A Taxing Situation: Addressing Tax Issues in International Franchising

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INTERNATIONAL FRANCHISE ASSOCIATION

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	Subpart F vs. GILTI Income	Applicable Tax Rates	Purpose	Franchising Examples
• 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 Includes low-taxed passive income like dividends, interest, rents, and royalties • Subpart F income taxed first • Remaining income subject to GILTI (net tested income)	• 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	• 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	• 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

License and Royalty Payments	• Payments for trademark and brand usage • Withholding tax rates can range from 0% to 30% depending on jurisdiction, applicable treaty
General Service Fees	• Payments for consulting or operational support • 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	Operational Benefits for Franchisees
• Reduces double taxation on royalties and fees • Increases net income • Avoids cash flow disruptions • Improves competitiveness	• 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

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

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)

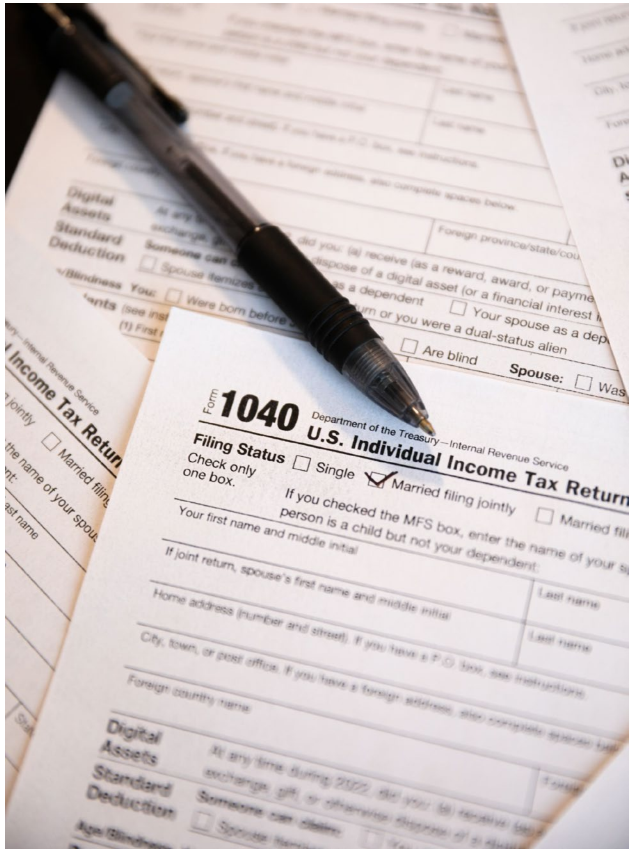
- DEMPE Principles of Transfer Pricing
  - Crucial for international tax planning for franchise networks
  - Focuses on income allocation from intellectual property assets
- Adoption by Tax Authorities
  - Part of OECD's BEPS Action Plan 8-10
  - Adopted by EU, Australia, Canada, etc.
- Requirements 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

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