreign) tax returns and to pay corporate tax there, and

(2) whether there is withholding tax payable by the local franchisee on the up-front payments, recurring royalties, advertising contributions, etc., under the local country’s tax laws (or applicable tax treaty with the US, if any).

Permanent Establishment (PE). The PE or tax nexus question is important, and informed, rigorous and internally-communicated restrictions to avoid an inadvertent or unwanted PE are critical. A failure to avoid a local PE will lead to tax audit, current and likely retroactive compliance (and tax/penalty/interest) obligations and perhaps to adverse public disclosure or publicity.6

PE’s are treated locally as separate taxpayers, meaning that once a country’s tax authority deems the foreign enterprise as having a PE in their country, the PE is considered a separate taxpayer from the “owner/parent” entity (for local tax purposes only), and all income properly “attributable” to that PE may be subject to local reporting and taxation. What income is “attributable” to a PE can be a significant point of difference between taxpayer and government, and may result in dispute over tax liability. Also, as a separate taxpayer, the usual “transfer pricing” issues can be asserted (as between the remote “owner/parent” and the PE); these matters raise numerous issues relating the contemporaneous documentation requirement, the validity of arm’s length comparables used to establish the related party pricing (such as corporate or overhead cost allocations), etc. Lastly in this complex set of issues, finding out that a franchisor is alleged to have a PE often means multiple tax years of

5 For an interesting view of the sliding scale relationship between the franchisor’s required investment and the nature of “control” attained, see Exhibit 1 hereto.
6 We will use the treaty-specific concept of “PE” as a short hand for local tax nexus in the cases where the country in question does not have a tax treaty with the US. The standard caveat in international tax planning applies specifically here: if there is a tax treaty in force, read it carefully as treaty provisions vary significantly from country pair to country pair; if there is no tax treaty in force between the US and the local country, be sure to get competent local tax advice regarding your intended structure and contracts to ensure you know if there is, or may be, a risk of unintended local tax nexus.
compliance and tax payment failures may be asserted by the local tax authorities. In other words, having an inadvertent PE is a significantly adverse development, one which can be avoided by proper advance education and planning, and proper administration and documentation.

So, what is a “PE”? There is no single definition in the US tax treaty network. Virtually all US tax treaties indicate that having an office or other fixed place of business in the local country will constitute a PE. When franchising directly into a country, if part of the arrangement is that the franchisor has dedicated access to a franchisee’s office space, then a PE characterization can sometimes be triggered for the franchisor. This is also true in the second structure pattern below, namely, where the franchisor establishes its foreign subsidiary abroad (normally not a PE under our treaties), but arranges that the US franchisor has dedicated office space in the subsidiary’s office suite. In either case, having a local office or having one regularly available to the US franchisor or its officers or employees can cause the US franchisor to have a PE.

Another form of PE risk has to do with signature authority locally with respect to the US franchisor entity. For example, if an employee or officer of a US franchisor while in the foreign country “has and habitually exercises contracting authority” on behalf of the US franchisor, that entity will be considered to have a PE locally—even if the US franchisor does not have an office or access to one locally. This type of “mobile PE” risk is insidious. There is no objective or mathematical test of this type of PE; no specific number or annual frequency of signed contracts or other arrangements which legally bind the US franchisor are specified, nor is the quantum or business significance of the “binding” contracts specifically relevant. This is a clear area for required advance education and establishment of rigorous procedures by or within the US companies in order for franchisors to avoid even getting onto this “slippery slope.” It is often recommended that both the employment contracts of the appropriate employees and the boilerplate in the international contracts themselves contain provisions establishing the binding validity and enforceability of all such contracts against the US franchisor must first be reviewed, approved and executed in the United States by authorized franchisor personnel.

Another area of risk regarding PEs has to do with required local services. Treaties like the US/Canada and US/China treaties, for example, contain separate PE provisions relating to the performance of services in such countries by or on behalf of the US franchisor. As with the other PE provisions in US tax treaties, “any one (PE provision) will do;” that is, if the franchisor is deemed to have a PE under one specific treaty PE provision, then it is deemed to have PE for the purposes of all of them; it does not take more than one type of exposure or provision to trigger a PE.

In the services PE situations, as in other treaty language differences, the requirements are specific to that treaty. The principle, however, is that the US franchisor engages persons (whether its employees or even independent contractors) to perform paid services locally (to the local franchisee); if the services are of sufficient duration, such as exceeding 183 days for the same or a connected “project” in that country, the US
franchisor could be considered to have a PE in that country. While conceptually it is difficult to come up with a situation where such extensive local services are required for a single franchise unit (even if they involve product or service training for the franchisee’s employees, installation/updates of technology/POS systems, accounting training, etc.), the risks of a services PE become more plausible in the event of high frequency unit openings in the local country by the franchisee (or Area/Master Developer), all of which could well be deemed the "same or connected project" under a US tax treaty with the requisite services PE provision. This may be even more likely in the earlier days in any particular market when the franchisor or its representatives attend to local markets in order to establish and maintain the basic infrastructure of the franchise system and to provide training and assistance to help get the system off the ground.

A last, but somewhat under-appreciated, risk of having a PE abroad has to do with owned computer servers. While not formally referenced in many treaties, there is an emerging consensus among international tax authorities that if (in our presumptive fact pattern) a US franchisor installs one of its owned servers abroad in a country, that server, by itself, could well be considered as a PE in that jurisdiction. Where proprietary technology is a key part of the franchise system and access by the foreign franchisees to the franchisor’s server is an essential link to the success of the franchise, the location and ownership of (vs. lease of space by the franchisor on) the server can be significant to the tax structure and risks.8

Withholding Taxes. A key benefit of a tax treaty, if applicable, is the lessening of withholding taxes on passive payments between the treaty countries, such as with respect to dividends, interest, rents and royalties. The consequences of having withholding taxes or not, or lessening the rate (as against a higher local rate otherwise applicable) can be dramatic. See, e.g., Exhibit 2. In the direct franchising structure (especially to unrelated local franchisees), the usual financial relationship between franchisor and franchisee will be the royalty provisions.9 “Royalties” are described

---

7 The presence, and interpretation, of a “services PE” provision, while still somewhat rare in US treaties requires careful analysis. Does it mean, for example, 183 person/days of performance, or just a total of 183 days by any number of performers? Does it require, for example, ALL 183 days to accumulate within a single taxable year, or during any 365 day period beginning or ending in the taxable year in question?
8 Thus far, the international situation has not lead to a Geoffrey-type nexus argument. Cf. Geoffrey, Inc. v. Commissioner of Revenue, 435 Mass. 17 (2009). That is, unlike the Massachusetts Supreme Judicial Court’s holding in that “Toys R Us™” case, finding state income tax nexus merely from ownership by a foreign entity receiving royalty fees from licensing in-state use of the intangibles, the international community is generally bound by the withholding tax provisions of local law or treaties to collect gross taxes on the royalty streams when paid for the use or right to use the IP in-country. As long as the country does not have an argument that a PE or other equivalent “doing business” nexus exists, this remains a distinction between international franchising and state franchising.
9 It is rare that a franchisor will formally loan funds to a local franchisee as part of the arrangements such that the “interest” provisions in a treaty would apply. It is rare, but not impossible. Of course, a formal (documented) loan would render that particular payment stream subject to a treaty’s interest withholding tax provisions. But, the situation could be more subtle than that. For example, what if the franchise (or separate) agreement allows the franchisee to pay off the upfront fee over time, or perhaps the franchisor allows a franchisee in default to pay accumulated but unpaid royalties over time. If the essential terms of a “debt” are included in these work-out cases, under local law, it is possible that the local tax authorities
differently in various treaties, but a common theme is that they are paid for the use or right to use in the other treaty country intellectual property of the franchisor, as spelled out in the applicable treaty. For example, some interesting variations in the definitions and applicable withholding rates under various US tax treaties are as follows:

- **UK**: exempts royalty withholding (payments for use of copyrights, TMs, patents, etc. ["IP"] AND for "industrial, commercial or scientific experience" ["Experience"])
- **Canada**: 10% withholding on payments for IP and Experience; exemption for use of software (other than in connection with a franchise)
- **China**: 10% on payments for IP, Experience AND “industrial, commercial or scientific equipment” ["Equipment"]
- **Mexico**: 10% on payments for IP, Experience AND Equipment
- **India**: 10% on payments for Equipment; 15% on payments for IP and Experience
- **Thailand**: 5% for payments for copyrights and software; 8% for Equipment; 15% for patents/TMs and Experience
- **Russia**: Exemption on payments for IP and Experience
- **Chile [US Treaty Pending]**: will impose 2% withholding on payments for Equipment; 10% on payments for IP and Equipment.

The unique India/US treaty provision relating to “included services” raises a question in other cases. Aside from the “services PE” risks discussed later, if a portion of the payment structure to the US franchisor includes both “pure” royalties and (explicitly or implicitly) payments for services rendered by the franchisor, there is a risk that the inclusion of the non-royalty or disqualifying element could taint the entire tax consequences expected from the undifferentiated payments which include the royalty payments. If the system and contracting arrangements between the franchisor and franchisees involves services of any significance (such as materiality to the success of the franchisee’s operation or frequency/duration of the services), or if there is any significant risk that a tax authority may assert tax on the services income piece by itself, it is recommended that the services elements and related compensation therefore be split out in separate contracts between the relevant parties so as to preserve the

---

10 The US/India tax treaty also includes within the “royalty” provisions payments for “fees for included services” associated with the initialization or training to enable enjoyment of the IP, etc., in question.
anticipated reduced withholding obligations on the otherwise-qualifying royalty streams.\textsuperscript{11}

Another issue to evaluate in documenting the licensing arrangements between franchisor and franchisee has to do with different types of IP associated with the proper operation of the brand by the franchisee. For example, the scope of IP relating to the franchise system can easily include trademarks, use of proprietary software, patents, know-how, trade secrets, secret formulas or processes, “industrial, commercial or scientific experience,” etc. On occasion, US tax treaties provide different treatment or withholding rates applicable to specific forms of IP or sub-sets thereof. For example, under the US/Thailand treaty (referenced above), the withholding rate on royalty payments for patents or trademarks (15%) differs significantly from the withholding rate under that treaty applicable to the use of software (5%). To the extent that a franchise relationship in Thailand involved both of these categories of IP, it would be worthwhile in the contract to split out the pricing for each of them separately and ensure only the applicable withholding rate is applied to each. Similar bifurcation options should be explored in other contexts, where the treaty applicable imposes differing withholding rates on certain forms of IP.

Among the more difficult tax questions, and ones that likely engender differing interpretations among the various foreign tax authorities, are whether the “royalty” provisions (in US tax treaties or otherwise) apply to the up-front payment, the recurring royalties, and/or the advertising fees, etc. The easy case is the recurring royalty payments, which almost universally are recited to be for the use of or right to use the franchisor’s IP as described in the franchise contract (such as the “system”, trademarks, franchisor software, etc., etc.).

The more difficult case is the \textit{up-front payment}. Frequently, the entire franchise agreement is couched as being with respect to a relationship between franchisor and franchisee such that the latter is permitted to use the IP and brand/system/know how/Experience of the former in return for certain payments and contractual undertakings. Many foreign tax authorities (and taxpayers) take the position that the up-front payment is the price of entry to enable the franchisee to use the franchisor’s system, etc., and to preserve a territorial exclusivity – in effect a payment (or one of several) for the “right to use” the IP in the local “territory.” This is the classic definition of a treaty “royalty” payment. Stated another way, “but for” the payment of the up-front fee (and the other stated fees in the agreement), would the franchisee be entitled to use the franchisor’s system and brand in the territory? If the answer is “no,” there is a pretty high likelihood that the local tax authorities will claim that the upfront fee, as thus described, is a form of royalty and subject to the applicable royalty withholding rates.

\textsuperscript{11} Note that this split out may also benefit the services payments. If the taxpayer performing the services in the local country does not otherwise have a PE there, and if the “services PE” rules in the applicable treaty are not triggered (e.g., the service providers locally are not there 183 days or otherwise meet the treaty’s duration test), then separately-denominated payments for those relatively brief local services may not be taxable.
On the other hand, some franchise agreements or separately documented relationships say that the up-front fee is a form of allocable repayment to the franchisor for its cost of developing and maintaining the system and know how, a kind of prorata reimbursement rather than a royalty. If the franchisor does not have a PE in the local country, and if this characterization of that fee as a “non-royalty” holds up, it is possible that there will be no local tax imposed on such an up-front fee. While the art of contract drafting and underlying substantiation in this area is still evolving, the local tax authorities can be expected to investigate this alternative characterization of the upfront fee to confirm, to their satisfaction, whether all (or part) of an upfront fee so characterized by the parties is substantiated as such upon review of the underlying documentation and parties’ intentions and understandings.

The advertising/marketing fees create a different set of issues. While they are frequently couched as a percentage of revenue (or sometimes profits), which are classic formulations for royalties, they may well not be paid to the franchisor for its unrestricted use or benefit. Usually, they are set aside in specific, segregated funds, to be administered (by the franchisor or appointed agents) for the good of the system, or in some cases for the good of franchisees in a country or region. In this case (payment into a separate fund) the advertising/marketing fees would seem not to be properly characterized as a royalty, since their payment per se does not entitle the franchisee to actually “use” the IP/TMs/system in the country and those funds do not “belong” to the franchisor. However, if the franchise agreement states that a ground for termination of the franchisee’s rights is the failure to pay the advertising/marketing fees, then the issue of royalty characterization of those payments can become considerably grayer, and “grey” is the color of tax audit mischief.

A last matter to raise when dealing with the US franchisor receiving treaty-eligible payments from a foreign franchisee (or even from a franchisor-owned subsidiary abroad): to justify entitlement to the lower or exempt treaty withholding rates, the US franchisor will have to provide the foreign franchisee with a certificate of US residency, a Form 6166 received from the US Treasury upon the filing of an IRS Form 8802 by the franchisor. In addition to this US-generated documentation, the foreign country may also require forms of their own to be filed by the franchisor, so caution must be exercised and local counsel obtained to secure the available reduced or exempt rates of withholding to which the franchisor is otherwise entitled. These residency certifications provide substantiation to the local franchisee, which is paying the withholdable amounts to the US franchisor, that the payee (the US franchisor) is a US treaty resident entitled to the reduced or exempt withholding rate under the treaty. In foreign countries as in the US if the withholding agent (here, the foreign franchisee

---

12 Local requirements may also impose obligations to file separate documents for, or at least describe the specific types of, different characterization of payments between the parties. In this structure, it seems that the principal payment type for which a reduced or exempt withholding rate would be sought would be royalties. However, in the second structure (the US franchisor licensing its own foreign subsidiary, which then sub-franchises to third parties), not only would there royalties payable to the US parent by the subsidiary/sub-franchisor, but also, possibly, dividends and interest. Given that these various types of payments may be subject to differing withholding rates under the applicable treaty or local law, differing documentation may be due for each of them.
making the payment) fails to properly withhold tax due under local law, that franchisee can be held personally liable for the amount of withholding tax due, plus interest plus penalties.

As a result, it is important for the applicable franchise agreement between the parties to clearly provide for the manner in which withholding tax obligations are to be fulfilled, and responsibility and liability in the event that those obligations are not properly discharged. For instance, it is not unusual for franchise agreements to recite that the parties will cooperate with each other to secure the lowest rate of withholding taxes properly available and to reciprocally file, or provide the other party with, all necessary documentation to establish the entitlement to and substantiation of the applicable beneficial withholding rates. In terms of the payment obligations themselves, in most cases, the withholding agent will either be subject to either a “remit and evidence” or a “gross up” type of arrangement.

In the first case, the withholding agent will be required by the franchise agreement to withhold the applicable amounts from payments to the US franchisor, remit the withheld amounts to the applicable tax authorities, and then provide evidence to the US franchisor of such actions and amounts in order for the US franchisor to be certain that withheld amounts have in fact been paid as required. A further obligation might exist for the withholding agent to provide such documentation and cooperate as may be needed to entitle the US franchisor to seek and obtain applicable foreign tax credits in its home jurisdiction.

In the second case, the withholding agent is likewise required to withhold the applicable amounts from payments to the US franchisor, and remit the withheld amounts to the applicable tax authorities, but in this case, in addition to making payment to the applicable tax authorities, the franchisee will “gross up” the payment it makes to the US franchisor (i.e., add back to the payment made to the US franchisor the same amount as it pays to the applicable tax authority (or other applicable amount to account for the “tax on a tax” problem) so that the franchisor receives the amount it would have received if no amount was withheld). In either case, a franchisor would expect the franchisee to indemnify it for any tax liabilities arising from franchisee’s non-compliance with the franchise agreement or applicable tax laws.

It should come as no surprise that the “gross up” option is less favorable to franchisees, even if the franchisee is able to recoup the grossed up amount through some available tax credit, deduction or other subsequent adjustment arrangement with the franchisor. For a franchisor that is able to obtain a foreign tax credit, the amounts withheld by the franchisee and remitted to the applicable tax authorities result in issues of cash flow management rather than of reduced or lost income.13 On the other hand, a gross up

---

13 For example, if there is a 10% withholding tax to be “grossed up” by the franchisee, the latter actually has to pay out a total of $111.11 on every $100 of royalty obligation, such that the franchisor nets out the contractually-required $100 after the gross up (the $11.11 represents the required 10% withholding on the full $111.11 payment). For a 15% withholding tax, the equivalent amount required of the franchisee is
obligation could have significant negative effects on the franchisee’s ability to manage its own financial affairs. For this reason, the “gross up” option is often the less utilized approach, even if it is the starting point for negotiations in some template form agreements.

A key issue when considering the most appropriate and efficient structure to franchise internationally is whether the franchisor will franchise directly to each of the individual franchisees (in which case EACH arrangement will require separate residency certifications, accounting admin, etc.) or whether the structure should contemplate a more limited number of franchisee contracts so as to limit the number of required residency certificates and related accounting and documentation. The next two structuring concepts build on that inherent simplicity and goal of reduced residency filing obligations and related administrative work.

2. Using an Owned Foreign Subsidiary to Sublicense Abroad.

Many of the principles and definitions discussed above apply to the alternative circumstances and situation in this and succeeding sections.

Single Country Franchising to a Subsidiary. Under this alternative, the franchisor contracts with its own subsidiary which then serves, in effect, as the country’s master franchisor. As also noted under the third situation below, this approach provides a low cost entry into the country (since the master contract, registration, licensing, and system implementation is done once through and to this single country entity). When the country franchisor is an owned subsidiary, the franchisor has much the same level of overall control as it does in the direct franchising situation described above. But, the franchisor receives directly only the contractual royalties and fees owed by the subsidiary; any other profits earned by the subsidiary must be remitted as dividends.

As noted above, direct franchising into a foreign country can, indeed, create the risk of the franchisor having a PE locally, with the consequent obligations to file local tax returns and pay tax on the income attributed to that PE. However, virtually all tax treaties say that merely having a subsidiary in the other jurisdiction does not mean that the owner has a PE there. Thus, in addition to ensuring the benefits of limited liability, a US franchisor that franchises to its own subsidiary, which in turn will sub-franchise to the unrelated franchisees in the local territory, will simplify at least some of the tax documentation and payment arrangements while virtually eliminating the risk that the US parent/franchisor is considered to have a PE in that country.\footnote{This assessment, of little PE risk under this type of structure, presumes that the US parent or its officers or employees do not violate any of the principles or restrictions referenced under the first structuring section (e.g., the US personnel do not “habitually” exercise contracting authority in that country that binds the US parent, or that offices are not set aside by the local subsidiary for regular use by the parent’s officers or employees, or that the parent does not install its owned server in that country where the subsidiary is formed, etc.).}

\[\text{\textdollar}117.67; \text{\textdollar}125.00; \text{\textdollar}133.33.\]
Clearly, this structuring concept has more appropriate application when the franchisor contemplates numerous, different/unrelated franchisees in the territory (such as a region or a large country or market that will have several/numerous independent franchisees with discrete territories within it). It may also be applicable when required product or ingredient sourcing is part of the system, or when the franchisor actually intends to make or manufacture items locally by itself for resale or supply to its franchisees. Lastly, having an owned subsidiary of the franchisor's abroad could be appropriate when the franchisor intends to establish a foreign presence staffed with its dedicated employees or contractors who will have various local servicing obligations or responsibilities that can best be accommodated under a separate corporate entity.\(^{15}\) However, this should be considered in light of the reality that sometimes an owned subsidiary may in fact be nothing more than an entity that is used merely to enter into contracts with franchisees and others in the local market, and is not necessarily staffed and managed by its own personnel. In those cases, the parent (or US franchisor) and its employees may nonetheless be in control of the subsidiary, provide “on the ground” services and management of the entity, and thereby create risk of a PE being triggered. The degree and continuity of corporate, personnel and economic “substance” of the subsidiary in these structures is a key issue to be addressed.

In any case, where the most appropriate structure involves establishing an owned subsidiary corporation abroad, much of the documentation and administration can be simplified vis-à-vis the US franchisor, and locally focused within or to the subsidiary. For example, there would be a single franchise agreement between the US franchisor and that subsidiary, entitling it to sub-license within the subsidiary’s broad territory.\(^{16}\) The franchisor’s local subsidiary would then be the single point of payment to the franchisor for all fees and royalties properly payable to the franchisor from within the entire territory. Thus, from a US perspective, a single US Certificate of Residency request Form 8802 would be filed (by the US franchisor) and the “certificate of residency” received from the US Treasury Department would be provided to the foreign

\(^{15}\) Where services are required as part of the system, the question for the franchisor is whether it sends US based employees or contractors into the local country for the limited periods required (with due regard for any “services PE” provisions in the applicable tax treaty/ies) or hires locally qualified contractors to perform those services (again, the services PE provisions may not distinguish between “foreign” employees who temporarily enter the country to provide the services or local contractors who do so on behalf of the US franchisor). The key question (in addition to the aggregated number of days) is whether the US franchisor is being paid for those services. It is not beyond the realm of possibility for an aggressive tax authority to assert the position that, in the case of extensive services essential to the successful operation of the system, some indirect portion of the fees otherwise payable (if the services payments are not separately stated) are implicitly for those services. This could lead to separate tax obligations for those services or to an increased level of inquiry as to a possible PE risk.

\(^{16}\) In some jurisdictions, notwithstanding that this agreement may be between a parent and a wholly-owned subsidiary, in theory, such an agreement would be a “master franchise agreement” because it would permit the subsidiary to effectively be the franchisor in another territory. Should that be the case, it may trigger a disclosure obligation between the related parties which (because the subsidiary would have no practical interest in suing its parent for making no disclosure) would be an obligation the franchisor might choose to ignore. As discussed above, the terms of that master franchise agreement would need to be carefully considered to ensure that withholding tax and transfer pricing issues were properly managed.
subsidiary. Only that subsidiary/sub-franchisor would be paying the US franchisor in accordance with their agreement, such as being the sole direct obligor to pay royalties to the franchisor. Accordingly, that subsidiary/sub-franchisor would be responsible for proper withholding taxes, etc. under an applicable US tax treaty, and that subsidiary would, alone, have privity of contract with the sub-franchisees within the territory, thus generally providing another layer of limited liability protection to the US franchisor. Care should be taken when drafting the form of unit franchise agreement so as not to inadvertently cause the parent any direct or indirect contractual liability to sub-franchisees, or to obligate the parent to perform any active or passive services in the foreign jurisdiction.

That having been said, there can be limitations to the insulation from liability that may be enjoyed by a US franchisor that chooses to use a subsidiary as franchisor in a foreign market, as well as drawbacks from a commercial and documentation point of view.

In Canada, for example, the statutory construct known as a “franchisor’s associate”1⁷ exists in order to impose disclosure obligations and potential liability upon a person other than the franchisor if that other person owns the franchisor, is owned by the franchisor, or is under common ownership with the franchisor, and has certain other levels of involvement in the franchisor’s business arrangements. With reference to the cumbersome statutory definition, franchisor’s associates are often found to exist within the relationship between parent and sister corporations of a franchisor that play meaningful roles in the affairs and franchising activities of that franchisor, especially when the franchisor is a newly formed entity with little assets, employees or infrastructure to manage its own affairs. However, the chance that the franchisor’s associate relationship might exist usually diminishes over time to the extent the subsidiary is able to establish its own infrastructure and management team in Canada.

1⁷ Each of the franchise statutes in Canada has a definition of a “franchisor’s associate” which are substantially similar. The following is the definition from the statute in Ontario: a “franchisor’s associate” means a person,
(a) who, directly or indirectly,
   (i) controls or is controlled by the franchisor, or
   (ii) is controlled by another person who also controls, directly or indirectly, the franchisor, and
(b) who,
   (i) is directly involved in the grant of the franchise,
       (A) by being involved in reviewing or approving the grant of the franchise, or
       (B) by making representations to the prospective franchisee on behalf of the franchisor for the purpose of granting the franchise, marketing the franchise or otherwise offering to grant the franchise, or
   (ii) exercises significant operational control over the franchisee and to whom the franchisee has a continuing financial obligation in respect of the franchise;
In cases where a “franchisor’s associate” relationship is found to exist, along with the franchisor, the franchisor’s associate can have disclosure obligations within the FDD, and can have statutory liability for disclosure errors under applicable Canadian provincial franchise laws. As a result, and notwithstanding the contractual separation that may exist between a US franchisor (who forms and uses a separate subsidiary in Canada to act as the Canadian franchisor) and a Canadian franchisee, that US franchisor, if found to be a franchisor’s associate, might not have the anonymity or the safety it might otherwise enjoy as a result of being external to the contractual relationship with Canadian franchisees. That having been said, the franchisor’s associate relationship would not cause liability to the US franchisor other than under the franchise statutes. So, liability for things like service contracts, distribution agreements, and other arrangements, if entered into by the Canadian subsidiary, would likely not flow up to the US franchisor. 

When a newly formed entity is used as the franchisor, the FDD that is created to comply with disclosure laws and market the franchise opportunity will need to disclose the relevant materials in respect of that newly formed entity. When reviewing that FDD, prospective franchisees should understand that the party with whom they are contracting is not a well-established and perhaps well-capitalized entity, but another entity that does not have the same track record and asset base. In many jurisdictions, the financial statements of the newly formed entity (which will need to be prepared to comply with disclosure obligations) need not meet any specific financial requirements. For example, a franchisor in Canada is entitled to use an opening balance sheet (with nominal assets) for as long as 18 months from the commencement of operations. A franchisee’s concern in this case would be understandable when one compares the risk factors that may exist when entering into a contract with an entity that owns and licenses franchisees throughout the US to those which may exist when doing so with a newly formed entity that has no significant assets or contracts in the foreign market. These concerns are relevant and legitimate and may detract from the ability to market and sell franchises, and in some cases are addressed by the US franchisor agreeing to guarantee or accept some responsibility for the obligations of the subsidiary – which could have the result of frustrating or undoing some of the careful tax and structuring plans. 

Moreover, when a foreign franchisor is franchising into the United States, similar issues arise. Notwithstanding the franchisor’s generally preferred method of and structure for market entry, it may well need to establish a US subsidiary (a “C” corporation, usually) because the foreign franchisor itself may not have audited financials that meet US GAAP requirements, which information is necessary to comply with US franchise disclosure requirements. 

Two nuances of the subsidiary-as-franchisor structure should be evaluated, both discussed below: first, the economic consequences of franchising by the subsidiary/sub-franchisor to franchisees in countries other than its own country of residence, and, second, the issue of transfer pricing as between the related subsidiary and its US franchisor/owner.
Third Country Franchising Issues. As respects third country franchising arrangements entered into by the subsidiary/sub-franchisor, that entity steps into the intermediation structure whereby it is required to secure rights to use (and to sublicense) the franchisor’s system/IP, etc., and to secure franchise payments from franchisees located outside its country of residence. Accordingly, it needs to make sure that it has secured any favorable withholding tax rates (and complied with all registration requirements, etc., in both its country and those of the countries into which it will be sub-franchising) vis-à-vis those third countries. This may well involve the use of and compliance with any applicable tax treaties between the subsidiary’s country and that of the franchisees’ country/ies.

Complexities abound when a franchisee formed in one country has a territory that includes other countries. Many times the “parent”/franchisee (really, a sub-franchisor) will establish subsidiaries for its operations in the other countries, so as to provide it with limited liability protection. When properly documented, there should be “sub-franchise” agreements running from the “parent” entity to those various country subsidiaries/franchisees.

What happens when royalties are paid first from the sub-franchisee/subsidiaries up to the sub-franchisor/parent? Assuming those second-tier franchisee royalty payments are subject to withholding taxes, who bears the economic consequences of that withholding? The US franchisor is expecting to receive the “full” royalty from its direct franchisee (the parent entity that is doing the subfranchising throughout its territory) based on total revenues or profits from its franchisee/sub-franchisor throughout its entire territory – and is expecting a single withholding tax to be imposed (if applicable) on the direct royalty payment stream from that parent sub-franchisor to the US franchisor. However, in order for that “parent” franchisee to make the payment to the US franchisor, the former has to get royalty payments from its own sub-franchisees in the other countries – and those payment streams may also be subject to withholding taxes, thus diminishing the net cash flowing up to the parent franchisee entity in order for it to discharge its own royalty payment obligation to the US franchisor. These “cascading tax” situations can produce tricky and confusing economics, as well as unexpected results.

Under conventional international tax principles, the “taxpayer” is usually entitled to a tax credit for income taxes imposed on the same income by another country. Given the direct and separate contractual relationships involved in this multi-level franchisee structure, there are two different taxpayers here with respect to the royalties: the US franchisor and the franchisee/sub-franchisor “parent” company. Without going into the very complex provisions of the US “Subpart F” tax rules relating to controlled foreign corporations and the opportunities under US tax law to file so-called “check the box” tax elections for US tax purposes using IRS Form 8832, the parent/sub-franchisor would be entitled to a tax credit in its country for the taxes withheld by the subsidiary/sub-franchisee’s country. The US franchisor would be entitled to a tax credit in the US for taxes withheld by the country of the franchisee/sub-franchisor’s “parent” entity on the
royalties paid to the US franchisor. But, the net cash remaining, at least from the royalty payments originating from the underlying sub-franchisees, may have been subject to two separate withholdings, only one of which (the withholding imposed by the parent/sub-franchisor’s country on the payment to the US franchisor) will be entitled to a tax credit in the US.

What to do about this significant cash tax leakage? The most elegant solution would be for the sub-franchisor’s country to not impose any withholding tax with respect to the royalty payments originating from the sub-franchisee’s country, when those amounts are embedded in the onward royalty payment to the US franchisor. Why? Because those underlying payments were not made by the parent company/sub-franchisor for use of the franchise system/IP/brand, etc., in THAT country. Instead, that portion of the royalty in question is really the sub-royalty payment by the subsidiary in the other territory country for use of the system/brand, etc. there. Only that underlying country should have the sole right to impose withholding taxes on them. Further, under any US tax treaty between the US and the sub-franchisor’s country, only royalties paid for use of IP and other defined rights are subject to withholding tax when the royalties in question are for use in that treaty country, which of course is not the case with respect to the sub-royalty stream emanating from the use of the system by the ultimate sub-franchisees in the other territories or countries. Confused? Don’t be; see your friendly neighborhood tax advisor.

Transfer Pricing Among Related Parties. There is another complexity in these types of multi-country, franchisee/sub-franchisor structures: transfer pricing. The tax issues in these situations are based on the over-arching principal that related parties should deal with each other as if they were unrelated. That is, what would an unrelated party have charged for the same product, service or license based on the same or substantially similar circumstances? If, for example, the parent sub-franchisor does not charge a mark-up with respect to the license to its subsidiary franchisee in the other country, will the parent entity’s tax authorities accept that? They will ask whether an unrelated franchisor would have let the subsidiary in question use the franchise rights without any income or profit thereon accruing to that parent entity (the sub-franchisor). The same inquiry occurs if a US franchisor licenses/franchises one of its own subsidiaries abroad: do the economics those two related parties reflect an arm’s length relationship?

---

18 We won’t go into the further intricacies of this situation, for example, the timing issues of when the taxes are withheld (at payment) vs. when the credit is effective (filing of returns), or the fact that ultimately, systemically, the higher marginal rate of withholding (as between the two countries within the territory here) will ultimately be paid (net of tax credits), or as implied in the text the ability of the US franchisor to make a CTB election so as to treat the Country B subsidiary as a “flow through” or disregarded entity for US tax purposes, thus entitling the US franchisor to claim BOTH the Country C and Country B net amount of withholding taxes as tax credits in the US.

19 Under some territorial tax systems, the royalties received by the Country B franchisee could be subject to income tax to the Country B subsidiary/sub-franchisor when received. Under this system, even though the royalty income was not derived “in” Country B, it was repatriated to Country B and thus exposed then to local tax. This is similar to the system in Hong Kong.

20 The same inquiry occurs if a US franchisor licenses/franchises one of its own subsidiaries abroad: do the economics between those two related parties reflect an arm’s length relationship?
As respects transfer pricing, the test is usually whether the pricing falls within a range of reasonable “comparables.” Here, there are readily available comparables for the tax authorities to look at, namely, the comparison on the one hand of the franchise contract between the two related parties within the territory (the contract between the parent sub-franchisor entity and the subsidiary/sub-franchisee) and, on the other hand, the franchise agreement between the US franchisor and the parent entity of the franchisee/sub-franchisor. Is there a profit embedded in these relationships as to the parent/sub-franchisor? Should there be? How much? What are the comparables that support that (missing) mark-up on the fees or costs charged to the subsidiary/sub-franchisee? And, as the tax authorities very much like to ask, is there contemporaneous documentation available to substantiate the pricing? Carefully drafted license and services agreements should be prepared and executed by the related parties, after input from tax advisors and potentially third party economists or consultants who help document the pricing justification and comparables. In some cases, especially in the case of a trademark license between the parent and the local subfranchisor, the terms of that license arrangement might need to be disclosed in a FDD, and on that basis, the existence of such a license would be necessary.

In transfer pricing disputes, inevitably one country’s tax authorities believe that the related parties have not operated on an “arm’s length” basis and, consciously or inadvertently, may have manipulated the pricing so as to allocate income away from the higher tax jurisdiction to the lower tax jurisdiction. Either country’s tax authorities could raise the issues, depending upon the circumstances, but the risk to the taxpayer is that the issue gets resolved inconsistently. That is, only one country makes a tax adjustment, or makes a different one than the other country. Transfer pricing audits and their resolutions are not guaranteed to be consistent as between the two or more countries involved.\(^{21}\)

3. Franchising to Unrelated Area/Master Developer.

Under this alternative, the franchisor contracts for the country (or perhaps large areas within a large country) with a single franchisee, which then has responsibility for and a schedule within which to develop the brand in that territory. This approach provides the lowest cost of entry for the franchisor, but provides it only with the contractual income streams owed as royalties and fees. In a sense, the “country model” approach results in the franchisor having the least control over its brand and products there since the franchisor only has privity of contract with the single country Area/Master Developer, but lacks in most structures direct access to the individual units or sub-franchisees. When the “area model” is applied (by which only defined geographies within the country are licensed to each specific area franchisor), the control element of the franchisor

\(^{21}\) To the extent the treaty countries’ tax authorities apply the treaty provisions differently or end up with inconsistent treatment of various items of income, such as transfer pricing audit adjustments on one side but not the other of a royalty stream between the two countries, the taxpayer(s) can seek common resolution under the so-called “Competent Authority” provisions of an applicable tax treaty. If there is no such common tax treaty, however, the taxpayer is in for a difficult, frustrating and quite possibly irreconcilable difference in tax treatment of the same item of income as between the two countries.
increases since the franchisor can terminate one area contract in one portion of the country without automatically terminating all franchise rights and relationships throughout the entire country or area. On the other hand, the "area model" requires more upfront due diligence by the franchisor since it must have multiple area franchisees to properly cover the entire country or region, and they must be able to cooperate with each other in building a consistent brand and service image throughout the entire country.

This franchising/business arrangement offers a number of advantages to the franchisor, although from a business performance standpoint it puts all the franchisor’s "eggs" in one local basket, that being the chosen Area or Master Developer’s. Given that all the due diligence, economic analysis and interpersonal “chemistry” and business integrity assessments will already have occurred, the tax and structuring questions in this arrangement build on the issues and opportunities from the two foregoing ones.

For example, this contractual relationship between the foreign Area/Master Developer and the US franchisor would also eliminate the risk to the US franchisor of a local PE. These are unrelated parties, and it would seem unlikely in the extreme that the US franchisor would knowingly trigger two of the most visible forms of PE under this arrangement. That is, the US franchisor would not allow anyone from the unrelated Area/Master to sign contracts on behalf of the US franchisor, even as the local entity itself is signing up its own franchisees/licensees. It is also highly unlikely that the parties would expressly provide that the Area/Master will set aside or dedicate any of its offices for use by the US franchisor. Nevertheless, it is advised that protective, anti-PE language be included in the Area/Master Developer agreement to make these and other prohibitions manifest, and of course, that conduct be consistent with such language.

A single, bilateral contracting arrangement between the US franchisor and the Area/Master Developer means that the latter will owe the former the aggregated fees and payments with respect to all units and franchisees under its responsibility. In this situation, the US franchisor would presumably file a single Form 8802 requesting a US residency certificate for the particular country designated by the Area/Master for its contracting corporation.

In addition, this simple bilateral contract allows the Area/Master Developer to arrange its structure and sub-franchising relationships/entities (depending upon the arrangement agreed with the US franchisor) in any way it wishes. It also transfers the financial obligations for actual royalty payments owed to the US franchisor to the Area/Master Developer, as well as the requirements to properly account for and pay over any withholding or other taxes imposed on the royalty streams.

As respects the US franchisor under this structure, it no longer has to worry about transfer pricing risks, since the only contract in this type of structure to which it is subject is the bilateral one directly with the Area/Master Developer who, by definition, is unrelated to the US franchisor. While the Area/Developer may itself have transfer pricing issues (for example, if it sets up separate subsidiaries of its own in various
countries within its “territory” to which it sub-franchises, then those related entity contracts could trigger transfer pricing audits locally), but those issues or questions do not reach the independent US franchisor.22

4. Engaging Unrelated Area Representative (or Agent) to Identify Suitable Franchisees.

This structure raises the usual issues in international tax planning and structuring regarding the real relationship between the two parties. Here, the Area Rep is an unrelated party, and intended to be an independent agent compensated essentially for success in matching a qualified franchisee to the US (or affiliated) franchisor. In these situations, the Area Rep/Agent receives a commission or flat fee upon success. While these arrangements can vary in the details (such as whether they are cost plus, whether the Area Rep/Agent collects funds on behalf of and remits those funds to the franchisor or is paid a downward commission, or whether the Area Rep gets some basic amount to offset some expenses plus a success fee), the key legal and tax issues revolve around their technical relationship and relative authorities and responsibilities.

PE Risks. As discussed earlier, if the unrelated party is an independent contractor without authority to sign contracts on behalf of the principal (here, the US franchisor), then there is a good chance that the arrangement will not constitute the Area Rep as a PE of the US franchisor. However, care must be taken on both elements.

If the Area Rep/agent is “exclusive” to the US franchisor, and not authorized to work for any other clients, the Rep looks less “independent” and more like a dependent agent of the US franchisor’s. Having a local agent is a possible ground for a tax authority to attribute the activities of the agent to the principal, both from a legal liability and a tax or PE perspective.23 It should be recognized, however, that the non-“exclusivity” label can accommodate the ability of the agent to work for non-competing clients, even as the agent is restricted from taking engagements in the same defined business or product “space” in which the franchisor operates. A key is whether the Area Rep is not only authorized but also expected to take on other clients or customers in the ordinary course of its business as an “independent” agent.

The other part of the equation is also key. Is the Area Rep authorized to sign or definitively “speak for” the US franchisor? As noted previously, having anyone locally able to sign for the US franchisor, anyone who “has and habitually exercises” such authority, can constitute a PE arrangement locally of the US franchisor. A nuance

22 Of course, if the US franchisor seeks to replicate this structure somewhere else using its own subsidiary in place of the unrelated Area/Master Developer here (such as in an extended Structure 2 situation), then the terms and pricing of any similar unrelated Area/Master Developer arrangements could be cited as “comparables” as against the related party arrangement. Also, if the Area/Master Developer’s territory extends to other countries, then the same type of cascading withholding tax issues, etc., discussed above would also apply.

23 Article 5, Section 5 of the US/China treaty contains an interesting twist on this concept. It provides that “when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, he will not be considered an agent of independent status … if it is shown that the transactions between the agent and the enterprise were not made under arm’s-length conditions.”
which some more aggressive or sophisticated tax authorities may pursue is the real authority and proforma execution processes being followed. For example, if the Area Rep (or anyone else locally) actually negotiates all the terms of the franchise agreement, and perhaps even “initials” it on behalf of the US franchisor, and then the US franchisor inevitably signs that document as is, then there is a good chance that the technical execution (in the US) by the franchisor will be disregarded and the “agent’s” substantive role in the agreement be recognized for what it was.

On the other hand, if the Area Rep’s role is just to identify, screen out and conduct due diligence on possible franchisee candidates, and even provide them with the franchisor’s signed confidentiality/non-disclosure documentation, and then to “withdraw from the field” substantively in favor of direct future discussions and actions by the US franchisor – including ultimate final negotiation, review and execution in the US of the franchise agreement – then it is likely that the Area Rep should not be viewed as a PE of the US franchisor. In reality, there is a lot of daylight between these two described fact patterns, and the key in establishing a structure and approach that can be acted and relied upon is to identify the issues, draft appropriate and clear agreements, and then ensure that the parties act in accordance with their stated obligations.

**Part 2: Overview of Some Benefits and Detriments of Tax Treaties**

Some Treaty Benefits. Tax treaties are frequently lauded for what is undoubtedly perceived as a primary benefit: certainty. As written, tax treaties, which are intergovernmental agreements available through multiple sources, provide specificity and definition of applicable terms and conditions that govern the tax treatment of commercial transactions between the country pair involved, for example, the definition of “royalties” or the tax treatment of “employees” (sometimes called dependent agents to distinguish them from independent contractors, called independent agents), etc. As will be discussed, there is perhaps less “certainty” than is first supposed, but the goal of treaties clearly is to provide predictability and consistency of application to like commercial or tax transactions. The general rule of interpretation is that the treaty, especially if later in time or more specific than general law, controls laws or regulations that are inconsistent therewith.

A key benefit of tax treaties is to reduce the withholding rate, or possibly provide an exemption therefrom, for specific categories of income, the classic situations being dividends, interests, and royalties. As referenced earlier in this paper, the rates of withholding (and the applicable definitions) vary widely from treaty to treaty, so a careful reading of the applicable treaty in question is required.

Another principal benefit of treaties involves the complex PE concepts of “doing business” and the requisite presence of “nexus” required before one country can fairly tax the business income of a company from the other treaty country; this is the PE

concept discussed earlier in this paper. Regardless of what local law or practice is outside of the treaty, if there is an applicable treaty then the PE rules will control as to when a business has, or lacks, adequate “presence” in the other country to necessitate tax filings and tax payments. Tax planning is certainly easier when the rules are there to read, rather than when subject to the vagaries of changing, possibly unpublished, local practice or over-aggressive, unrestrained tax auditors. A failure to have a PE means that “business profits” derived locally are not subject to local tax under a treaty; similarly, a failure of business profits to be “attributable” to the PE means that, at least in theory, there is no local tax due either.25

Another benefit of tax treaties is a coherent process for dispute resolution, the so-called “mutual agreement” or Competent Authority procedures. These can apply when there is inconsistent application or interpretation of treaty provisions by the country pairs, or an inconsistent treatment proposed for item(s) of income or expense incident to an audit. One of the classic areas these days for Competent Authority is transfer pricing audits for related party transactions between the country pairs. If the auditing tax authority claims that the pricing in question is inconsistent with the auditor’s views on arm’s length pricing (and not supported by unrelated “comparables”), the proposed adjustment may well produce an inequity on the other side of the same pricing transaction.26

Treaties also include provisions relating to “conduit” arrangements, and more recently relating to “limitation on benefits” (LOB) rules. Each of these is intended to make sure that the permissible taxpayers eligible for the treaty benefits are, indeed, substantive residents of one of the treaty countries. When, for example, there is a mere “post office” box company, incorporated in a treaty country without any real business activities, employees or infrastructure, that seeks to use this most technical “presence” to claim benefits under the treaty, the tax authorities have the right to look to the substance of the business and transactions before allowing the treaty benefits to be secured.

25 There is, however, a significant risk under a “force of attraction” concept that disparate, even wholly unconnected, income streams originating out of the same country can be swept up under the PE “attribution” rules and taxed at full corporate rates. PEs are couched in terms of whether “the enterprise” has one; they are not targeted to specific offshore legal entities on an entity by entity basis. Hence, it is possible that tax authorities locally will first seek to establish a PE, and then attribute all income streams from the same offshore business “enterprise” to it. One example may be a division (or separate entity) the sells products into the foreign country through a PE, but another division (or separate legal entity) that conducts only licensing of technology there under the royalty rules. The local tax authorities may seek to attribute the royalty stream to the PE and tax all such income at corporate tax rates.

26 For example, if Country A (a high tax jurisdiction) believes that a license fee owed to Country B (a low tax jurisdiction) is too high, thus costing Country A income and taxes (because of an exorbitant licensing expense), Country A could unilaterally reduce the license expense allowable as a tax deduction under Country A’s transfer pricing guidelines. This unilateral change should be coupled with Country B agreeing to the change and then correlatively allowing less income on their side of the same licensing transaction. If the two countries do not agree to such reciprocal changes, the taxpayer is caught in the middle of the two audit/reporting systems and is the inequitable loser. The Competent Authority rules are designed to give the taxpayer a forum to develop a fair dispute resolution that ought to be reciprocally agreed to by the country pair.
Some Treaty Detriments. The existence of an applicable tax treaty is not always a panacea or favorable to the parties.

For example, tax treaties include "exchange of information" provisions that may require, or permit, the exchange of tax related information between the governments concerned. Some of these provisions are written as permissive ("may" exchange) while others are written as mandatory ("shall" exchange), and some are written for particular requests ("request in particular cases"), so as referenced already each particular treaty must be closely read. The presence of this type of provision, however, should raise a caution with taxpayers who are trying to "game" the international tax system or, as many Americans with previously-undeclared foreign accounts or income have learned, taxpayers who are trying to secrete or non-report funds offshore.

Another provision that may be of interest (and its availability can cut both ways) is the relatively unusual one whereby the other country will assist in the collection of taxes (using its normal procedures) for the treaty partner. For example, Article 27, Section 5 of the US/UK treaty states that the contracting states "shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted from taxation imposed by that other State does not inure" to the benefit of parties or persons not entitled to it. (Emphasis added.)

Despite the presence of written provisions, tax treaties do not always provide the true certainty desired by all parties. Like any document written at one point in time, treaties do not automatically "catch up" to advances in society, structures or technology. For example, the treaties do not define clearly what really constitutes a "fixed place of business" under the PE rules. Today, unlike years past, companies are more flexible in allowing workers to work "remotely" and this trend has also expanded into the international community. Consider the PE and employer tax implications of a US company allowing a direct employee to work "remotely" from his or her home in India.

In addition, the certainty desired by treaties lags behind other forms or developments in international commerce, such as the proliferation of internet sales. If the local country cannot establish that the seller has a PE, then it cannot in theory impose income tax on sales to customers into that country. One of the responses to that problem is for countries to assert that a PE exists when the foreign company has its owned server in the sale country. A case showed how this reach for a PE connection can be extended, when a country asserted that computer system’s “connectivity” triggered a PE (the local agents had to acquire “dead terminals” which were then required to connect to the taxpayer’s remote search/technology systems in order to allow local customers to make airplane and hotel reservations).

Amendments (“Protocols”) to treaties often lag well behind society’s changes, thus prolonging the risk that a particular treaty does not clearly and adequately address a new technology or structuring concept. External groups (like the UN or OECD) may produce “commentary” on various provisions as the world evolves from their respective
model treaties, etc., and while these are some evidence of one set of interpretations, they are not definitive as to a particular in-force treaty.

Transfer pricing disputes are also a source, sometimes, of disruptions to the principle of desired certainty under treaties. Local rules for “contemporaneous documentation” vary, and the treaties are not so detailed as to standardize what is needed. In addition, the range of possible “comparables” against which the taxpayer’s transfer price (and substantiation) is tested varies from country to country (and auditor to auditor), including the auditor’s screening processes to cull out the non-comparables, and even disputes in identifying the business segments or processes that are to be considered “comparable” in the first place. The other treaty country may have widely different views as well on these issues, or data, leading the competent authority process to be extremely frustrating for all parties.

Another issue with the competent authority or dispute resolution process is the length of time, and expense, it takes to get through it to resolution. The benefit of the treaty is that there is such a process; the burden of the process is that it takes a long time. It wasn’t too long ago that the backlog in the US of competent authority cases was such that individual cases took well over 500 days, and multiparty cases took well over 1200 days. This frustration led the US and Canada to implement, in the Fifth Protocol to that treaty, a “baseball”-like arbitration process should the competent authorities fail to resolve the dispute within a fairly quick period (two years).

Lastly, the limitation on benefits (LOB) provisions, and other incarnations of the similar efforts (such as anti-conduit language) to ensure there is some tax substance to the party seeking the advantage of the treaty, may prove to be an unexpectedly high bar to satisfy. It is certainly a deterrent to certain structures or bare-bones entities, but the existence and terms of LOB provisions vary greatly: the US/UK treaty provision (Article 23) goes on for four very complex pages, the LOB provision in the US/India treaty (Article 24) is barely a page, and there is no separately denominated LOB provision in the US/China treaty.

SUMMARY

This paper is meant to stimulate further discussion within your respective franchising organizations and with your international advisors. What works in the United States will not necessarily work abroad, and frankly may well lead to more adverse consequences than were ever contemplated. The tax issues described in this paper illustrate the intricate balance between the efficient operation of the franchise “system” and the pitfalls of inadequate, or even the absence of, tax planning. When proceeding to franchise internationally, whether inbound or outbound, care must be taken to evaluate the tax elements carefully, for that failure can well undo the carefully-constructed, projected net economics expected from tapping successfully into all those new markets.

27 There are also arbitration provisions in US tax treaties or protocols with Belgium, Germany and France in addition to Canada.
From a tax perspective, try to evaluate the tax issues from multiple perspectives to make sure your planners have at least asked the right questions that would surface concerns, such as assessing the effect of the planned expansion on the franchisor and franchisee, the impacts under both US and local/foreign tax regimes, and the presence of (and application of) a tax treaty.

And, of course, seek advice from competent counsel…
Exhibit 1
Investment vs. Control in Different Franchise Structures

International Expansion Options Though Licensing

Adapted from Kurt Ullman
Exhibit 2  
The “With” and “Without” Effect of Withholding Taxes

Here is an example of a franchisor's revenue, expenses and return from awarding a franchise to a mid-sized country with and without withholding tax. Included below is a 5 year, area franchise in a single country showing the franchisor’s revenue and expense statement without the impact of withholding tax, and then with withholding tax.

<table>
<thead>
<tr>
<th>No Withholding Tax Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Franchisor Revenue From Master</td>
</tr>
<tr>
<td>Unit Franchise Fees Paid to the Franchisor</td>
</tr>
<tr>
<td>Franchise Royalties paid to ASC Franchise by the County Franchisee</td>
</tr>
<tr>
<td>Franchisor Estimated Gross Revenue</td>
</tr>
<tr>
<td>Per Month Expense</td>
</tr>
<tr>
<td>Country Master Market Research &amp; Marketing</td>
</tr>
<tr>
<td>Technology costs (intranet, etc.)</td>
</tr>
<tr>
<td>On-going Master: Level Support, including travel &amp; staff salary costs</td>
</tr>
<tr>
<td>Legal (trademarks and master agreement)</td>
</tr>
<tr>
<td>Franchisor Per Country Cost</td>
</tr>
<tr>
<td>Franchisor ‘Net’ Estimate: Single Country</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Initial Fee, On-going Royalty and Paying Tax Withholding Tax Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchisor Revenue From Master</td>
</tr>
<tr>
<td>Unit Franchise Fees Paid to the Franchisor</td>
</tr>
<tr>
<td>Franchise Royalties paid to ASC Franchise by the County Franchisee</td>
</tr>
<tr>
<td>Franchisor Estimated Gross Revenue</td>
</tr>
<tr>
<td>Per Month Expense</td>
</tr>
<tr>
<td>Country Master Market Research &amp; Marketing</td>
</tr>
<tr>
<td>Technology costs (intranet, etc.)</td>
</tr>
<tr>
<td>On-going Master: Level Support, including travel &amp; staff salary costs</td>
</tr>
<tr>
<td>Legal (trademarks and master agreement)</td>
</tr>
<tr>
<td>Franchisor Per Country Cost</td>
</tr>
<tr>
<td>Franchisor ‘Net’ Estimate: Single Country</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Initial Fee, On-going Royalty and Paying Tax Withholding Tax Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchisor Revenue From Master</td>
</tr>
<tr>
<td>Unit Franchise Fees Paid to the Franchisor</td>
</tr>
<tr>
<td>Franchise Royalties paid to ASC Franchise by the County Franchisee</td>
</tr>
<tr>
<td>Franchisor Estimated Gross Revenue</td>
</tr>
<tr>
<td>Per Month Expense</td>
</tr>
<tr>
<td>Country Master Market Research &amp; Marketing</td>
</tr>
<tr>
<td>Technology costs (intranet, etc.)</td>
</tr>
<tr>
<td>On-going Master: Level Support, including travel &amp; staff salary costs</td>
</tr>
<tr>
<td>Legal (trademarks and master agreement)</td>
</tr>
<tr>
<td>Franchisor Per Country Cost</td>
</tr>
<tr>
<td>Franchisor ‘Net’ Estimate: Single Country</td>
</tr>
</tbody>
</table>