TAX ISSUES IN INTERNATIONAL FRANCHISING

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International tax is a key element to consider when planning on franchising abroad. This article considers the many complex, and at times apparently inconsistent rules and structuring considerations affecting wishing to expand their brand abroad, with a particular focus on US outbound franchising. The analysis covers the application of double taxation rules in tax treaties, the crucial concepts of permanent establishment and transfer pricing, and the impact of withholding taxes. The authors also discuss a number of practical tax planning structures which can be employed by international franchisors.

1. Introduction

International tax is a key element to consider when planning on franchising abroad. The rules are complex and at times apparently even inconsistent. The pitfalls are many. Advance planning and consultation with both home country and foreign tax counsel is strongly suggested,[1] so that all of the parties, and perhaps even more importantly their administrative/compliance personnel, know what is going on, what their respective responsibilities are, and the applicable timing and filing requirements. To capture the essence, "an ounce of prevention is worth a pound of cure."

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[1] For purposes of this paper, we will focus primarily on US "outbound" franchising, that is, the situation where a US franchisor intends to extend its brand abroad (outside the US), though many of the same issues and structuring considerations will apply reciprocally if a foreign franchisor seeks to expand into the US, whether by franchising or corporate-owned operations. One difference is that while in franchising out-bound, US franchisors often do so directly without setting up local in-country subsidiaries, in franchising in-bound, foreign franchisors often conclude that franchising through a US subsidiary, rather than directly from the home country entity, is preferred in complying with the US franchise laws. We will comment from time to time on some of the US tax law nuances regarding these "inbound" franchise issues as well.

Having said that, everyone wants to get a deal done and allowing the tax "tail to wag the dog" may not be tolerated by the business people. To complicate the situation, during negotiations and after start-up, matters may change for practical or other reasons, which could throw a tax plan and structure into disarray. So, in tax planning for international franchising, advisors need to marry many different factors, goals, resources and capabilities into one cohesive and executed plan of action.

1.1 An overview of the US tax system

The US, as most lawyers and tax practitioners know all too well, imposes tax on its citizens and residents on a worldwide basis. That is, if a US person (such as a US individual or US entity) earns or receives income itself from non-US sources, that income is taxable in the US regardless of whether it is or is not taxable locally in the foreign country of origin.[2] This US approach to taxation is at odds with most of the world's tax systems, which may tax income only on a source or territorial basis. Thus, for example, royalties or various franchise fees payable to a US franchisor by a foreign franchisee may be subject to tax in both countries: (1) the foreign country from which the fees are paid may assert either withholding tax or possibly regular income tax (depending on the structure and contracts) on such fees; and (2) the US will also require the gross amount of income payable to the US franchisor to be taxed in the US. If the foreign country will impose tax on those royalties or franchise fees, the parties must understand upfront what the reporting and withholding/tax payment requirements are, which party is required to do what and when, and how the tax to be paid is reconciled and accounted for properly – to the applicable government(s) and by the parties.

1.2 US double taxation and foreign tax credits

When the US and a foreign country do impose tax on the same income stream or item of income, double taxation arises. In general, the "source" country first gets paid the cash tax owed on the income being remitted to the franchisor. Thus, for example, if a royalty withholding tax of 10% is imposed under foreign law, the local franchisee (as payor) will generally be obliged to withhold that 10% amount from the royalty payable to the US franchisor, and to account for and pay that 10% amount over to the local tax authority. The franchisee would then remit the 90% "net" amount to the franchisor and would also provide the franchisor a tax certificate or other official document showing the prior withholding and payment of the 10% withholding tax. The US franchisor would report the full 100% royalty amount as royalty income for US tax purposes, but would claim a US foreign tax credit for the 10% withholding tax paid already to the foreign government by withholding from the franchisee, a payment required to be documented and substantiated for US tax purposes by the tax certificate or other official document the US franchisor receives from the franchisee.

1.3 Applicability of tax treaties.

The applicability of tax treaties is a big part of cross-border transactions and relationships. They are reciprocal; that is, tax treaties apply equally in both directions regarding payments from one of the Contracting States (i.e., countries) to the other. Absent an applicable treaty, local law controls. That is, the tax characterizations, doing business/nexus issues, withholding tax rates, etc., would all be subject solely to the provisions of applicable foreign

[2] In addition to US taxation applying to amounts received by US taxpayers directly from foreign sources, US tax law also imposes "deemed taxation" on certain types of income or transactions realized by foreign subsidiaries of US persons. Two principal examples where this deemed taxation can apply to US persons relate to certain income of "controlled foreign corporations" (CFCs) and to income earned by "passive foreign investment companies" (PFICs). In these examples, income subject to these deemed taxation rules must be reported, and tax paid currently, by the applicable US persons "as if" they had received the amounts in question, even though they have not actually received it and the cash in question is actually still in the CFC or PFIC entity. These deemed taxation rules thus create cash flow pressures on the taxable US persons, since they must pay the required US tax from other sources rather than from the receipt of the deemed taxable income (the actual cash still remaining in the actual entity, the CFC or PFIC, respectively). These cash flow pressures that must be contemplated upfront in the planning and structuring process, such as by a commitment to make a "cash tax distribution." CFC or PFIC structures also require specific tax reporting requirements by the applicable US persons who own the requisite type or proportion of interests in those entities.

law. However, if a tax treaty does apply between the two countries and with respect to the entities and transaction in question, then the treaty will control to that extent. The US has about 68 tax treaties in force currently, but it is said there are over 2500 tax treaties worldwide, so despite the size and relative scope of US business activities and foreign entity ownership worldwide, the US is only modestly prolific in entering into tax treaties when compared to other countries.[3] This may create added difficulties in some situations for US franchisors seeking to expand their brands abroad. For example, treaties cover substantially more than just beneficial withholding tax rates. They cover doing business/nexus questions (i.e., when the business is considered to have a "permanent establishment" or PE locally thereby subjecting it to full local tax and reporting obligations in that country), limitation on business provisions (which set forth requirements for local entities to be eligible for that treaty's benefits), exchange of information and enforcement provisions, dispute resolution provisions (such that the two governments through their respective "Competent Authorities" can resolve taxpayer disputes regarding inconsistent applications of the treaty, transfer pricing differences, interpretation issues, etc.), and other matters. Significantly, having an applicable treaty in force provides a pre-agreed structure and agreed nomenclature/definitions which, in turn, promote greater certainty in many situations than if the applicability of law were left strictly to local interpretation or discretion.

"… the definition of PE varies between and among treaties and it is essential to read carefully the relevant definition in the specifically applicable treaty."

[3] For example, the UK has about 129 tax treaties in force; Canada has about 92 tax treaties in force; Switzerland has over 80 tax treaties in force; China has about 100 tax treaties in force; India has about 122 tax treaties in force; Japan has about 56 tax treaties in force; Brazil has about 30 tax treaties in force (though not one with the US); and Mexico has about 51 tax treaties in force.

2. "Permanent Establishments" and tax nexus

2.1 Defining PE and tax nexus

The concept of a "PE" is peculiarly a tax treaty concept, one embodied in the varying definitions of what constitutes a "PE" with respect a particular treaty. So, that is a key "take-away," namely, the definition of PE varies between and among treaties and it is essential to read carefully the relevant definition in the specifically applicable treaty. If the enterprise has a PE in a treaty country, it is required to file tax returns locally and generally pay regular corporate tax rates on the income (net of expenses) attributed to the PE. The usual non-treaty equivalent of a PE, or "tax nexus," is based on the situation when there is no treaty but the enterprise is considered under local law to be "engaged in trade or business" there, thereby triggering comparable tax filings and tax payment requirements locally.

In general, as discussed below, there are numerous common elements in the definitions of PEs among tax treaties, though the differences are what generally present traps for the unwary. To illustrate, here are some US treaty examples when a PE exists:

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on;
2. The term "permanent establishment" includes especially:
   (a) place of management;
   (b) a branch;
   (c) an office;
   (d) a factory;
   (e) a workshop; and
   (f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.
3. A building site or construction or installation project only constitutes a permanent establishment if it lasts for more than twelve months.

4. Where a person [other than an agent of an independent status] is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise;[4]

5. That enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:

   (a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or
   (b) The services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

6. The furnishing of services [other than included services as defined in another Article] within a Contracting State by an enterprise through employees or other personnel, but only if:

   (a) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve month period; or
   (b) the services are performed within that State for a related enterprise.

7. Other miscellaneous examples, such as:

   (a) a warehouse, in relation to a person providing storage facilities for others;
   (b) a store or premises used as a sales outlet; or
   (c) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve month period.[5]

2.2 The consequences of having a PE or tax nexus

Overall, the concept of a PE in the treaties is that once an enterprise has at least one of the indicia or treaty-specified PE "triggers," the enterprise is considered to be subject to tax there. That is, once it crosses the applicable treaty's PE threshold, the business is subject to local tax return filings and corporate tax on income considered to be "attributed" to that PE.

[4] This example is truncated to simply highlight the "habitual exercise of contracting authority" PE provision found in virtually all tax treaties. There are cross-references in this particular provision to other treaty definitions (in the US/India tax treaty from which it is taken) that may exclude certain contract signing activities from a PE determination, but this provision generally is an important one to be aware of since it does not require any physical facility or office connection for a PE to arise. Frequently the personnel most likely to run afoul of this PE provision without realizing it would be salespersons and executives, each of whom usually have authority to sign contracts binding the company. Under this PE provision, where and how many such contracts they sign will abroad could very well trigger a PE problem for the company, a problem that will inevitably surface years after the local tax authorities will claim the PE began.

[5] This list, while somewhat representative of various types of PE provisions, is actually a composite of illustrations from three US tax treaties. Items 1-4 are from Art. 5 of the US/UK tax treaty; Item 5 is from Art. V in the US/Canada tax treaty (as amended by the Fifth Protocol); and Items 6 and 7 are from Art. 5 of the US/India tax treaty. Note the differences in the two "services" PE provisions between Items 5(b) and 6(a), and the differences in the construction site duration PE provisions, such as Items 3 and 7(c). Also, note the uniqueness of Item 6(b) from the US/India tax treaty; read literally, it means that any services performed in India for a "related person" constitutes a PE in India for the performing non-resident enterprise. Imagine the surprise of a US franchisor that sends its experts over to assist in the set up or training requirements of the franchisor's India subsidiary (for example, a company-owned store in India that is owned in a separate legal entity there).

"… local tax authorities then may seek to "attribute" other, even unrelated income streams and activities in-country as also being subject to local taxation."

Further, if the enterprise is considered to have a PE locally, there is a risk of application of the "force of attraction" principle, whereby the local tax authorities then may seek to "attribute" other, even unrelated income streams and activities in-country as also being subject to local taxation. Since the treaty language almost universally relating to PEs focuses on the "enterprise" (not the "business" or the "company" or "the taxpayer"), the concept is broad enough to embrace cross-divisional or even cross-entity activities in the same country.[6]

Critically, an "enterprise" having the PE is treated as a separate taxpayer, even though by definition it is not a separate legal entity.[7] Thus, this is the second take-away: the basic operational and legal implications of having an unexpected PE are effectively the worst of all worlds, namely:

- the PE has to pay tax on a standalone basis with respect to all items of interest and expense that the overall enterprise believes (though the local tax authorities may differ) are "attributable" to the PE (even if there is no real "net" impact overall since the two "parties" are consolidated and the actual related activities, charges and payments are "zeroed out" overall), while
- the entity that "owns" the PE is responsible legally, without limitation, for full liability of all the obligations of the PE and its personnel there; there is no limited liability available to the US "parent" with respect to a PE since the "parent" is the only legal entity and is thus responsible for the actions and inactions associated with that PE and its personnel.

Contrast the PE issues and exposures above (having a local office or fixed place of business, etc., that constitute a PE) with an alternative structure of having an actual corporate subsidiary established in the country, or—where permitted—having a "rep office" established there, neither of which ordinarily are PEs.

"the basic operational and legal implications of having an unexpected PE are effectively the worst of all worlds"

[6] Consider a situation where one part of the "enterprise" is licensing technology such as a franchise system into a country (which is assumed to only be subject to withholding tax), while another part has a trading office locally. Given that the trading office will likely be considered a PE, the local tax authorities would be expected under the broad PE provisions to also "attribute" the royalty payments to the PE, thereby subjecting them to regular local corporate tax instead of the lesser withholding rate otherwise applicable on that type of income.

[7] For example, a US franchisor that establishes an office or fixed place of business in a local country with a US tax treaty will be considered to have a PE there according to virtually all US (and other) tax treaties. Once that determination is made (by the foreign tax authorities if not self-reported by the US franchisor), the PE is treated as if there is a "ring fence" around it for purposes of calculating its taxable income or loss for local reporting purposes. This segregated status of the PE for tax reporting purposes raises additional issues to be considered, such as (a) treating "intercompany" charges and other transactions between the PE and the US franchisor "parent" under generally applicable transfer pricing rules, or (b) the requirements of taxpayers generally (here, the PE) to substantiate deductions, payments and invoices despite what may be less than clear or current documentation, or (c) local book vs. tax accounting record discrepancies and informalities.

2.3 Practical issues for franchisors

(i) Subsidiaries as a PE

While an actual branch or local office is certainly a PE under all tax treaties, one thing usually that is not a PE, as mentioned earlier, is a subsidiary. Art. 5.7 of the US/China tax treaty is representative of this principle:

> The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

However, even this seemingly secure exception to PE status can be violated, causing a PE. There are a number of cases around the world where the local tax authorities asserted that a PE existed, notwithstanding this "subsidiary is not a PE" type of treaty language, where the related entity (such as a UK "parent" of an India subsidiary) had offices and facilities in the subsidiary, which are set aside strictly for use by the parent's traveling officers or salespersons. The local tax authorities in India established that those offices (even though owned by the subsidiary) constituted an office or fixed place of business regularly available to the UK parent entity, hence constituted a PE under language comparable to Item 1 or Item 2(b) or (c) above.[8]

Similarly, another country's tax authorities (Canada) went so far as to assert a PE when employees of a US company were providing services to an unrelated Canadian customer at the customer's offices in Canada.[9] The customer set aside offices there for the exclusive use of the US company's personnel, and the Canada Revenue Agency asserted that that type of regularly available office as "set aside" by the Canadian company was sufficient to constitute a PE of the unrelated US company. While that argument ultimately lost in a higher Canadian court, it did so only because there was insufficient proof that the US personnel on-site in Canada were doing anything while there, in those offices, other than working for that Canadian customer pursuant to the services agreement in place. Had the US personnel taken advantage of their extended Canadian presence and used their location to do other business activities in Canada unrelated to that particular customer contract, the outcome in that case might have been different. Today, however, it likely would be different based on the "services PE" rules that are now part of the US/Canada tax treaty. See Item 5 above, which comes directly from the amended US/Canada tax treaty.

(ii) Joint ventures

JVs create many issues, especially in franchising, that need to be considered before being implemented. Some of those issues relate to how to value each party's contribution to the JV, whether in-kind contributions of assets to the JV may be made tax-free under applicable law, a variety of governance and decision-making issues, the duration of the JV, the required amount of capital investment, the appointment of officers (and board members), terms of buy-sell rights, put/call options for each party, whether to license or transfer ownership of intellectual property rights to the JV, various liquidation/termination matters, risks of the JV being considered a CFC (or, remotely, a PFIC) for US tax purposes, and, last but definitely not the least, whether transactions, licenses, sales of products or ingredients/components, etc. to the JV entity constitute transactions covered by transfer pricing rules (and locally-required reporting and substantiation requirements).

However, among the key issues with respect to the focus of this paper regarding JVs are those relating to the type of JV entity which is to be formed and whether the arrangement represents a possible PE risk to the foreign participant. The type of entity question usually involves decisions by the parties as to whether the entity is to be a "corporation" or some type of partnership or flow-through entity. In most cases, the parties are concerned with preserving limited liability for legal purposes so the entity choice may well be an entity that is the equivalent of a corporation or LLC using US

[8] See, e.g., *Rolls Royce Plc v. Dy. Director of Income Tax*, (2008) 113 TTJ Delhi 446.

[9] See, e.g., *The Queen v. Dudney*, 2000 DTC 6169, Docket: A-707-98 (FCA).

analogies, rather than a legal partnership. The former entities tend to preserve limited liability for the owners under local law, while the latter can impose joint and several liability on each of the partners.

This is where the tax results and legal benefits sometimes collide. Using the US example for illustration, assume a situation in which a foreign franchisor is going to enter into a US "JV" with a local (US) partner. Often US taxpayers want only to be subjected to a single level of tax, which is accomplished via a flow-through or partnership vehicle for US tax purposes. These types of entities are frequently called "fiscally transparent" entities internationally. The problem is that an unsuspecting foreign "partner" who invests in a US LLC has thereby subjected itself to full US tax on its prorata share of the income, etc., from the LLC. Essentially for US tax purposes, ownership by foreigners of interests in US fiscally transparent entities (like an LLC for which a "check the box" election is not made[10]) triggers direct US tax because those foreign owners are considered to be directly engaged in US business through an office or fixed place of business, i.e., by virtue of their prorata ownership of the partnership's offices and facilities. In other words, depending on local law, owning an interest in a fiscally transparent entity can constitute that owner as having a PE locally.

"… evaluate the type of entity that is to become the JV itself and assess whether merely by owning an interest in that entity constitutes a PE locally …"

Thus, before innocently agreeing to participate in a foreign JV (as a US person), or in a US JV/LLC entity (as a foreign person), be sure to evaluate the type of entity that is to become the JV itself and assess whether merely by owning an interest in that entity constitutes a PE locally (or results in other local characterization as being engaged in local trade or business as a "partner" if there is not an applicable tax treaty). Often, international tax advisers suggest considering use of a "blocker" corporation to hold the actual partnership/JV interest. In this manner, the foreign party can own an interest in the JV without itself having a local tax liability or PE. The blocker subsidiary is the "partner" in this case, which allows the local party to utilize a fiscally transparent entity for the JV without triggering PE status for the principal foreign "partner." But, while these structures satisfy the local party's desire for a single level of taxation through the fiscally transparent "JV" entity (such as a US LLC), the foreign partner is subject to two levels of tax as to its ownership structure: the blocker is taxable as to its share of the JV's profits and losses, and then the principal foreign partner is subject to tax (certainly dividend withholding tax) when the blocker distributes after-tax cash to the foreign principal in the form of a dividend.[11]

[10] The "check the box" election (CTB) is available solely for US tax purposes to enable taxpayers to control the US tax characterization and consequences of ownership of certain entities. For example, the "default" US tax treatment of a US LLC is as a flow-through (a partnership if there is more than one member, or a disregarded entity for tax purposes if there is only one member), while the default treatment of most foreign companies (other than the few specified "per se" corporations) is that of a separate "corporation" for US tax purposes. If, however, a proper CTB election is made, the default characterizations above may be overridden and reversed (the LLC becomes a separate "corporation" while the foreign entity becomes a flow-through entity), but solely for US tax purposes… In the case of foreign entities for which a CTB election is made, they remain separate companies and separate tax-reporting entities for local tax purposes, their limited liability benefits under local law are unchanged, and they general remain "companies" for purposes of almost all US tax treaties when it comes to the local (foreign) country's ability to collect withholding taxes, etc., (such as dividend withholding taxes) when the entity makes a distribution to its US owner(s).

[11] These "blocker" structures are present the foreign partner with an opportunity to use the blocker not only to shield the foreign principal from tax presence locally, but also to capture and preserve tax net operating losses should the JV initially have tax losses. Many foreign jurisdictions do not allow use of "offshore" tax losses to offset locally-generating taxable income, but the US "blocker" structure enables any JV tax losses allocated to the blocker to be retained within that entity, so as to be available in the future to offset future profits flowing to it from the JV.

(iii) In-country support and training personnel

This is an area fraught with danger, on multiple levels. There are clear issues and trip-wires for the "remote" foreign franchisor that sends its people to help establish or train the local franchisee(s), as well as issues regarding the individuals themselves.

With respect to risks to the franchisor (such as a US franchisor that sends its employees abroad as provided for under the franchise agreement to help the new franchisee get established, to assist in setting up the new store/technology, to train the franchisee's key personnel and store managers, etc.), the presence of these nonresident employees in the foreign country represent a variety of issues. What type of visas do those persons need in order to come into the foreign country? What are they actually going to do there? What entity is to be their "sponsor" during the visa process? How long can they stay? Will they have contracting authority on behalf of the US franchisor and will they exercise it while in-country? (This is the "habitual exercise of contracting authority" PE risk described above.) Will they arrange an office or other fixed place of business from which to work? (This is the "office or fixed place of business" PE risk described above.) Are the services being performed of such a type or duration that they trigger either a corporate tax liability or withholding tax locally? These are a variety of issues that affect the US franchisor.

"There are clear issues and trip-wires for the "remote" foreign franchisor that sends its people to help establish or train the local franchisee(s)"

Separately, as to the employees themselves, who will pay them? If they are paid by the US franchisor throughout and their remuneration is not charged back to a local resident employer or PE, those employees may avoid personal income tax liability to that foreign country, as long as their physical presence in-country does not exceed the stated maximum number of days. But, the terms required for such avoidance vary by treaty. For example, under Art. 14 of the US/China treaty and Art. 16.2 of the US/India tax treaty, the employees in-country may not be taxable locally if they are not there more than an aggregate of 183 days during the taxable year involved, and if their remuneration is not paid by a resident employer or borne by a local PE. However, under Art. 16 (2) of the US/Italy treaty, the maximum number of "free" days of presence is only 90 days in the taxable year and, even if the other requirements are met (such as the remuneration not being paid by an Italian resident or PE), the employee's pay must be "subject to tax" in his home country. By contrast, Art. 15.2 of the US/Mexico tax treaty calculates the "183 day" period as only having to occur "in a 12 month period." The comparable provision in the US/Luxembourg tax treaty, as does the US/Japan tax treaty, reads that the aggregate 183 day period is one "commencing or ending in the taxable year concerned." Lastly, for comparison, Art. 19 (2) of the US/Korea tax treaty provides the same general provisions as above but restricts the amount of locally-untaxed income to not more than US$3000.

Sometimes, however, franchisors (and others) seek to use "independent contractors" (ICs) to perform services in-country rather than sending their own employees there. They reason that ICs tend to insulate them from local liability and PE/presence issues. It is fair to say, though, that for both employment and tax purposes, the label on a personnel relationship does not control; it is the reality of the situation that does. For example, if the IC is stated to be "exclusively" engaged in the foreign country by the US franchisor, with no authority or ability to seek other clients, and is expressly subject to detailed control, specified methods of conducting the services, rigid reporting and procedures, etc., the relationship looks much like an employer/employee arrangement. On the other hand, if the contractual relationship with the IC actually is a true independent contractor arrangement with a local party who is acting in the ordinary course of their IC activities, then having a local IC in-country can certainly cut off the risks of the US franchisor having a PE locally or other risks of exposures as a result of the actions of the IC. Note, however, that the "contracting authority" PE rules almost all use the predicate language "a person – other than an agent of independent status" (or similar language) to focus on the key phrase "who has and habitually exercises … an authority to conclude contracts in the name of the enterprise" (from the US/Japan treaty); thus, there will be added pressure on the PE question if a supposed "IC" has and exercises "habitual" contract signing authority on behalf of the enterprise. Lastly, since ICs frequently already reside in the foreign country in question, they usually don't need visas or work permits.

The third type of personnel relationship that may be considered, depending on the local (in-country) needs of the US franchisor, is the concept of "secondment." In these cases, generally, a US employee of the US franchisor entity is assigned (or seconded) to a local entity for a specified period of time or project. The local entity could be the franchisor's in-country subsidiary, or it could be the local franchisee to which the US franchisor has agreed to "loan" the employee for a certain period. This arrangement is often necessary in countries where the franchisor's employees' activities on the ground would be considered "working" which requires a "work visa," and only a local entity is permitted to sponsor work visas for its employees.

Usually, but not always, the local entity is responsible for paying the seconded employee and for arranging his/her visa and work permits. But, in other cases, there may be an intercompany services agreement between the US franchisor entity and the local subsidiary (to account for the expertise required from the US entity to be made available to the local subsidiary), with the US entity retaining nominal payroll and benefits responsibility for the seconded employee. In either of these two situations, care must be taken. If the seconded employee continues to do work for the US franchisor while in-country (that is, while seconded to the local entity), then those activities or contracts entered into by the seconded employee can certainly constitute a PE as to that US franchisor. Further, as discussed above, the fact that the seconded employee is paid by or the remuneration is borne by the local entity, or if the secondment lasts longer than the maximum number of treaty days (183) in a given year, then the employee will be subject to local taxation personally. This then raises all types of tax equalization and cost of living / hardship pay increases, plus moving and housing expenses, etc., to accommodate the seconded employee's needs.

If the local entity is the franchisee, this also raises the issue of who the employee is really working for: the foreign franchisor or the local franchisee? The local franchisee obviously is the "employer" in the technical sense, but if in reality the foreign franchisor is directing such seconded employee's job activities with the requisite control in fact over that person, the arrangement could cause an inquisitive tax auditor to consider whether it amounts to a local PE of the foreign franchisor. Consider that situation where the foreign franchisor is considered to have one of "its" employees stationed in-country, with an office or fixed place of business readily and obviously available to such person (hence its foreign employer). This appears to be a classical formulation of a PE. Hence care must be taken when considering this type of arrangement.

3. Withholding taxes

3.1 Withholding agent vs. taxpayer

In the "Introduction" section of this paper, we have described generally how withholding taxes apply in the international context. The obligation to withhold, account for and pay over the required withholding taxes to the local tax authority is universally imposed on the local payor. This is reasonable because that party is the last one to possess or control the payment before it leaves the country in question, so any efficient ability to obtain tax payments due with respect to the withholdable payment exists at that moment and the withholding agent is the one with the best opportunity to satisfy the law. While the withholding agent in virtually all cases is subject to severe penalties if the agent fails to properly carry out its responsibilities (such as penalties and interest due), it may well be liable for the full amount of the withholding tax that should have been collected but wasn't. The rationale behind this is that the withholding agent is the agent of the government and a failure to do that job should be dealt with severely. Since the withholding agent knows who it paid, it, rather than the government, is in the best position to seek reimbursement from the recipient, who is after all the actual "taxpayer". But, it is important to understand that if the withholding agent over-withholds tax for whatever reason (such as a failure of the recipient/payee to provide proper documentation establishing its entitlement to a lesser withholding rate pursuant to an applicable tax treaty), the actual taxpayer (not the withholding agent) is the proper party to seek a refund from the local tax authority.

3.2 Withholding tax rates and nature of payments

Tax treaties vary across the board regarding rates of withholding tax for comparable categories of income. Suffice to say that treaty withholding rates can vary from exempt (0%) up to 15% for dividends, interest and royalty payments. Local law withholding rates may be substantially higher, and if the taxpayer does not meet the treaty requirements for a beneficial withholding rate, the local withholding agent/payor will be required to default to the local statutory rate applicable. (The US statutory withholding rate, for example, is 30% and other countries have similar rates.)

"The obligation to withhold, account for and pay over the required withholding taxes to the local tax authority is universally imposed on the local payor."

As stated previously, franchisors, and any other entity claiming treaty benefits, must read the actual terms of the specifically applicable treaty, and meet the requirements and definitions therein for qualification. While the administrative provisions vary, treaty eligibility for the reduced/exempt withholding rates requires some type of documentation to be presented, before the payment is made, by the treaty-eligible recipient to the in-country payor/withholding agent. For US franchisors receiving royalties from foreign treaty-based franchisees, the process starts with obtaining a US "certificate of residency" from the IRS, but may also involve the required execution of various local (foreign) forms and certifications, such as the certificates of nonresidence required by Canada and other countries before entitlement to the lesser treaty withholding rates is established.[12]

(i) Royalties

While the rates of withholding taxes vary greatly among the US tax treaties, as noted briefly above, so, too, do the technical definitions of the payments that are eligible for the treaty withholding rate benefits. For example, most treaties define "royalties" to include payments for the use or right to use intellectual property in the country in question (such as patents, copyrights, TMs, designs or models, plans, secret formulae or processes, etc.). While the treaty rates may vary (the US/UK and other treaties, including interestingly the US/Russia treaty, provides such royalties are exempt from withholding tax), and a number of US tax treaties provide different rates for different types of royalty payments,[13] the definitions of eligible royalty payments most definitely vary.

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[12] The reciprocal is also true. That is, US payors making payment of treaty-eligible withholdable payments to a foreign party will need first to receive a properly completed Form W-8BEN-E (or a Form W-8BEN from a foreign individual) before it can, and should, give effect to the claim for a reduced, or exempt, treaty withholding rate.

[13] One US treaty provides stated withholding rates on royalties, but is noteworthy because that treaty also includes a "most favored nation" provision: the royalty withholding rate is reduced to "the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State." Art. 13(2)(b)(iii) of the US/Philippines tax treaty.

A few examples:

- The US/UK treaty includes in the definition of "royalties" the phrase "industrial, commercial or scientific experience" as do other US treaties, such as the US/Russia, US/India, US/China, US/Canada, US/Thailand, and US/Mexico treaties.
- However, some treaties also include within the definition of eligible "royalties" the phrase "industrial, commercial or scientific equipment," such as the US/India, US/China, and US/Mexico treaties. In other words, these treaties apply the royalty provisions to rents of equipment (and not just to payments for the use in those countries of intellectual property).
- The US/India tax treaty further provides a relatively unique provision within the "royalty" definition, namely, as including "fees for included services." In general, this special category of "royalty" eligible treatment is for described services that are either "ancillary and subsidiary to the application or enjoyment" of the "right, property or information" for which the royalty is being paid, or paid to "make available technical knowledge, experience, skill, know-how or processes". What is of further interest is that the withholding rate on "fees for included services" relating to payments for conventional IP rights is higher (15%) than for services payments relating to the use of industrial, commercial or scientific equipment (10%).
- The US/Canada treaty contains an interesting provision that exempts payments for use of software from royalty withholding, but not if the software is used in connection with a franchise.

In the franchise situations, which we are concerned with here, the treaty definition of eligible royalty payments often comes into play. Recall that the applicability of withholding taxes to royalty payments has to do with payments for the "use or right to use" the defined royalty property in the country. The issue frequently is whether the payment is, or can be interpreted as being, for the "use or right to use" a defined type of royalty property in the country in question. For example, many up-front fees are couched in terms of providing the franchisee exclusivity to operate the franchise system in the defined "territory". Those would generally be payments for the use or right to use the franchise system in that country, hence subject to royalty withholding tax.

It should be noted that some franchise agreements purport to treat the upfront payment, or a sizable portion of it, as a payment for the reimbursement of development expenses to the franchisor, a characterization that presumably seeks to remove that payment (or applicable portion) from the withholding rate applicable to "royalties." Care must be taken to pursue this path, since the tax authorities are aware of this approach and will be expected to audit it vigorously. The characterization of the upfront payment as a reimbursement would have to be backed up by actual documentation and substantiation of how and when the system development expenses were incurred by the franchisor, how the specific franchisee's allocable "reimbursement" payment is determined and whether it actually is based on expenses incurred by the franchisor to develop the system (or variation) for that franchisee (or merely reflects the costs incurred as to others at an earlier time, for which the system development costs are merely being amortized over future franchisees not present initially), whether the fee thus characterized is paid irrespective of whether the system is actually operated in country by that franchisee (or, stated another way, would the franchisee have to pay it

"... The characterization of the upfront payment as a reimbursement would have to be backed up by actual documentation and substantiation ..."

even if someone else actually acquired the right to operate the system in-country?), etc. As is evident, this is a highly fact-dependent argument to make, and one that in the real world of franchising rarely has a chance of succeeding upon aggressive audit by a skeptical tax authority.

On the other hand, if all or a specified portion of the up-front fees are paid for specific services and training that the franchisor will provide to the franchisee in connection with the establishment of the franchisee's business, those amounts could be treated as service fees (see the discussions below), rather than royalties, but care must be taken to ensure such "services" are performed outside the franchisee's country.

Further, the periodic royalties paid based on store performance (such as gross revenues, etc.) would generally be considered a payment for the actual use of the system in-country, hence a royalty subject to the treaty withholding rate.

(ii) Services

Aside from the category of "fees for included services" in the US/India tax treaty, the tax issues involving cross border services arise in many franchise arrangements because of the need to support franchisees to some degree. These services could be mandated by the franchise agreement or provided by the franchisor on an optional basis, sometimes even on a payment-for-services rendered basis. The assistance can take the form of education, training, or even a "help desk" facility to assist a franchisee. When, however, the services or assistance provisions are contractual in nature, the issue is whether they are separately compensable or are embedded (indistinguishably) in the various other contractual obligations and royalty provisions.

"The general international tax rule on sourcing services is that they are sourced where they are performed."

The key tax issues regarding services, frequently, are: where are the services in question to be performed and by whom? The general international tax rule on sourcing services is that they are sourced where they are performed. If the "help desk" or internet assistance is available outside the country where the franchisee is operating, it seems hard to imagine a taxing authority asserting tax liability over the "services payment" (however the agent calculates or identifies the amount of such payment) as arising from within the franchisee's country. If the parties are careful in their contracts and attentive to these kinds of performance details, and if the franchisor does not have a PE locally, it seems apparent that payments for services performed outside the franchisee's country should be payable by the franchisee without tax liability locally.

Even if the services are to some limited degree performed in-country without a specified fee payable for them (such as an initial training by the franchisor's personnel for a brief period in-country), the absence of a PE there by the franchisor and the absence of a segregated payment for such brief services in-country may well be sufficient to avoid local tax on those limited services But, that is the point: if the services are frequent, or of long duration, or repeatedly performed in-country by the same basic employees/services group, there is a distinct risk that the local tax authorities may take the view that the franchisor is in the business of performing services in that jurisdiction for pay, which certainly looks like an opening for them to make a trade or business (or PE) argument. It should not be forgotten, as well, that there are some US tax treaties (such as the US/Canada and US/India treaties referenced earlier) that actually treat certain local services as amounting to a PE and thus grant authority to tax in-country services locally—as well as establishing a basis to assert a broader PE exposure under the "force of attraction" principle discussed above.

(iii Withholding taxes and utilization of tax credits

Lastly, even if withholding taxes are imposed on fees paid to the franchisor by the foreign franchisee, it is not the end of the world. That is because, as mentioned earlier, the US has a system of foreign tax credits which grants a dollar-for-dollar tax credit in the US for income or withholding taxes paid abroad on the same income. While there are limitations on determining the current utilization of the credits here (for example, there are two "baskets" for types of income with respect to which the foreign taxes are imposed, and current utilization of the tax credits in each "basket" is separately calculated), there is an overarching conceptual limitation, namely, the total credits utilizable currently from each basket cannot exceed the tentative US tax on the foreign income.[14] Stated in another, overly simplified, way: when looking solely at the type of income that was subjected to foreign withholding tax, the available US credit cannot exceed the amount of US tax due on that income. If for some reason (such as domestic tax losses or offsetting expenses in the US) the actual US tax is lower than the available amount of tax credits attributable to the foreign income, there is an "excess credit" situation. That is, there are more available foreign tax credits that year than can be used in the US because of the credit limitation. Not to worry; under the current tax code, excess foreign tax credits can be carried back one year, and carried forward ten years.

Another way of looking at foreign tax credits is as follows: given the US worldwide system of taxation described initially in this paper, income such as foreign royalties received directly by US taxpayers (such as franchisors) will be subject overall to the highest marginal rate of tax applicable to that income. With the US corporate rate of 35%, that is likely to be about the highest marginal rate applicable to the royalty income. Since the withholding rates on royalties can vary anywhere from zero (exempt) to 15%, the overall marginal tax on that particular income stream to a US franchisor will be 35%, but it will be paid in two tranches: a payment of the 15% rate (for example) to the foreign country (by withholding) and a separate payment to the IRS of an additional 20%. That is because the overall US rate applicable is 35%, but 15% was already paid to the foreign country, so with the full use of that foreign tax credit here, the incremental tax due to the IRS as to that royalty amount generally would be the other 20%.

The only other threat to utilization of tax credits in the US has to do with a possible structure problem, one that should be anticipated before being set up by the tax planners. It has to do with the case where the US franchisor is a flow-through entity (such as an LLC or a Subchapter S corporation), but the US franchisor has an interest in a profitable foreign corporation which itself is paying income taxes to the foreign country. This structure could arise because, for example, the US franchisor (a flow-through entity owned by US individuals) has an interest in a foreign corporate JV entity, or perhaps because the franchisor itself owns a profitable foreign corporate subsidiary (maybe a services or procurement/sourcing company to assist the foreign franchisees). In any case, usually dividends from a foreign corporation carry with them another type of foreign tax credit for US tax purposes, one that is different than credits for direct withholding taxes. This other type of tax credit is called an "indirect credit", and essentially it represents the pro rata share of the foreign corporation's corporate income taxes paid to the foreign country with respect to the dividend distribution paid out.[15] However, indirect tax credits are only available to US corporate owners that own at least 10% of the voting stock of the foreign corporation. Thus, when the US ownership structure involves flow-through entities (like LLCs or S Corps), for indirect tax credit purposes, the US tax law essentially requires the parties to "look through" the flow-through entity to its actual owners, in order to determine entitlement or not to indirect tax credits attributable to the distributing foreign corporation. If those ultimate "look through" owners are US individuals, as may be the case, they are ineligible to claim indirect credits. All those ultimate US individuals can claim are the direct foreign tax credits (such as actual withholding taxes imposed on the royalty payments received in the

[14] Actually, the general limitation formula is the tentative US tax multiplied by the fraction: foreign source taxable income (for the applicable "basket") / worldwide taxable income.

[15] For a simple example: if a 100% owned foreign corporate subsidiary has earned 1000X in pretax profits and paid 200X in foreign income taxes, the US company receiving a dividend of the remaining 800X would also be able to claim an "indirect tax credit" in the US for the 200X of taxes paid by the distributing foreign subsidiary.

US). The structuring lesson in this is generally to avoid a US flow-through entity owning a profitable foreign corporation; while there are ways to overcome that type of structuring situation (such as properly using the CTB election process described earlier), that is beyond the scope of this paper, or the reader's interest!

4. Transfer pricing

4.1 What is transfer pricing?

The world we live in is a world where through advances in technology, transportation and communication the reach of companies has expanded globally, as such creating many multinational enterprises ("MNEs"). A significant volume of global trade consists of international transfers of goods, services, capital and intangibles. Such transfers often occur within the MNE group, or even, within one and the same legal entity (between the "head office" and a PE). Companies within a MNE group are less likely to operate under the same market conditions as third parties would normally do, if this would not be in the common interest of the MNE group. For instance, one could set up its activities in such a way that within the MNE group most of the income is earned in low tax countries, whereas the related expenses are incurred in high tax countries. The overall tax burden, or "effective tax rate", of the MNE can as such be reduced. Particularly in situations where it is easy to shift profits from one country to another, it has become increasingly important to establish the right price, or "transfer price", for intra-group transactions such as the transfer of goods, services, intangibles and services.[16] The need for transfer pricing should however not be seen only as a way to counter tax avoidance, contrary to the feeling one may get sometimes nowadays when dealing with tax law. In the first place, transfer pricing is simply a requirement for determining a price where there is no real third party price, making it more of a tool for measuring the performance of separate entities within a MNE group.

Transfer pricing has evolved over the years on various levels, both domestically and internationally. The principles that have been developed in an international context play an important role, considering that transfer pricing is foremost a mechanism to establish a transfer price in cross-border transactions. The OECD Transfer Pricing Guidelines for Multinational Enterprises (the "OECD Guidelines") represent a consensus between the OECD member countries, and many countries' domestic rules are derived from the OECD Guidelines, with different degrees of variations.

"in situations where it is easy to shift profits from one country to another, it has become increasingly important to establish the right price, or "transfer price""

[16] Consider Company A in country X which is subject to corporate income at rate of 35%. Company A sells its products to Company B, a related company in Country Y. Company B is subject to a 10% corporate income tax rate. If Company A sells its products for 100, Company A and Company B each realize a profit of 50. The tax liability of Company A would be 17.5 (35% * 50) and that of Company B would be 5 (10% * 50). The overall tax burden of the MNE group is 22.5 on a total income of 100, as such resulting in an effective tax rate of 22.5% (22.5 / 100). Now assume that Company A does not sell its products for 100, but for 70. Company A's profit would be reduced to 20 and would pay a tax of 7.5 on that (35% * 20). Company B's profit would increase to 80, in respect of which it pays a tax of 8 (10% * 80). The overall tax burden of the MNE group is 15.5 on (still) a total income of 100, as such resulting in an effective tax rate of 15.5% (15.5 / 100). The effective tax rate of the MNE group would thus be reduced by 7 percentage points as a result of adjusting the transfer price used. Such shift in profits should only be allowed to the extent the nature of the transaction, and the functions performed by the controlled companies justify this. Transfer pricing should provide for such justification.

The basis underlying the OECD Guidelines is the "arm's length principle." In brief, the idea of the arm's length principle is that affiliated entities should enter into transactions under the same conditions as third parties would. As such, under the arm's length principle, transactions within a group are to be compared to transactions between unrelated entities. When making this comparison, it is important to realize that the aim is to find the highest practicable degree of comparability, knowing that there are many unique transactions for which there may be no clear comparables. When making the comparability analysis, the following factors are of importance: (i) characteristics of the property or services, (ii) functional analysis, (iii) contractual terms, (iv) market conditions, and (v) business strategies. The extent to which each of these factors matters in establishing comparability will depend upon the nature of the transaction and the transfer pricing method applied.

There are a number of possible transfer pricing methods that can be used to subsequently determine the at arm's length price of a transaction. No single method is considered suitable in every situation and therefore the taxpayer must select the method that provides the best estimate of an arm's length price of each particular transaction. The common divider between the various transfer pricing methods is that they all rely, directly or indirectly, on the comparable profit, price or margin information of comparable transactions. This information can be obtained from sources within or outside the MNE group, i.e., internal comparables vs. external comparables. The five main transfer pricing methods are:

(i) Comparable Uncontrolled Price method (the "CUP method"). The CUP method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances.

(ii) Resale Price Method (the "RPM"). The RPM is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

(iii) Cost Plus method (the "C+ method"). The C+ method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs the supplier incurred an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions performed.

(iv) Profit comparison methods (the Transactional Net Margin Method or "TNMM" / Comparable Profits Method or "CPM"). These methods seek to compare the level of profits that would have resulted from controlled transactions with the return realized by the comparable independent enterprise. The TNMM compares the net profit margin realized from the controlled transactions with the net profit margin realized from uncontrolled transactions.

(v) Profit split methods (the "PSM"). Profit split methods take the combined profits earned by two related parties from one or a series of transactions and then divide the profits using a defined basis that is aimed at replicating the division of profits that would have been anticipated in an agreement made at arm's length.

The first three methods above, i.e., CUP, RPM and C+ are often called "traditional transaction" methods and the last two are called "profit based" methods. Although all these methods are widely accepted by national tax authorities, there is growing acceptance of the practical importance of the profit based methods.

4.2 Transfer pricing and PE

As noted above, transfer pricing should be used not only between related entities, but also between a taxpayer in one country and its PE in another country. Having the PE treated as a separate taxpayer, even though by definition it is not a separate legal entity, means that one could also recognize transactions between the head office and its PE. The application of the OECD Guidelines and the above methods should apply the same way in head office vs. PE relations as in legal entity vs. legal entity relations. In addition, the PE concept provides for another complication, which is the attribution of profits to a PE. As stated above, the PE threshold should be met before a country can tax the business profits of a company which is not established (as a legal entity) in that particular country. That being said, it does not mean that all profits of that foreign taxpayer can be taxed, but only the profits that are attributable to that country.[17] Transfer pricing plays an important role in the analysis of which profits are attributable to a PE. The basis of this analysis is an analysis of the functions performed, assets used and risks by the PE. In this paper we will not discuss in more detail how the profits are actually attributed to the PE. The "take-away" should be, however, that the consequences and practical issues involved with having a PE as described in sections 2.2 and 2.3, may in practice not result in a substantial profit allocation to the PE if the functional analysis does not permit this.[18]

4.3 Practical issues for franchisors

(i) Product distribution franchisors

The pricing of products under a product distribution franchise agreement if entered into with an unrelated party franchisee should by definition be at arm's length. After all, the transaction is entered into between unrelated parties.

In a related party transaction, generally the CUP method would be the most appropriate method to determine the transfer price between the franchisor and franchisee if the franchisor also franchises to third parties. In such a case, the transfer price in the related party transaction should be equal to the unrelated party transaction. The difficulty with applying the CUP method is, however, as with transfer pricing in general, that the facts and circumstances of the unrelated party transaction are not always comparable with the facts and circumstances of a related party transaction. Say that a franchisor licenses to unrelated parties in its home country ("Country A") and to related parties in another country ("Country B"). The risk profile of the Country B related party franchisee may differ substantially from that of the Country A third party franchisee, as well as for instance the market conditions in Country B. If the CUP method cannot be used because the facts and circumstances are not sufficiently comparable, then the "profit based" methods such as the TNMM or PSM can be used. The TNMM can be used if the risks and activities of the related party franchisee are of a limited nature. The remuneration earned by the related party franchisee would then generally be based on a certain percentage of its gross income. The PSM can be used if the activities of and risks incurred by the franchisee are more substantial, and generally the activities of the franchisee are of a more valued added nature. The PSM allocates the profits of the franchisee based on either the profits of comparable parties, or an allocation of based on the relative contributions of the franchisor and franchisee.

[17] This limitation can be found in article 7 of many tax treaties, of which article 7 of the OECD Model Tax Convention on Income and on Capital may be used as an example: "Paragraph 1: profits of an enterprise of a Contract State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as foresaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other state." Paragraph 2 : "… the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealing with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumes by the enterprise through the permanent establishment and through the other parts of the enterprise."

[18] Note that in certain circumstances it may be advantageous and in other circumstances it may be disadvantageous to have a substantial profit allocated to the PE. We will not elaborate on the details, but note that this depends on the level of the corporate income tax rates in the head office and PE country, and the system the head office country uses for the avoidance of double taxation (i.e., credit vs. exemption).

The requirement to comply with the transfer pricing rules is an ongoing requirement. This means that once every so many years, the transfer pricing of intercompany transactions needs to be updated. If the facts and circumstances underlying the transaction have not changed (substantially), and the same transfer pricing methodologies can be used, then one could generally easily update its transfer pricing, e.g., by taking into account more recent financial figures of comparable companies. Should the facts and circumstances have changed however, then a more extensive update can be required or justified. Say for instance that a franchisor/supplier agrees (as a result of negotiation) to charge a franchisee/distributor in a particular country at a price that is lower than what it has charged its affiliates in other markets. The lower price could be commercially justified because the franchisee will also pay a royalty on the retail sales, or because the franchisee is facing a challenging market and the franchisor is willing to accept a lower level of profits for that market (either for a short period of time or well into the future) in order to penetrate that market. The franchisor could now also consider using that same mechanism it agreed on with the third party franchisee/supplier in related party situations, i.e., provided that the facts and circumstances are sufficiently comparable.

(ii) Business format franchisors

The pricing of products, services or a license under a business format franchise agreement if entered into with an unrelated party franchisee should by definition also be at arm's length. One could wonder whether also in a third party arrangement the transfer prices could not be at arm's length if for instance the source country would have a withholding tax on royalty payments, but not on service payments. As such, it could be beneficial for the franchisor if a higher percentage is paid as a service fee instead of as a royalty. In this respect it should, however, not be forgotten that the franchisee, as withholding agent, is in virtually all cases subject to severe penalties if it fails to properly carry out its responsibilities (as mentioned in section 3.1). As such, it would normally be in the interest of the franchisee to ensure that it does not clearly take the wrong position.

In a related party transaction, the transfer pricing problems are twofold. On the one hand the question is what the overall remuneration of the related party franchisee should be, whilst on the other hand the question is how the total payment from franchisee to franchisor should be split into products, services and license components. For the overall remuneration, the same "profit based" methods as mentioned above can generally be used. With respect to the second part, the split of the overall payment, a franchisor may generally be more inclined to take a documentation and substantiation risk than a third party franchisee and as such try to allocate more of the total payment to the non-withholding part of the payment. Therefore, it would be more important to apply the right transfer prices in a related party situation. The only proper way to find the transfer price is to be break down the contract by means of a reasonable apportionment and to find comparables for each of the distinguishable payments. From a practical perspective, the first step would be to remunerate the functions that are the easiest functions to find comparables for, which will often be the services and products components. Subsequently, the remainder of the payment could be allocated to the use of the IP.

5. Tax planning

5.1 The why and the how and the risks

Without tax planning, a franchisor operating abroad could easily end up in a situation where it would pay tax twice in respect of the same income. Considering that tax is a cost for a company, the logical step would be to try to minimize that tax burden. The main aim of tax planning can be said to be organizing your activities in such a way, that tax aligns with all of the other elements of a financial plan. Generally speaking this would mean one would aim for minimizing its tax liability. In itself, tax planning is an appropriate and legal measure for companies to reduce their tax burden: within the framework of domestic and international (tax) laws, companies are free to structure their activities in such a way that they reach the most optimal tax structure.

"Without tax planning, a franchisor operating abroad could easily end up in a situation where it would pay tax twice in respect of the same income."

For franchisors and franchisees, the main reasons for tax planning relate to the topics discussed in this paper. A franchisor for instance would want to avoid having a PE if having a PE, with all of the administrative and possible other costs related thereto, would make the investment, or franchise agreement, economically unviable. Also, even if these costs in themselves would make the investment economically viable, the franchisor would want to avoid that it pays tax twice on the profits the PE makes. This could happen if the profits of a PE are taxed in both the PE country and the country where the head office is located. Double taxation can often be avoided by way of tax treaties, which provide that the profits earned in the PE country should either be exempt from tax in the country where the "head office" is located, or that the head office country should provide for a tax credit for the tax paid in the PE country. The tax planning in the aforementioned examples could be that the activities are structured in such a way that either the activities in the PE country do not fall within the scope of the PE definition, or alternatively that the tax payer is eligible for the benefits of a tax treaty which provides for an exemption or credit for the income or tax paid in the PE.

(i) Reasons for moving to another tax jurisdiction[19]

In certain circumstances, the tax system in the franchisor's home country, in combination with the tax treaties entered into by such country, do not provide for sufficient possibilities to minimize a company's tax liability in such a way that the envisaged results are reached, i.e., organizing the activities in such a way that tax aligns with all of the other elements of a financial plan. In these situations, a company may look at alternative structuring solutions which could provide for the envisaged result. Often such structuring solutions involve structuring the activities through other tax jurisdictions.

For example, franchisor in Country A enters into a franchise agreement with franchisee in Country B. On the basis of the franchise agreement, franchisee would make a payment of 100 to franchisor for the use of franchisor's IP, which would qualify as a royalty under the Country A / Country B tax treaty. Royalties are subject to a 10% withholding tax in Country B. Franchisee would be required to withhold 10 on the payment to franchisor.[20] The net income for franchisor is 90, instead of 100. This example is shown below as Figure A.

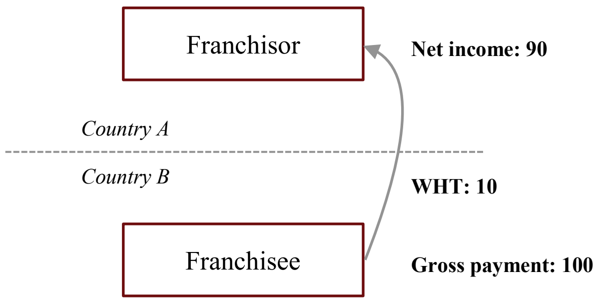

Figure A - Direct license

[19] In this paper we only discuss the tax reasons for franchisors for moving to another jurisdiction. Apart from the tax reasons there may of course also be other non-business reasons for moving to another jurisdictions such as political, geographical reasons or investments protection.

[20] The 10% withholding tax under the Country A – Country B tax treaty only results in the actual withholding of such tax if Country A domestically had a withholding tax on royalties. A tax treaty can only limit the rights of a country to tax certain income, it cannot create such right. As such, we assume that Country B has a domestic withholding tax of at least 10%.

"... it is important to determine which conditions need to be met in order to qualify for the benefits of a particular tax treaty."

Now assume that the franchisor also has a (substantial) presence in Country C, through an affiliated entity ("Affiliate"). Country C does not have a withholding tax on royalty payments. The tax treaty between Country C and Country B provides for a 0% withholding tax rate on royalty payments. If the franchisor would license the IP to the Affiliate and if the Affiliate would subsequently enter into the franchise agreement with the franchisee, then both the payment made by the franchisee to the Affiliate and the payment from the Affiliate to the franchisor would not be subject to a royalty withholding tax. As such, the net income of the franchisor would be 100.[21] This example is shown as Figure B.

(ii) What would it take?

The example provided for above is of course a somewhat stylized overview. In order for this to work, the Affiliate should be able to claim the benefits of the tax treaty between Country B and Country C with respect to the reduced royalty rate.[22] To illustrate, what if the tax treaty between Country B and Country C would have a royalty provision that is similar to the royalty provision in the tax treaty between the United States and Japan, which contains the following royalty article:

> 1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other Contracting State.
>
> .....
>
> 5. A resident of a Contracting State shall not be considered the beneficial owner of royalties in respect of the use of intangible property if such royalties would not have been paid to the resident unless the resident pays royalties in respect of the same intangible property to a person:
>
> (a) that is not entitled to benefits with respect to royalties arising in the other Contracting State which are equivalent to, or more favorable than, those available under this Convention to a resident of the first-mentioned Contracting State; and
>
> (b) that is not a resident of either Contracting State.

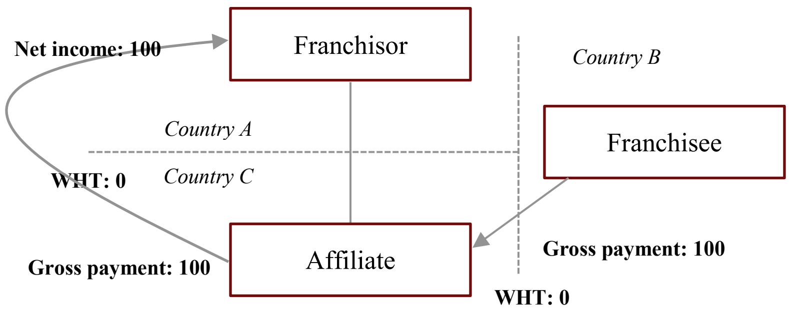

Figure B - License via affiliate

[21] In practice the net income of franchisor would be slightly less than 100, as Affiliate would earn a margin on its sub licensing activities, to be determined in accordance with the arm's length principle.

[22] Generally, this requires that the person/company claiming the benefits of the treaty should at least be considered a " resident" under the treaty.

What this article says is that the Affiliate would not be able to claim the benefits of the tax treaty if the Affiliate will pay royalty to another party which would not be subject to the same 0% rate for royalties. This means that it is important to determine which conditions need to be met in order to qualify for the benefits of a particular tax treaty. These conditions differ from country to country and from tax treaty to tax treaty. There is often a requirement that the sub licensor, the Affiliate in this case, has at least a certain presence, or substance, in Country C and that as such, it is capable of performing the functions and controlling the risks involved with the activities. In the above example it is assumed that the franchisor already has a (substantial) presence in Country C via an affiliated entity. In such case the existing set-up may be used to reach the envisaged result. Should the franchisor not have a presence already in Country C, then it could consider setting up a subsidiary in that country through with it would structure its foreign activities.

(a) IP – sale or license?

In the above example the franchisor licenses its IP to the Affiliate, directly from Country A. The royalty payment from the Affiliate to the franchisor would be fully subject to tax in Country A in the year the payment is made. Say Country A is the US, then such income would be subject to a 35% tax. If the royalty payment would be 100, the after tax profit would be 65. The franchisor could use such after tax profits to further invest in its business or distribute to its shareholders. What if the franchisor would be able to defer paying tax on the 100 of income, then the franchisor could invest 100 in its business, with a chance of an overall higher return. Such deferral structures are currently being used by most US MNEs for their international operations.

In these structures, the franchisor would typically set-up a subsidiary ("Affiliate 1") in a low tax country ("Country B") to which it sells its international IP rights. Affiliate 1 holds another affiliated company in Country C ("Affiliate 2"). Country C does not have a withholding tax on royalty payments. The Affiliate licenses the IP rights to Affiliate 2 and Affiliate 2 subsequently enters into a franchise agreement with third party franchisees. Affiliate 1 does not enter into the franchise agreement directly with the third party franchisees because then the third party franchisees would have to withhold a 10% royalty withholding tax. Affiliate 2 has 100 income, which it on-pays to Affiliate 1. Affiliate 1 has no on-payment obligation towards franchisor. Affiliate 1 could distribute the funds as a dividend distribution, in which case the franchisor would pay tax on the income received, or alternatively, Affiliate 1 could re-invest the total amount of 100 into the activities of its subsidiaries. It is clear that generally the franchisor would want to have the flexibility to choose to either distribute or reinvest the funds. Such flexibility could be provided by using this type of structure. This structure can be summarized as follows:

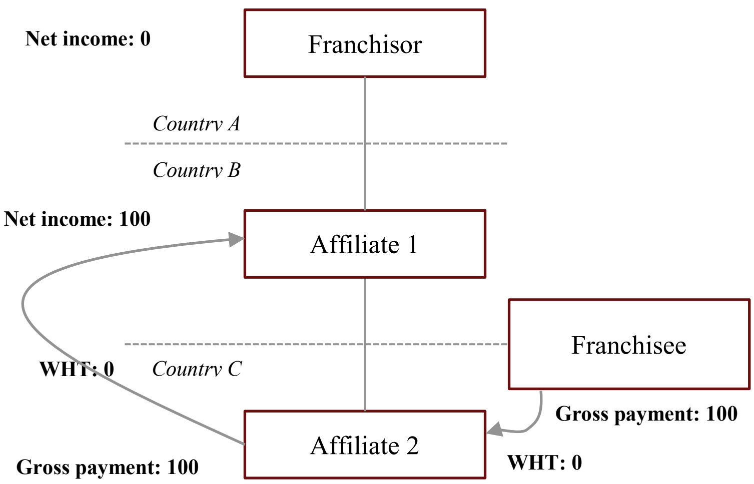

Figure C - Deferral of franchisor tax

"Key in these types of structures is that the decision-making authority is centralized in one particular place, and that the local offices operate as representative offices."

(b) Support/services – What must be moved and what can stay?

The ownership of an IP asset is often (still) based on the legal ownership of such asset,[23] which can easily be moved from one country to another by way of a sale. The place where services are provided is generally the place where the people providing such services are located. Moving people from one location to another is more difficult than transferring the ownership of an IP asset. Often however, it is not required to move (all) people in order to change the place where services are provided from. For example, take the example provided in Section 2.2. In this example one part of an "enterprise" is licensing technology such as a franchise system into a country, while another part has a trading office locally. It is assumed that the trading office can be considered a PE. This likely means that the employees in the trading office have a certain authority to execute trades on behalf of the "enterprise", i.e., they have the authority to conclude contracts. If these employees would be stripped of such authority to conclude contracts and other decision-making related functions and these functions would instead be centralized either at the level of the company's head office or another affiliated company ("principal company"), the trading office's function would change from an actual trading office, to a representative office of the principal company. At the same time, part of the profits that were initially attributable to the trading office shift to the principal company. This is beneficial if the principal company is located in a country which has a lower tax rate than the country in which the trading office is located. This structure, commonly referred to as "commissionaire structure", is often used in various set-ups. Key in these types of structures is that the decision-making authority is centralized in one particular place, and that the local offices operate as representative offices.

[23] There is an international shift to more of a substance over form approach whereby not so much the legal ownership of an asset, but the relevant functions performed and management of risks are considered increasingly more important.

(iii) Recent developments and the future of tools/structures currently used

In the last few years political and media attention have increasingly focused on corporate tax affairs of MNEs. This resulted in a growing public perception that through cross-border tax structuring, MNEs have been excessively reducing their global effective tax rates and are therefore not paying their "fair share." The G20, politicians, the media, the OECD and the EU have claimed that action is needed to eliminate certain types of tax avoidance by MNEs. That is the main reason why the OECD published its report on Base Erosion and Profit Shifting ("BEPS") on 12 February 2013, its action plan on BEPS on 19 July 2013 ("OECD BEPS Action Plan") and various discussion drafts on specific topics.[24]

From a practical perspective, the OECD BEPS Action Plan, other similar international initiatives, such as the EU efforts, and the continuing political and media pressure have already resulted in a "change of climate" in the international corporate tax world. The "naming and shaming" by politicians

[24] EPS deals with tax planning strategies used by MNEs in cross-border situations. These tax planning strategies include using loopholes in the international tax rules and shifting taxable basis to tax havens where there is little or no real activity. As a result, the profits of cross-border operating businesses are taxed at low effective tax rates. Although legal, this is believed to be harmful for various stakeholders (governments, individual taxpayers and businesses). According to the OECD, there is an increasing discrepancy between the allocation of income and the economic activities that generate such income, as a result of a mounting use of perceived harmful tax planning techniques internationally. In particular, the elements "intellectual property", "capital" and "risk" are - in the eyes of the OECD - believed to accommodate the shifting of profits to a low or non-tax environment. Therefore, the OECD BEPS Action Plan is very much focused on combatting tax planning techniques which aim to make use of these three elements.

and the media attention for MNEs that are making use of the loopholes in the international tax field, have made some MNEs more reluctant to initiate international tax planning schemes. Reputational risks have a far greater weight than in the past. Whatever the outcome of the political process will be, the publication of the BEPS discussion drafts as well as the publication of proposals by other organizations like the EU (such as the approved amendments to the EU Parent Subsidiary Directive as per 31 December 2015) will affect cross-border investment structures of MNEs. Although it is currently still difficult to predict what the effects will be exactly, certain trends can however be expected: access to tax treaties will become more difficult, there will be more attention and pressure on transfer pricing aspects, more transparency, and more unilateral anti-base erosion rules.

These trends may also affect the structures used by franchisors and franchisees. For instance, in the structures described in this paper, the affiliate acting as sub licensor/franchisor of the ultimate franchisor may no longer be eligible to claim the benefits of the tax treaty between the affiliate country and the country where the franchisee is located if it does not have a substantial presence in the affiliate country and/or has been interposed only to obtain the benefit of that particular tax treaty. As such, the affiliate may no longer be able to claim the reduced royalty withholding tax rate under the tax treaty. It is recommendable to develop a view on how best to keep abreast of the expected trends and to be ready to further adapt to specific amendments of the tax rules based on BEPS, other projects.

6. Conclusion

It is hoped that the foregoing has provided useful and useable information both to the readers seeking to avoid tax pitfalls and the readers seeking a greater understanding of the tax planning possibilities in international franchising. This area of commerce is incredibly complex and calls for expert input to minimize risk and maximize benefits. Failure to see and avoid the risks can result in double taxation of the same revenue, higher than necessary tax rates and/or tax liabilities that did not have to arise in the first place. Proper tax planning can unearth additional revenues that can be deployed more productively to achieve desired enterprise growth and financial outcomes.

“Reputational risks have a far greater weight than in the past.”

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