# A Taxing Situation: Addressing Tax Issues in International Franchising

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# Topics Covered

- Background on U.S. and International Tax Systems
- Fee Categories and Their Tax Implications
- Double Taxation and the Role of Tax Treaties
- Permanent Establishment (PE) Considerations
- Transfer Pricing in Franchising
- U.S. and Global Tax Trends
- Practical Tax Planning Considerations for Franchisors

# International Tax for Franchising

- **Importance of International Franchising**
  - Key growth strategy for businesses
  - Common in industries like restaurants, hotels, and retail
- **International tax issues for global businesses**
  - Complex disputes arise due to varying tax laws
  - Impact of OECD’s Pillar 2 initiative
  - Increased transparency requirements
- **Understanding international tax**
  - Essential for structuring franchise operations
  - Aligns with critical business goals
  - Ensures compliance and maximizes efficiency

# Background on U.S. and International Tax Systems

# Tax Systems in Other Countries

- **Worldwide vs. Territorial Tax System**
  - Worldwide: Residents taxed on global income, wherever earned.
  - Territorial: Only tax income earned within their borders
- **Tax Incentives for Foreign Investors**
  - Exemptions, low rates encourage international business expansion
  - Countries like Ireland, Singapore, and the Cayman Islands attract multinational companies with competitive corporate tax rates
  - Tax competition mitigated by the OECD Pillar 2 Initiative, which seeks to impose a global minimum tax of approximately 15%
- **Interaction with U.S. Tax Laws**
  - Crucial for U.S. based franchisors expanding abroad
  - Local subsidiaries, licensing agreements, or joint ventures influence tax treatment

# U.S. Tax System

- **Worldwide Taxation**
  - U.S. corporations and individuals taxed on all income, regardless of where it is earned
  - Income also subject to state and local taxes
- **Tax Cuts and Jobs Act (TCJA) of 2017**
  - Transition to quasi-territorial system
  - Some offshore income taxed currently
  - Other  income deferred or exempt
  - Lower tax rates to incentivize certain behaviors
- **Key Provisions for U.S.-Headquartered Franchisors**
  - Subpart F & GILTI apply to tax U.S. shareholders on certain foreign undistributed profits
  - Foreign Derived Intangible Income (FDII)
  - Base Erosion Anti-Abuse Tax (BEAT) on certain cross-border payments
  - Section 245A Dividend Received Deduction (DRD) for foreign dividends

# Key International Provisions – 1/2

## Subpart F & GILTI: Foreign Undistributed Profits

### Subpart F & GILTI Rules for U.S. Shareholders

- Apply to shareholders owning more than 10% of any stock in a controlled foreign corporation (‘CFC”)
- Require reporting and paying tax on certain profits before they are distributed

### Subpart F vs. GILTI Income

- Subpart F Includes low-taxed passive income like dividends, interest, rents, and royalties
- Subpart F income taxed first
- Remaining income subject to GILTI (net tested income)

### Applicable Tax Rates

- Subpart F - ordinary U.S. federal tax rate (21% for corporations)
- GILTI currently taxed at a maximum rate of 10.5%
- GILTI Rate set to increase to 13.125% starting January 1, 2026

### Purpose

- Subpart F and GILTI limit ability of U.S. companies to defer U.S. tax on certain types of income earned by foreign subsidiaries
- GILTI targets income from assets generating high returns compared to their tax basis

### Franchising Examples

- Royalties paid by third parties to a CFC can be subject to Subpart F income
- Subpart F active marketing exception applies if CFC regularly engages in substantial marketing activities

# Key International Provisions – 2/2
## FDII, BEAT, DRD "Territorial" Rules

**Foreign Derived Intangible Income (FDII)**

- Encourages retaining functions and assets in the U.S.
- Provides a reduced tax rate on certain types of income from foreign parties (e.g., royalties paying for foreign uses of U.S.-owned I.P.)
- FDII current rate is 13.125%, increasing to 16.406% in 2026
- Relation to GILTI
  - FDII rate moves in tandem with GILTI rate
  - Discourages moving functions or assets offshore
- Method for allocating expenses can result in a higher effective rate

**Base Erosion Anti-Abuse Tax (BEAT)**

- Discourages US companies from making excessive deductible payments to foreign entities
- Applies to payments made to any foreign related party
- Targets US companies with $500 million or more in gross receipts
- Base erosion deductions must exceed 3% of total deductions
- Excludes cost of goods sold and services cost method expenses
- Current BEAT tax rate is 10% of modified taxable income, increasing to 12.5% starting in 2026.

**Section 245A Dividend Received Deduction**

- Limited to U.S. corporations owning at least 10% of any shares of a CFC
  - Must meet holding period and other requirements
- Exclusion of Foreign-Source Dividends
- Limitations of DRD in Franchising Operations
  - Most CFC income subject to GILTI provisions
- Repatriation Flexibility
  - Beneficial for companies with lower GILTI income
  - Significant QBAI in GILTI calculations

# U.S. Foreign Tax Credit

- Double Taxation of Foreign Income
  - U.S. taxes worldwide income of corporations and individuals
  - Foreign earned income often taxed by foreign governments
  - Result is double taxation
- U.S. Foreign Tax Credit
  - Credit for qualifying taxes paid on foreign income
  - Includes withholding taxes on foreign dividends and royalties
  - Reduces U.S. tax on foreign income only
- Calculation of Foreign Tax Credit
  - The U.S. foreign tax credit calculation is complex – general notion is that the foreign tax credit reduces the U.S. tax imposed on a U.S. corporation's foreign income by crediting foreign taxes subject to expense allocation and apportionment, taxable income limitations and overall basketing of income.

# Fee Categories and their International Tax Implications

# Why Fee Categorization Matters

## Impact on Effective Tax Rate

- Different types of payments attract varying withholding tax rates
- Royalty payments may have higher withholding tax compared to service fees

## VAT and Indirect Taxes

- SaaS and digital service fees may be subject to VAT
- Additional registration and compliance efforts required
- VAT may or may not be recoverable

## Transfer Pricing Compliance

- Payments between related party entities must be at arm's length
- Incorrect categorization can lead to tax audits and adjustments
- Ensures payments reflect an arm's-length standard

## Treaty benefits and exemptions

- Tax treaties allocate taxing rights between countries according to payment category

# Common Fee and Payment Categories

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|---|---|
| License and Royalty Payments | • Payments for trademark and brand usage<br>• Withholding tax rates can range from 0% to 30% depending on jurisdiction, applicable treaty |
| General Service Fees | • Payments for consulting or operational support<br>• Lower or no withholding tax rates or VAT |
| Technology Service Fees | • Taxed as service fees or royalties, DST may apply |
| SaaS Fees | • Australia, Korea have treated certain SaaS fees as royalties in the case of SaaS resellers |
| Marketing and Advertising Service Fees | • Subject to VAT where services are performed |

# Examples

### U.S.-based fast-food franchisor expanding into Europe

Charges European franchisees a brand royalty fee

May need to withhold tax at 15-30% depending on the country's tax treaty with the U.S.

If structured as a service fee for brand support, tax may be lower or exempt

### European software-based franchise network

Charges U.S. franchisees a SaaS subscription fee

If categorized as a technology license, fee may be subject to withholding tax

If structured as a service fee, it may avoid withholding tax but be subject to U.S. sales tax

### U.S. fitness franchisor expanding into Asia

Provides training programs as part of the franchise package

If categorized as consulting service, fees may be exempt from withholding taxes

# Practical Fee Categorization Considerations

- Importance of Absolute Revenue Stream
  - More significant than segregation of revenue into different types of income
  - OECD acknowledges this in 2022 Transfer Pricing Guidelines
- Business Franchise Arrangement Pricing
  - Combination of services and intangibles for a single fee
  - Segregation necessary if reliable comparables cannot be identified
- Tax Treatment
  - Different tax treatments for licenses vs. services
  - Segregation may be  necessary for proper tax treatment
- Practical Recommendations
  - Explicitly split fees for different licenses and services
  - Proper transfer pricing documentation also helps in the event that the split is challenged by taxing authorities
- Franchisors must review fee structures

# Double Taxation Challenges under Tax Treaties

# The Problem of Double Taxation

- Double taxation occurs if income is taxed in both the country where it is earned  and the franchisor's home country
- Double taxation significantly reduces profitability without proper tax planning
- Example: U.S.-based franchisor earns royalties from a franchisee in Germany
    - German charges withholding taxes on the royalty income
    - U.S. also taxes the same income
    - Potential 0% withholding rate available under the Germany-U.S. Tax Treaty
- Mitigation Strategies
    - Application of tax treaties
    - Utilization of foreign tax credits under U.S. law
    - Local law exemptions

# The Role of Tax Treaties

- Mitigation of Double Taxation
  - Tax treaties provide exemptions or reduced tax rates for certain income
  - Business profits taxed differently than royalties, etc.
- U.S. Franchisors benefit from U.S. Tax Treaty Network
  - Bilateral treaties with over 60 countries
  - Lower withholding tax rates on royalties, service fees, interest, and dividends
- Variation in Treaty Provisions – Withholding example
  - Some treaties exempt royalties from withholding tax
  - Others set specific limits (e.g., 10% treaty withholding rate instead of 30% withholding applied under local law)
- Proper Treaty Application
  - Local law filings
  - Residency certificates
  - Limitation of benefits and "substance" requirements

# Importance of Treaty Benefits for Withholding

## Financial Benefits for Franchisors

- Reduces double taxation on royalties and fees
- Increases net income
- Avoids cash flow disruptions
- Improves competitiveness

## Operational Benefits for Franchisees

- Lowers costs on payments to franchisors
- Encourages compliance by reducing complexity
- Enhances profitability
- Keeps more funds for local business growth

# Treaty Concepts: Permanent Establishments

# What is a Permanent Establishment?

### Permanent Establishment (PE)

Occurs when a franchisor has a physical presence or business activity in a foreign country

Triggers local corporate tax obligations on any profits attributable to the PE

### Criteria for PE

Fixed place of business such as an office or warehouse

Dependent agent with contract-signing authority

### Tax Implications

Local taxes may apply to all income attributed to the PE

Potential for double taxation

Disputes with taxing authorities

Compliance burdens

### Concerns for Franchisors

# How to Avoid Unintended PE Status

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|---|---|
| Use Independent Contractors | Opt for contractors instead of employees in foreign markets |
| Restrict Contract Authority | Ensure local sales representatives cannot sign contracts |
| Limit Visits by Franchisor Staff | Control the duration and frequency of visits |
| Structure Agreements Strategically | Provide services outside the franchisee's country |
| Manage PE Risks | Avoid unexpected tax liabilities, penalties, and increased compliance costs |

# Treaty Concepts: Transfer Pricing

# Legal Entity Accounting and Transfer Pricing

**Transfer pricing ensures the actual economics of internal transactions are appropriately accounted for and taxed**

- Legal Entity Accounting
  - Allocates income and expenses to each legal entity
  - Used to determine each entity's tax liability
- Transfer Pricing
  - Sets price of transactions between related parties for accounting and tax purposes
  - Computed as if parties are unrelated (arm's length) using comparable transactions
  - Accounts for flows of income in each jurisdiction
- Compliance with Transfer Pricing Regulations
  - Proper structuring of intercompany arrangements
  - Preventing tax avoidance
- Transfer Pricing Documentation
  - Required before tax return filing or upon tax authority request

# Common Transfer Pricing Methods

Franchising Transfer Pricing Examples:

- Royalty payments
- Service fees
- Interest payments
- Intellectual property licensing

| | |
|---|---|
| Comparable Uncontrolled Price (CUP) Method | Comparing fees with third-party agreements |
| Resale Price Method (RPM) | Ensuring resale markups align with market rates |
| Cost-Plus Method (C+M) | Adding a profit margin to service costs |
| Profit Split Method (PSM) | Dividing profits based on value contributions |
| OECD "DEMPE" method | Intended to align taxation to value creation functions for IP.<br>DEMPE: "Development, Enhancement, Maintenance, Protection" |

# Transfer Pricing Disputes

## Transfer Pricing Disputes

- Significant burden on franchisors
- Dispute often arises when Jurisdiction claims related party payment is not arm’s length and proposes an adjustment
- Additional tax is asserted based on the adjustment in addition to penalties

## Risk of Double Taxation

- Potential for double taxation on disputed amounts
- Example: U.S. franchisor and Germany company royalty payment
- Dispute on royalty payment amount

## Challenging Assessments

- Company can challenge assessment under local law
- Treaty may also provide dispute resolution mechanism
- If not, taxpayer can only seek relief from the tax authority disputing the pricing

## Dispute Resolution & Prevention Tools

- Mutual Agreement Procedure (MAP)
- Advance Pricing Agreement (APA)

# Global Developments

# OECD Pillar 2 (1/2)

- Initiative established in 2019, adopted by EU Directive in 2022
  - Aims to set a 15% global minimum tax for large companies
  - Calculated based on financial statement income
- Minimum Tax Requirements
  - Applies to companies with annual global revenues of at least €750 million
  - Minimum tax rate of 15% on taxable profits in each jurisdiction
  - Top-up tax if local tax rate is below 15%
- Implementation Mechanisms
  - Qualified Domestic Minimum Top-Up Tax (QDMTT)
  - Undertaxed Profits Rule (UTPR)
  - Income Inclusion Rule (IIR)
- Adoption and Compliance (continued on next slide)

# OECD Pillar 2 (2/2)

- Adoption of Pillar 2 Legislation
  - Implemented by EU countries, UK, Japan, and Canada
  - Imposes 15% minimum tax on profits in each jurisdiction
- Effectiveness and Interpretation
  - Pillar 2 rules are now effective in most jurisdictions
  - Interpretations of the rules are still being developed
- Impact on Franchisors
  - Evaluation of operating structures to quantify tax impact
  - Consideration of modifying structures due to significant burden
  - Efforts to ensure compliance
- United States' Position
- Trade Disputes

# Digital Services Taxes (DST)

### Emergence of Digital Services Taxes (DST)

Unilateral measures by various countries

Target revenue from digital business models

### Impact on Franchisors

Affects those with significant digital operations

Applies to online advertising, digital marketplaces, streaming services

May capture revenue streams like franchise fees, online training, marketing support

### Assessment and Mitigation

Franchisors must assess exposure to DSTs

Consider structuring options to mitigate tax risks

### Evolution and Monitoring

OECD seeking a unified global framework

# DEMPE (Development, Enhancement, Maintenance, Protection, and Exploitation)

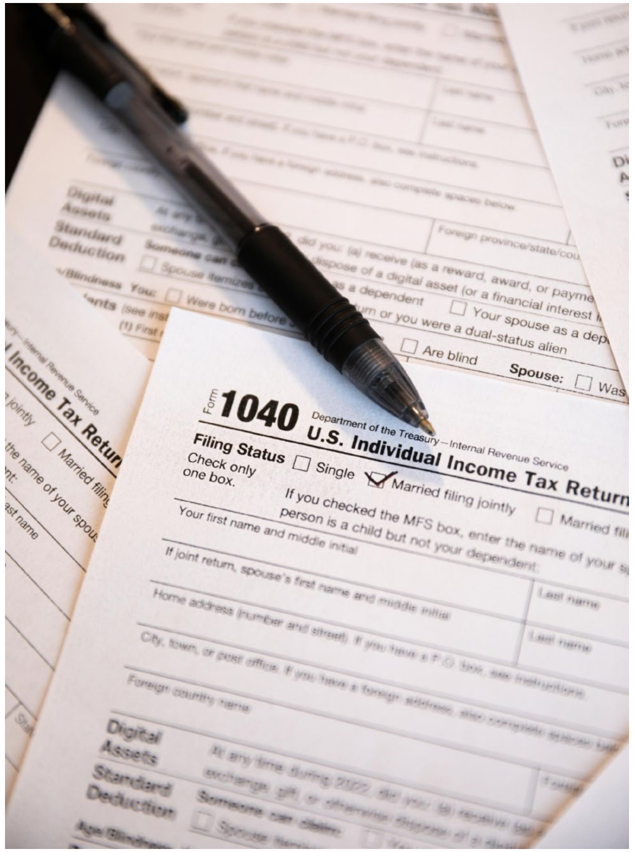
- DEMPE Principles of Transfer Pricing
  - Crucial for international tax planning  for franchise networks
  - Focuses on income allocation from intellectual property assets
- Adoption by Tax Authorities
  - Part of OECD's BEPS Action Plan 8-10
  - Adopted by EU, Australia, Canada, etc.
- Requirements under DEMPE Guidelines
  - Jurisdiction must have personnel and resources for IP management
  - Registration in low-tax jurisdictions without economic activity is insufficient
- Implications for Franchisors
  - IP ownership structures must reflect actual contributions to value
- Consequences of Non-Compliance

# EU Trends

- Focus on General Tax Avoidance and E-Commerce
  - Implementation of transparency measures and reporting
  - Anti-Tax Avoidance Directives
  - Cryptocurrency, digital sales and services
- New Rules on Tax Residence
  - Directive requires “sufficient substance” for treaty residence, but term has remained undefined

# Practical Considerations

# Staying Compliant with Evolving Local Tax Laws




- Importance of Staying Current on New Legislation
  - e.g., Pillar 2 developments, U.S. tax law
- Engage Tax Professionals in Each Jurisdiction
  - Ensures compliance with local tax laws
- Develop a Customized Tax Strategy
  - Align strategy with global expansion plans
  - Collaborate with tax advisors and legal experts

# Practical International Tax Considerations

- Choosing the Right Entity Structure
  - Subsidiaries (full control and ownership)
  - Joint ventures (shared risks and resources_
  - Licensing models (lower investment and quicker market entry)
- Optimizing Revenue Streams
  - Minimizing exposures to double taxation or adjustments
  - Structuring franchise fees, royalties, and service fees to accurately determine tax exposure
  - Setting royalties to reflect intellectual property value
  - Implementing service fees to cover operational costs
- Managing Employee Presence Abroad
  - Avoiding PE risks  through careful workforce planning

# Conclusions