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Franchising Q&A: US

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US-specific information concerning the key legal and commercial issues to be considered when setting up a franchise.

This Q&A provides country-specific commentary on Practice note, Franchising: Cross-border overview, and forms part of Cross-border commercial transactions.

General

1. Is franchising common? What statistics are available to show the importance of franchising in the national economy? What types of products/businesses are susceptible to franchising? What comments can be made about the expansion of domestic franchisors overseas?

The International Franchise Association (IFA) engaged FRANdata, a research and advisory firm, to prepare the Franchise Business Economic Outlook 2020 report (which can be accessed at https://franchiseeconomy.com). The report was released on 7 February 2020, just before the 2019 novel coronavirus disease (COVID-19) pandemic sent most areas of the US into economic lockdown. The report forecast that in 2020:

- The number of "franchise establishments" in the US would increase by 1.5% to 785,316 establishments (this includes both businesses owned by franchisees and businesses owned by franchisors).
- Franchise business employment in the US would increase by 232,000 jobs (2.8%) to 8.67 million.
- Economic output of franchise establishments in the US would grow by 4.1% to USD819.57 billion.
- The GDP contribution of the franchise industry would grow by 4.6%, while the industry's GDP contribution to the total US nominal GDP would remain steady at 3%, generating a total of USD494.96 billion.

These projections for 2020 are no longer valid as a result of the economic impact of COVID-19. Nevertheless, franchising remains an important part of the US economy and affects dozens of lines of business, including restaurants, lodging, business services, personal services, fitness, healthcare, senior care, educational services, retail, automotive, entertainment, and residential services, to name a few.

Overseas expansion by US franchisors is also quite common. In 2017, the IFA website noted that more than 400 US franchise systems operated internationally, and it is fair to assume that number has only increased.

Overseas expansion

2. Does national law permit a foreign franchisor to enter into a franchise agreement without establishing a wholly-owned subsidiary or a branch office in the foreign country?

Yes. However, many foreign franchisors choose to establish a US subsidiary, for several reasons, including:

- To serve as a liability shield for the parent.
- To simplify the preparation of franchisor financial statements (which must be included in the US franchise disclosure document).
- To protect the parent company's financial statements from disclosure (though parent company financial statements might still be required in some circumstances).
- To simplify other aspects of the disclosure (because a new company, by definition, will have no operating history, however, certain information concerning the parent company might nevertheless be required by franchise disclosure laws or under general anti-fraud standards).
- To simplify payments and contract terms with franchisees (because the franchise agreement and related payments will be between US entities).

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- To give the foreign franchisor options as to the form in which it receives income from the US (for example, as dividends instead of royalties).

Of course, establishing a US subsidiary will likely have tax, transfer pricing, staffing, and other consequences. The foreign franchisor should work through these considerations with its accounting team and other advisers.

3. Are there any rules which would restrict the setting up of branches or subsidiaries or joint ventures by a foreign owned business?

No.

4. Will there be any difficulties in a domestic franchisee making payment to a foreign franchisor either in local currency or in the currency of the franchisor's country? Are there any exchange controls in operation?

No, assuming the franchisor's country is not subject to any applicable US economic and trade sanctions. For information on sanctions, see Office of Foreign Assets Control, US Department of the Treasury.

Regulation of franchising

5. Is franchising specifically regulated by law? Is any legislation pending, which is likely to affect franchising? Are there any formalities that a franchisor must comply with when setting up a franchise system, for example, any registration or disclosure requirements?

Franchising is regulated at both the national level and the state level. Registration and disclosure laws apply to the initial offer and sale of a franchise. State "relationship" laws govern termination, non-renewal, and transfer of existing franchises, as well as various other aspects of the franchise relationship.

Federal disclosure law

The US Federal Trade Commission enforces a trade regulation rule, Disclosure Requirements and Prohibitions Concerning Franchising 16 C.F.R. Part 436 (FTC Rule, also known as the Franchise Rule). The FTC Rule imposes a nationwide requirement to deliver a Franchise Disclosure Document (FDD) in connection with the offer of a franchise. The FTC Rule prescribes the information to be included in the FDD, but the FTC Rule does not require any filing with the federal government or any federal government review of the FDD before use.

The franchisor must deliver the FDD to a prospective franchisee at least 14 days before the prospective franchisee signs a binding agreement or makes any payment to the franchisor in connection with the proposed franchise sale. The franchisor must deliver the FDD earlier in the sales process upon reasonable request by the prospective franchisee. If the franchisor unilaterally makes any material changes to the franchise agreement or any related agreements after delivering the FDD, the franchisor must furnish a copy of the revised agreement at least seven days before the prospective franchisee signs it. The FDD can be delivered electronically, subject to certain conditions.

Significantly for foreign franchisors, the FTC Rule permits the use in the FDD of financial statements prepared using accounting principles other than US generally accepted accounting principles (US GAAP), as long as the statements meet the criteria of the US Securities and Exchange Commission, which require:

- Reconciliation with US GAAP.
- That the statements be audited according to US generally accepted auditing standards.

If the franchisor forms a US subsidiary, the parent company's financial statements must still be disclosed in the FDD if the parent guarantees the franchisor's obligations or commits to perform post-sale obligations of the franchisor to franchisees.

The FTC Rule applies only to franchises operating in the US or US territories and possessions. The FTC Rule contains several exemptions, including for:

- Franchises requiring investment above a certain threshold (USD1.223 million as of 1 July 2020).
- Offers to prospective franchisees with at least five years of business experience and a net worth above a certain threshold (USD6.1655 million as of 1 July 2020).
- Offers to "insiders" (owners, officers and managers of the franchisor) who meet certain criteria.

State registration and disclosure laws

The following states require franchisors not only to provide disclosure, but also to register with the state government before offering franchises in the state: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. The registration requirements vary from a simple notice

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filing to full review of the FDD. Oregon requires pre-sale disclosure but does not require registration. All of the so-called "registration states" accept the disclosure format prescribed by the FTC Rule, with certain adjustments to reflect state requirements. A few states differ slightly from the FTC Rule in the timing requirements for delivery of the FDD.

Business opportunity laws

Franchise offerings may also fall under "business opportunity" laws. Two dozen or so states have business opportunity laws, which typically cover ventures in which a promoter:

- Offers to sell or lease products, equipment, or services for the purpose of enabling the investor to start a business.
- Makes certain representations to induce the investment, such as a guarantee that the investor will make a profit or that the promoter will buy output or arrange customers.

Business opportunity laws impose registration and disclosure requirements similar to those under the franchise laws. Business format franchises often fall within the basic definition of a "business opportunity," but the statute usually has an exception or exemption by which franchisors avoid having to comply. In some cases franchisors must file a notice to obtain the exemption. For example, franchisors typically file notices in the states of Florida, Kentucky, Nebraska, Texas and Utah to obtain exemptions from the business opportunity laws in those states. In other states, exemption depends on having a registered trade mark in the US. If the franchisor does not have a registered trade mark in the US, full registrations are likely to be necessary under business opportunity laws in Connecticut, North Carolina, South Carolina, and other states.

The FTC Rule used to cover business opportunities as well as franchises, but business opportunities are now covered by a separate trade regulation rule, Disclosure Requirements and Prohibitions Concerning Business Opportunities 16 C.F.R. Part 437 (Business Opportunity Rule). To avoid duplicative regulation, the Business Opportunity Rule is structured so that it does not apply if the offeror complies with the FTC Rule or qualifies for an exemption under that Rule.

Relationship laws

The following 22 states and US territories regulate various aspects of the relationship between franchisor and franchisee: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Puerto Rico, Rhode Island, the Virgin Islands, Virginia, Washington and Wisconsin. The content and exact coverage of these relationship laws varies greatly. Most require notice and/or good cause and/or an opportunity to cure before a franchisor may terminate a franchise in the state or territory.

In addition to termination, the subjects that may be covered include:

- Notice and good cause requirements for refusal to renew a franchise.
- Inventory repurchase or other compensation if the franchisor terminates or refuses to renew.
- Limitations on a franchisee's ability to transfer the franchise or ownership interests in the business.
- Limitations on a franchisor's ability to restrict transfer of the franchise.
- Limitations on a franchisor's ability to restrict purchasing from other suppliers or to accept rebates or commissions from suppliers (see Question 8).
- Limitations on discrimination among franchisees (see Question 8).
- A statutory duty of good faith.
- Exclusivity and non-compete provisions (see Question 10).
- Restrictions on choice of law provisions and waivers of the franchisee's rights and remedies under the statute.

Legislative proposals to add or expand state relationship laws are not uncommon. There is no major trend towards such additional legislation, however. The current legislation that is much more likely to affect franchising is on a different subject, namely, franchisors' potential liability as "employers" of their franchisees and as "joint employers" of their franchisees' employees (see Question 21).

6. Are there any laws, regulations or case law which apply to distributorship or agency relationships that might be interpreted in such a way as to apply to the franchise relationship?

The Alaska, Delaware, Maryland, Rhode Island, Wisconsin and Puerto Rico statutes mentioned in Question 5 are dealership statutes that will or may apply to most franchises. In addition, a large body of statutes governs termination or other aspects of the relationship in specific industries. At the federal level, the Automobile Dealers Day in Court Act and the Petroleum Marketing Practices Act govern relationships with automobile dealers and gasoline retailers respectively. At the state level, industry-specific laws typically govern relationships with motor vehicle dealers, industrial and

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farm equipment dealers, liquor wholesalers, and beer and wine distributors.

Product dealerships and distributorships are also subject to Article 2 of the Uniform Commercial Code (UCC), which has been adopted in all 50 states. The UCC may apply to a franchise relationship if the sale of goods is part of the relationship (in some states, the sale of goods must be the "dominant" or "predominant" part of the relationship for the UCC to apply).

Court decisions in dealership and distributor disputes often involve issues relevant to franchising. In fact, the Business Franchise Guide, published by Wolters Kluwer and other popular reporters of legal developments in US franchising, usually include decisions in dealer and distributor cases.

It is not uncommon in the US for third parties (especially customers and employees) to seek to hold the franchisor liable for acts or omissions by the franchisee or for events that occur on the franchisee's premises. Accordingly, case law on agency relationships is also relevant to franchising. The franchise agreement typically disclaims the existence of an agency relationship between the franchisor and franchisee, which is usually sufficient to defeat claims based on a theory of "actual" agency. To combat claims based on a theory of "apparent" agency, the franchise agreement (or operations manual) typically requires the franchisee to post a notice that the business is independently owned and operated and to use the franchisee's own legal name on business forms, human resources materials, and so forth.

7. Is there an obligation on franchisors and/or franchisees to comply with any voluntary code? What are the main obligations imposed in such code? Is it usual practice to incorporate the code into the franchise agreement?

If the franchisor is a member of the IFA, the franchisor is subject to the IFA Code of Ethics. However, membership in the IFA is voluntary.

The IFA Code of Ethics does not impose specific requirements; for example, unlike the European Code, there is no express requirement that the franchisor have a pilot operation. Rather, the IFA Code of Ethics states "ideals" and "core values" which franchisors and franchisees are expected to observe in dealing with each other. They include:

- Fulfilment of contractual obligations.
- Openness, candour, and truthfulness.
- Mutual respect and shared responsibility in improving the franchise system.
- Open and frequent communication.
- Full compliance with federal and state franchise regulations.
- Amicable and prompt resolution of disputes, including access to an internal dispute resolution mechanism.

The Preface states that the Code "is not intended to establish standards to be applied by third parties, such as the courts, but to create a framework under which the IFA and its members will govern themselves". Members who feel that another member has violated the Code in their US operations may file a formal written complaint with the President of the IFA. It is not common practice to incorporate the IFA Code of Ethics or other voluntary codes into a franchise agreement.

Competition law

8. Are there any national laws or regulations that would affect the following business practices:

- Exclusive dealing?
- Territorial restrictions?
- Customer restrictions?
- Resale price maintenance?
- Minimum purchase targets?
- Imposition by the franchisor of restrictions on the sources of supply to franchisees?
- Discrimination by the franchisor among franchisees for fees, royalties, payment for goods, services, and so on?

All franchise and distribution relationships in the US are subject to federal and state anti-trust (competition) laws. The principal federal anti-trust statutes are the:

- Sherman Act.
- Clayton Act.
- Federal Trade Commission Act (FTC Act).
- Robinson-Patman Act.

These laws are enforceable both by government agencies and (except for the FTC Act and portions of the Robinson-Patman Act) by private parties. A vast body of judicial decisions and principles has developed under the general language of these statutes. Accordingly, the following summary should be read with appropriate caution against over generalisation.

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Vertical non-price restraints. The legality of vertical non-price restraints such as exclusive dealing arrangements, exclusive distributorships, customer restrictions and territorial restrictions has long been tested under a flexible "rule of reason" standard. This standard requires an analysis of the actual competitive effects of the restriction in a properly defined product and geographic market. In practice, vertical non-price restraints are rarely found to be unlawful, and then only in circumstances where the seller has "market power". The courts generally hold that a seller which has less than a 30% share of the relevant market does not have market power.

Vertical price restraints. Vertical price restraints (also known as resale price maintenance) were deemed illegal without regard to proof of anti-competitive effects in the particular case for decades. Therefore, a franchisor could not dictate either the maximum price or minimum price at which franchisees resold goods purchased from the franchisor. However, the US Supreme Court changed the rules with respect to maximum prices and minimum prices, respectively, in landmark decisions handed down in 1997 and 2007. Under federal law, vertical price restraints are now tested under the rule of reason, just like vertical non-price restraints. The 2007 Supreme Court decision regarding minimum prices was controversial when announced; in particular, some prominent state enforcement authorities announced that the approach to minimum prices would not change under their state anti-trust laws (see Question 9). However, efforts to restore the rule of per se illegality for minimum resale price restraints under federal law have not gained momentum in Congress.

Minimum purchase targets and restrictions on sources of supply. These may raise exclusive dealing issues or "tying" issues under the anti-trust laws. A tying arrangement is one in which the franchisor conditions the sale of one product (the "tying product", in this context, usually the franchise itself) on the franchisee's agreement to purchase a separate product (the "tied product", for example, inventory or supplies) from the franchisor, its affiliate, or a third party who pays a rebate or commission to the franchisor.

Under general principles of tying law, a tying arrangement will not be deemed unlawful unless the seller possesses sufficient market power in the market for the tying product to enable it to restrain trade appreciably in the market for the tied product. Most franchisors are unlikely to be deemed to possess market power, at least if the requirement to buy the tied product was fully disclosed before the franchisee entered into the relationship, when the franchisee was free to consider any number of alternative investments. However, franchisees have challenged purchasing requirements that allegedly were not fully disclosed before entering into the franchise agreement. These challenges have relied on the controversial theory that the franchisor had "market power" with respect to its own franchisees because they were "locked in" by their investment at the time the purchasing requirement was imposed. A number of courts have rejected this theory on the grounds that the franchisor's power to restrict purchasing derived from the contract itself, not from the franchisor's position in the relevant market.

In addition to the anti-trust laws, certain state franchise relationship laws address purchasing restrictions. A few of these statutes prohibit the franchisor from receiving rebates or commissions from suppliers based on franchisee purchases, unless the franchisor discloses the arrangement to franchisees. This is one of the few instances in which US laws require disclosures to existing franchisees, as opposed to prospective franchisees. The Indiana statute requires the franchisor not only to disclose but also to pass through to the franchisee any rebate or commission received from suppliers based on the franchisee's purchases.

Minimum purchase targets are also relevant to the issue of whether a buyer-seller relationship constitutes a "franchise". In jurisdictions in which the payment of a "franchise fee" is an element of the "franchise" definition, requirements to buy excessive amounts of inventory have sometimes been deemed to satisfy the franchise fee element.

Discrimination. Discrimination among franchisees may raise issues under both the Robinson-Patman Act and state relationship laws. The Robinson-Patman Act prohibits certain forms of price discrimination by a seller between competing buyers, but the Act applies only to the sale of tangible goods. If one franchisee must pay the franchisor a higher price for goods than the franchisor charges to other franchisees with whom the "disfavoured" franchisee competes, the disfavoured franchisee may be able to assert a price discrimination claim, but the jurisdictional requirements are many and proof of a violation is difficult.

The franchise relationship laws of Hawaii, Illinois, Indiana and Washington, and the franchise regulations in Minnesota contain provisions that broadly prohibit discrimination among franchisees. However, all either expressly permit or have been construed to permit differential treatment resulting from franchises granted at different times or based on other distinctions that are "reasonable" or "proper and justified" and "not arbitrary".

Some franchise relationship laws also have a non-discrimination principle built into the standards for termination or non-renewal, for example:

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- The definition of "good cause" for termination in Iowa includes the proviso that "the termination by the franchisor is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances".
- Michigan prohibits refusing to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances.

9. Are there any local provisions relating to the imposition of minimum or maximum prices?

All 50 states and the District of Columbia, Puerto Rico and the US Virgin Islands have their own anti-trust statutes, such as the Cartwright Act in California and the Donnelly Act in New York. Most states, either by statute or by case law, give deference to precedent under the federal anti-trust laws in applying the state antitrust statute. Accordingly, state standards relating to the imposition of maximum and minimum prices generally will be similar to those described in Question 8. However, some state anti-trust authorities vehemently opposed the change in federal law regarding vertical minimum price restraints (see Question 8). Enforcement authorities in New York, California, Illinois and Michigan publicly took the position that minimum price restraints would remain per se illegal under their existing state laws, and the state of Maryland subsequently passed legislation to codify the rule of per se illegality for vertical minimum price restraints under Maryland law.

In practice, however, there have been very few recent lawsuits or government enforcement actions targeting price minimums in franchise systems. One possible reason is that not many franchisors are actually setting minimum prices because of the continued uncertainty at the state level. When franchisors do impose pricing restrictions, they are usually maximum prices. Franchisors wishing to set minimum prices for franchisees in the US must recognise that this practice may still be considered per se illegal in certain states and should seek further guidance on a state-by-state basis.

10. Are there any laws or regulations relating to restrictive covenants or covenants not to compete during the franchise agreement? To what extent is it possible to continue the restrictions after the agreement has expired? In particular, to what extent does the geographical extent and or the length of time of the restriction affect its enforceability?

Covenants not to compete are governed by state law, usually as a matter of the common law of contracts but sometimes as a matter of statute. There is considerable variation among the states (see below). The American Bar Association's Forum on Franchising publishes two excellent resources on this topic, *Covenants Against Competition in Franchise Agreements*, Third Edition (ABA Forum on Franchising 2012) (Michael R. Gray & Tami McKnew, editors) and the *Annual Franchise and Distribution Law Developments* volumes published in connection with the annual meeting of the Forum on Franchising.

In most of the states, the courts have not expressly distinguished between covenants that apply during the existence of the franchise agreement and covenants that apply after its expiration or termination. Where the courts have made a distinction, they have applied more lenient standards toward in-term covenants. Indeed, in-term covenants are often drafted without a geographic restriction, and are nevertheless thought to be generally enforceable.

In practice, most judicial decisions on covenants not to compete involve the enforceability of post-term covenants. The courts in most states will evaluate the reasonableness of a post-term covenant in terms of its duration, geographic scope and activities prohibited. Post-term covenants have generally been deemed to be reasonable where they are limited:

- In terms of duration, to one to two years.
- In terms of geographic scope, to the area of operation of the franchise.

However, post-term covenants are sometimes drafted to prohibit competition with other franchised or company owned locations or in a "buffer" zone outside the franchise's area of operation. Some state courts have been willing to enforce post-term covenants with these broader types of geographic scope, while other state courts have not.

States differ sharply in their approach to restrictive covenants that are found to be too broad and unenforceable as written:

- In a few states, a covenant that is deemed to be too broad will not be enforced at all.
- Other states take a "blue pencil" approach, under which the court determines whether a sensible covenant remains after striking the portion which made the original covenant too broad. If so, the remaining portions of the covenant will be enforced. For example, the court might strike language applying the covenant to other franchised locations, but still enforce language applying it to the area of operation of the franchise.

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- A third group of states will modify an overbroad covenant and enforce it to the extent deemed reasonable by the court. For instance, the court might change the duration from two years to one, or change the protected area from a 20-mile radius to a five-mile radius.

In some states, statutory provisions govern the enforceability of restrictive covenants, for example:

- In Indiana and Iowa, the franchise relationship law imposes limitations on enforcing post-term covenants.
- In California, a statute of general applicability (*Calif. Bus. & Prof. Code §§ 16600 et seq*.) voids any post-term covenant not to compete unless specifically exempted by the statute. The statute contains no exemption for franchise agreements. Thus, a franchisor may not enforce a contract provision that prohibits a terminated California franchisee from continuing in business under another name. However, the California courts have held that a franchisor may nevertheless enforce post-term obligations not to use its confidential know-how and not to solicit persons who were customers of the franchise.

Several other states also have statutes of general applicability, but their application in the franchising context has varied:

- In contrast with California, a Texas statute affirmatively requires the enforcement of covenants not to compete that meet certain reasonableness standards.
- In Georgia, voters in November 2010 approved an amendment to the state constitution that cleared the way for legislation setting standards for enforcing covenants not to compete in certain commercial contracts, including franchise agreements. The legislation effectively overturned a 2009 Georgia Supreme Court decision that had refused to enforce an in-term covenant not to compete in a franchise agreement on the basis that it lacked a geographic restriction. The Georgia statute sets out detailed standards for enforceability and expressly authorises courts to modify non-compete clauses found to be unreasonable as written.

Although the franchise agreement usually designates the law of a particular jurisdiction as the governing law of the contract, the contractual choice of law might not be enforced if it is deemed to be contrary to the "fundamental public policy" of the state in which the covenant is sought to be enforced. Rules on covenants not to compete are often deemed to be matters of "fundamental public policy".

Finally, covenants not to compete can also have federal anti-trust law implications, but because they are vertical non-price restraints judged under the rule of reason, a violation is unlikely. (See Question 8.)

11. Does national law allow the franchisor to retain for its own exclusive use volume rebates, commissions, allowances paid by suppliers of products or services to franchisees?

Rebates or commissions received from suppliers based on franchisee purchases potentially raise multiple issues:

- An anti-trust "tying" issue, if the franchisor requires purchasing from the supplier who pays the rebate (see Question 8).
- An issue of "unlawful brokerage" under the Robinson-Patman Act.
- A pre-sale disclosure issue, because the franchisor must reveal in its FDD certain information about rebates received by the franchisor and its affiliates from suppliers who deal with franchisees.
- A state franchise relationship law issue. As noted in Question 8, a handful of states require disclosure of rebates to existing franchisees in the state, and one requires the franchisor to pass the rebate through to the franchisee whose purchase generated the rebate.

The franchisor can reduce these risks by disclosing fully before the franchisee enters into the relationship that the franchisor receives rebates or other economic benefits from suppliers (or that the franchisor reserves the right to receive them in the future).

Intellectual property

12. How are trade marks protected under national law?

Trade marks are protected in the US under the Federal Trademark Act of 1946, as amended, 15 USC § 1051 et seq. (better known as the Lanham Act). The owner of a trade mark may bring an action for damages and/or an accounting of profits against a party who uses a confusingly similar mark, and attorney fees are available to the prevailing party in "exceptional" cases. Protection is available to registered and unregistered marks, though registration affords significant evidentiary presumptions.

Trade marks also are protected under separate state trade mark laws. Unlike under the Lanham Act, in most states, registration is required to obtain rights. Statutory damages of up to USD100,000 per domain name are available for domain names that infringe trade mark rights (*Anti-Cybersquatting Consumer Protection Act, 15 USC § 1125(d)*).

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13. In the event that the franchisor is based abroad, is it necessary that the franchisee is registered as owner or user of the trade mark in order to be able to import goods bearing the trade mark?

No, not unless a third party with superior rights in the trade mark takes measures to block importation of the goods at the border. If, however, the franchisor has registered its trade mark with US Customs and Border Protection, then that registration should include all parties authorised to apply the mark or import products bearing the mark.

14. What intellectual property rights are typically licensed in a franchise agreement?

A US franchise agreement typically grants the right to use one or more trade marks and service marks of the franchisor. It also typically grants the right to use the franchisor's "system", which is usually defined broadly to include the body of specifications, procedures, marketing techniques and methods of operation constituting the franchisor's know-how, as well as the franchisor's distinctive trade dress and proprietary materials.

15. What provisions are usually made in respect of trade marks in addition to any licensing of their use?

The franchise agreement typically includes the following:

- Agreement by the franchisee not to contest the validity or the franchisor's ownership of the marks.
- An obligation by the franchisee to notify the franchisor of any suspected unauthorised use of the marks by others or of any challenge to the franchisor's rights in them. This provision usually specifies that the franchisor has the exclusive right (but no obligation) to initiate, direct, and control any legal proceeding involving the marks. It also typically requires the franchisee to co-operate in such proceedings.
- An acknowledgment that the franchisee does not gain any ownership interest in the marks and that all goodwill derived from them is solely the franchisor's property.
- An express right of the franchisor to add to, change, discontinue, or substitute for any of the marks and an obligation of the franchisee to adopt the change at its own expense.
- A series of specific restrictions governing the franchisee's use of the marks (use only in the manner authorised, do not use any derivation, do not use as part of a corporate name, use proper trade mark/service mark designations, and so on).

16. Does the franchisee become entitled to any rights in a trade mark (or any other intellectual property right) by virtue of selling the trade marked products in his territory?

No. The franchise agreement typically disclaims the creation of any such rights and states that all rights created by the use belong to the franchisor.

17. What provisions are usually made in respect of goodwill?

A US franchise agreement typically provides that all goodwill from use of the mark inures to the benefit of the franchisor.

18. Can the franchisor impose restrictions on the use of the franchisor's know-how and other confidential information by a franchisee either during or after the expiration of the franchise agreement?

Yes, both during the agreement term and after its expiration or termination. Such restrictions are governed by state law.

19. Are there any competition law implications of licensing intellectual property rights?

The anti-trust rules described in the response to Question 8 generally apply to the licensing of intellectual property rights (an exception is the Robinson-Patman Act, which applies only to "commodities"). In practice, the anti-trust rules may be more difficult to apply in the context of licensing intellectual property rights, particularly with respect to technology licensing. The reason is that many of the anti-trust rules depend on definitions of relevant markets, and such definitions are elusive in the technology context. In addition, a countervailing consideration in the technology context is to avoid allowing the anti-trust laws to stifle innovation.

Real property

20. Are there any restrictions on ownership or leasing of immoveable property which may arise in a franchising situation?

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Franchise agreements in the US sometimes specify that the lease for the franchisee's premises must contain certain provisions, such as:

- An obligation for the landlord to copy the franchisor on any notices of default given to the franchisee under the lease.
- A right for the franchisor to assume the lease upon expiration or termination of the franchise agreement.
- A right for the franchisor to enter the premises for purposes relating to protection of its trade marks.
- A provision restricting use of the premises solely to operation of the franchise.
- A right of the franchisee to remodel the premises without the landlord's approval.

In practice, it may be difficult to get the landlord to agree to such restrictions, and the franchisor may have to waive the requirement.

Employment issues

21. Is there a risk that franchisees may be treated as employees of the franchisor?

Until the last ten years, the risk of franchisees being treated as employees of the franchisor was modest. Federal and state agencies responsible for employment law matters determined in a handful of situations that franchisees were "employees" of the franchisor for purposes of certain labour and benefit laws. These rulings were isolated and limited to situations where the franchisor exercised an unusually high degree of control over the franchisees' activities.

The last decade, however, has seen a broader effort by franchisees, employees of franchisees, and regulators to hold franchisors responsible for employment obligations. The number of private claims has multiplied, and the level of franchisor control deemed necessary to support liability seems to have declined.

The most recent manifestation of this trend is the adoption of a new independent contractor statute in California. The new law took effect on 1 January 2020 and set a broad standard for determining whether a worker is a legitimate contractor or a misclassified employee. The new standard makes it much harder to avoid the "employee" label and the resulting employer liabilities. The new law is generally known as "AB-5", its legislative bill number prior to passage, and it tracks a prior statute in Massachusetts. AB-5 was preceded by an April 2018 California Supreme Court decision adopting the broader standard as a matter of judicial interpretation. It was also preceded by a decision from the federal appellate court covering California, which ruled in May 2019 that the broader standard applied in determining whether franchisees are employees or independent contractors of the franchisor.

AB-5 was not directed at franchising specifically; rather, its target was "gig economy" workers such as persons driving vehicles for companies like Uber and Lyft. These companies are aggressively fighting the new law and seeking a California ballot initiative to reverse its application to them.

AB-5 adopted the so-called "ABC" test for determining whether a worker is an employee. Under the ABC test, a worker is presumed an employee – not an independent contractor – unless the hiring entity can show all of the following:

- The worker is free from control and direction of the hiring entity in the performance of the work, both under the contract and in fact.
- The worker performs work that is outside the usual course of the hiring entity's business.
- The worker is customarily engaged in an independently established trade, occupation or business of the same nature as the work performed for the hiring entity.

Based on the legislative history, it does not appear that AB-5's sponsor intended to transform the owners of independent franchised businesses into employees. Nevertheless, as written, AB-5 makes it extremely difficult for a franchisor to establish that franchisees meet the test of an "independent contractor".

The AB-5 statute contains multiple exceptions for specific types of commercial and professional relationships, but it does not have an exception for franchisor-franchisee relationships. The IFA, franchisors doing business in California and their California franchisees have been working with California legislators to obtain an exception assuring that franchisees will not be considered "employees" under normal circumstances. As AB-5 was not targeted at franchising and because franchising is already separately regulated in California, there is a possibility that legislators may be willing to add an exception.

A related legal issue is whether a franchisor may be treated as the "joint employer" of a franchisee's employees. In a number of private lawsuits, employees of franchisees have sought to hold franchisors responsible for employment obligations as a "joint employer". These efforts have seen mixed results in the courts. For example, in November 2012, a federal court in Missouri conditionally certified a class of all current and former hourly-paid employees working in franchised restaurants in a case brought against the restaurants' franchisor under the Fair Labor Standards Act (FLSA).

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By contrast, in October 2019, a federal appellate court ruled in favour of McDonald's in a wage-and-hour case asserting that McDonald's was the joint employer of its franchisee's employees under California law. The court considered the ABC test, that was soon to be codified in California, but concluded that the new test did not apply in the circumstances. The purpose of the ABC test is to distinguish employees from independent contractors, since neither party was arguing that the franchisee's workers were independent contractors it had no bearing on the McDonald's case.

Unions and some state regulators have supported and paralleled the private efforts to extend joint employer liability to franchisors. Under the Obama administration, federal agencies also joined this effort, led by the National Labor Relations Board, which adopted an expansive legal standard for determining when joint employer liability may be imposed. However, the actions at the federal level have been reversed under the Trump administration. The National Labor Relations Board, for example, has reverted to its prior legal standard for joint employer liability, and the US Department of Labor initiated a rulemaking to define "joint employment" similarly for purposes of the FLSA.

The franchise business community, led by the IFA, has continuously engaged with state and federal policymakers regarding the perceived risks that these employment law developments create for franchisee investment, ownership, and independence. These policy efforts have been met with some success. For example, 18 states have since adopted legislation to clarify that franchisors are not the employer of their franchisees or of their franchisees' employees. However, these state enactments only affect the states in which they were adopted. Efforts continue to encourage similar legislation at the federal level.

Court decisions in this area, even in California, generally still hold that a franchisor's enforcement of system-wide brand standards, standing alone, does not support joint employment liability. Nevertheless, there are steps a franchisor can and should take, both within its franchise agreement and in the company's operations, to reduce its risks of employer and joint employer liability.

The Franchise agreement

22. Are any particular formalities required for a franchise agreement to be enforceable under national law?

There are no required signature formalities for franchise agreements under national law.

However, under state law the franchise agreement may be subject to rescission by the franchisee if the franchisor failed to comply with applicable registration and disclosure requirements in selling the franchise.

23. What rights does the franchisor usually grant to the franchisee?

The franchise agreement typically grants the right to operate the business using the franchisor's marks and system, at a particular location and/or within a particular territory.

24. Is it usual for the franchisor to grant exclusivity? Does this have any competition implications?

Although practice varies by industry, the majority of franchisors provide some degree of territorial exclusivity to franchisees. However, the exclusivity is rarely absolute. Often franchisors provide territorial protection only against outlets of the same type, while reserving the right to certain types of venues or to distribute branded products and services through e-commerce or other channels. In practice, exclusive territories usually do not raise significant competition law issues (see Question 8).

25. What term is commonly agreed for a franchise? Is it common to include a test period?

The typical agreement term depends on the type of business and the initial investment required of the franchisee. An initial term of ten years is probably the most common. It is not common to include a "test period" provision.

26. What rights of renewal are commonly included in the agreement? Is a charge made for renewal?

The franchise agreement typically provides for a limited number of renewal periods, which are often shorter than the initial term of the agreement. Duration varies by industry, but a common approach would be an initial term of ten years and two renewal terms of five years each. It is common to provide for a renewal fee, although in practice the franchisor may choose to reduce or waive the fee. Usually the franchisee must also satisfy a number of other conditions in order to renew, such as:

- Giving advance notice of its desire to renew.
- Not being in default.
- Having a good record of customer service.
- Refurbishing its premises.

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- Entering into the franchisor's then-current form of franchise agreement.
- Signing a release of claims against the franchisor.

If the franchisee is entitled to the protection of a state relationship law, the law may override the contract terms and limit the franchisor's ability to refuse renewal (see Question 5).

27. Does national law impose any obligations on the franchisor?

In general, federal law does not impose obligations on franchisors solely by virtue of their status as franchisors. However, the Petroleum Marketing Practices Act and the Automobile Dealers Day in Court Act do impose obligations on gasoline refiners and automobile manufacturers, respectively. At the state level, franchise relationship laws impose certain limitations on the conduct of franchisors with respect to their franchise relationships.

Franchisors may, of course, be subject to any number of federal and state laws based on their line of business or their status as employers, manufacturers and so on.

28. What events will be regarded in law as justifying termination of the franchise agreement? Do any statutory obligations arise on termination? What provision is usually made in the agreement for termination?

In general, parties to a franchise agreement may specify the grounds and procedures for termination, and the contract provisions will be enforced unless deemed by a court to be unconscionable or contrary to public policy. However, the franchise "relationship" laws described above may supersede the parties' own provisions. The relationship statutes typically require "good cause" for termination, as well as notice of default and an opportunity to cure. Some statutes specify circumstances (such as voluntary abandonment of the franchise, conviction of a crime, or repeated defaults) in which notice and opportunity to cure are not necessary.

No two statutory formulations are exactly alike, so the specific statute must always be consulted. Most of them, however, provide that good cause includes failure by the franchisee to comply with any lawful (and in some cases, "material" or "reasonable") requirement of the franchise agreement. Thus, most of the statutes define good cause in a non-exhaustive manner, leaving room to argue that good cause exists even in circumstances where the facts do not match any of the examples of good cause in the statute. The Nebraska and New Jersey laws, however, specify that good cause is "limited to" breaches by the franchisee; by contrast, the Iowa law permits termination for any "legitimate business reason".

If no relationship statute applies, the terms of the franchise agreement will govern. Franchise agreements typically provide for:

- Immediate or even "automatic" termination in cases of the franchisee's bankruptcy or insolvency. However, under the US Bankruptcy Code, the franchisor must deliver notice of termination before the franchisee files a bankruptcy petition. Once a petition has been filed, the automatic stay provision of the Bankruptcy Code operates to prevent the franchisor from terminating. Moreover, even if the franchisee receives notice of termination before filing the petition, the franchise agreement will still be drawn into the bankruptcy estate if the franchisee is entitled to a cure period that extends beyond the filing date of the petition.
- Termination by written notice, without opportunity to cure, in egregious circumstances, such as:
  - failing training;
  - failing to get the business open;
  - abandonment of the business;
  - conviction of a crime;
  - unauthorised transfer of ownership;
  - refusing to allow inspections or audits;
  - submitting false information to the franchisor;
  - disclosing the franchisor's confidential information;
  - creating hazards to public safety;
  - losing possession of the business premises; or
  - committing repeated defaults.
- Termination following expiration of a cure period, for routine defaults.

If the relationship is subject to Article 2 of the UCC (see Question 6), the UCC will not disturb the agreement made by the parties, even if their provisions produce a different result than would application of the UCC. However, if the parties have not specified their own conditions, UCC rules (or common law rules, if the UCC does not apply) will affect termination.

29. What rights does the franchisee have to compensation on termination of the franchising agreement? How is compensation for termination calculated?

The franchisee generally has no right to compensation if the termination is in accordance with the franchise agreement and any applicable statutes, however:

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- The Connecticut, Hawaii, Washington and Wisconsin relationship statutes require repurchase of inventory in all cases of termination.
- Hawaii, Michigan, and Washington require repurchase in all cases of non-renewal.
- Illinois and Iowa condition enforcement of a post-termination covenant not to compete on fulfilment of certain repurchase obligations.

International taxation

30. What is the tax treatment of the initial fee paid by the franchisee?

US income taxation is a very complicated subject involving federal, state, and local taxing authorities. The responses to Question 30 *to 42* are limited to US federal income taxation of franchise revenue. Foreign franchisors wishing to do business in the US should consult professional tax advisers; in practice, franchisors usually obtain such advice from their accounting firms. For an overview of the subject, see C. Feldman & B. Olivas, "Tax Considerations Related to Cross-Border Franchise Transactions", which appears as Chapter 3 of *Fundamentals of International Franchising, Second Edition*, a book published by the ABA Forum on Franchising (Will K. Woods, editor). The information below draws on this chapter.

In addition, the responses to Question 30 *to 42*are based on the current US tax law in effect as of 31 July 2020. As of this update, there are pending proposals for US tax reform that may affect US tax considerations for foreign franchisors. Foreign franchisors wishing to do business in the US should consult their professional advisors to determine whether any changes in US tax law are relevant to their plans.

Foreign franchisors might enter the US market either by forming a US subsidiary to serve as a base of operations in the US or by entering into a franchise agreement directly with an unrelated US party. Unless otherwise stated, the responses to Question 30 to 42 assume that a foreign franchisor has entered into a franchise agreement directly with an unrelated US party. Direct payment of royalties to the foreign franchisor can have tax advantages for the franchisor; however, other considerations may argue for the formation of a US subsidiary through which to franchise in the US (see Question 2).

As a general rule, US source income will be subject to US tax and foreign source income will not be subject to US tax (see Question 33 for when foreign source income may be subject to US tax). Therefore, in order to determine if income derived by a foreign franchisor is subject to US tax, the franchisor must determine if the income is US or foreign source income for US tax purposes.

There are different sourcing rules for different types of income under US tax law. For example, the general rules are that:

- Royalty income is sourced to where the property is used.
- Capital gains are generally sourced to the residence of the seller.
- Sales income is generally sourced where legal title passes.
- Income from personal services is sourced to the place where those services are performed.

US tax law contains direct sourcing rules only for specific types of income such as those mentioned above. Other transactions, for which there are no direct sourcing rules, are sourced by reference to the traditional types of income with direct sourcing rules.

Franchise income is not a type of income under the sourcing rules. Therefore, it is necessary to determine how to characterise franchise income by examining the franchise arrangement and considering the surrounding facts and circumstances.

Generally, for US federal income tax purposes, franchise income received by the franchisor (including the initial franchise fee) is treated as payment for the right to use the franchisor's intangible property, payment for the transfer of intangible or tangible property, payment for providing personal services, or some combination thereof. The portion of the franchise fee that relates to:

- Use of intangible property (trade name, trademarks, know how) generally will be treated as a royalty. Royalties will be US sourced and subject to US taxation to the extent they are attributable to the use of the intangible property within the US.
- Payments for the transfer of intangible property from the franchisor will be treated as capital gains. These payments will be treated as foreign source and generally not subject to US tax for a foreign franchisor. Note that intangibles will be treated as sold or transferred only if "substantially all rights" to the intangible asset are transferred for the entire legal duration of the property and the payment is not contingent on productivity, use, or disposition of the intangible. If less than "substantially all rights" are transferred or if the payment is contingent, the payment may be treated as a royalty.
- Payments for the transfer of tangible property from the franchisor will be treated as sales income if the tangible property is considered inventory property. These payments will be treated as foreign source

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if the sale occurs outside the US and are generally not subject to US tax for a foreign franchisor. If the tangible property is non-inventory property, the transfer will be treated as capital gains. These payments will be treated as foreign source and are generally not subject to US tax for a foreign franchisor.

- Payments for personal services performed will be sourced to where those services are performed. Services such as management and back office support performed in the foreign franchisor's country are not US sourced and generally not subject to US taxation.

There are two distinct ways that income may be taxed to a foreign franchisor:

- As effectively connected income (ECI). ECI is the income attributable to a trade or business in the US. For more information on carrying on a trade or business in the US and ECI, see Question 33.
- As fixed or determinable annual or periodic income (FDAP). FDAP income includes but is not limited to interest, dividends, rents, royalties, and annuities. Income that is US-sourced but is not ECI is treated as FDAP income.

FDAP income is subject to default 30% US tax withholding. The payor of FDAP income (the franchisee) is considered a withholding agent and is personally liable for any tax required to be withheld. If the franchisee as withholding agent and the foreign payee (the franchisor) fail to satisfy its US tax liability, then both the franchisee and franchisor are liable for tax, as well as interest and any applicable penalties. The withholding rate on FDAP income applicable to foreign franchisors including royalties, dividends, and interest may be reduced by income tax treaties. There are also carve outs for interest (see Question 39).

31. How will management and other continuing fees from the franchisee to the franchisor be treated in the franchisee's hands and, in particular, are there any tax deductions which have to be made?

From the franchisee's perspective, generally 100% of management fees and other continuing fees paid to the franchisor are deductible business expenses for purposes of computing the franchisee's US federal income tax. This is the case whether the payments are treated as US or foreign source income to the franchisor and whether they are treated as ECI or FDAP income for the franchisor.

The franchisee will be required to withhold and report US sourced FDAP payments made to a foreign franchisor. Reporting is done on Forms 1042 and 1042-S. See Question 30 for more information.

32. What is the tax treatment of intellectual property royalties paid by the franchisee?

Royalties for use of intangible property within the US will be treated as US sourced income. Assuming the franchisor is not engaged in a US trade or business, the royalties will be treated as FDAP income and subject to a 30% rate of withholding. See Question 30, Question 31, and Question 33 for more information.

33. Will a foreign franchisor who appoints a franchisee directly in your national territory be regarded as carrying on business in the national jurisdiction and therefore subject to the national tax regime?

The US tax treatment of a foreign franchisor will depend on whether or not the franchisor is deemed to be "engaged in a trade or business" in the US.

Being "engaged in a trade or business" is not defined in the US Internal Revenue Code (IRC) or the Treasury Regulations. The IRC does specify that a trade or business within the US includes the performance of personal services within the US at any time during the year. Thus, there is a very low threshold where personal services are performed.

Franchisors can rely on fact-specific Revenue Rulings by the US Internal Revenue Service and on case law to get a better idea of when a US trade or business exists in other circumstances. These rulings and decisions have not specifically addressed whether a franchise relationship with an independent party in the US by itself constitutes a US trade or business. In general, the decisions establish that activity in the US must be "considerable, continuous, and regular" to constitute a US trade or business. While a single transaction or passive collection of income is not likely to meet this test, case law suggests that the threshold for what constitutes conducting business in the US is fairly low.

For example, in *InverWorld v Commissioner, T.C. Memo 1996-301 (1997)*, the US Tax Court undertook a detailed analysis in concluding that a foreign company was conducting a US trade or business through the activities of its US subsidiary. Taking a closer look at the case:

- InverWorld Ltd (FC) was a Cayman Islands company that owned 100% of InverWorld Inc (DC), a Delaware corporation.
- DC acted exclusively on behalf of FC and its clients. DC maintained FC's client account files in its Texas office; purchased, sold and redeemed financial instruments in the names of clients or in FC's name on a regular basis; provided FC with investment advice;

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and maintained the books and ledgers for such transactions on behalf of FC.

- The agreement between FC and DC specified that DC "shall for all purposes be an independent contractor and not an agent or employee of FC, and DC shall have no authority to act for, represent, bind or obligate FC, any of its affiliates or any account managed or advised by FC".
- The court disregarded this disclaimer and instead focused on how DC and FC actually conducted business. The finding was that DC was a dependent agent that regularly executed contracts on behalf of FC. FC was therefore found to be engaged in a US trade or business.
- The court also concluded that FC required a fixed place of business and that its place of business was DC's office in the US, the Texas office's address was used on financial documents, on FC's return, and client files were maintained there.

US income tax treaties, where applicable, may raise the threshold of when a foreign company is subject to US tax on business income. Income tax treaties include permanent establishment provisions. Those provisions generally specify that a foreign person is not engaged in a US trade or business unless it has a fixed place of business in the US or there is a dependent agent that regularly concludes contracts on its behalf within the US. Note that each US income tax treaty is different and qualification for treaty benefits should be reviewed based on the franchisor's facts and circumstances.

Being "engaged in a US trade or business" is determined for each taxable year. A foreign person is engaged in a US trade or business if the person is so engaged at any time during the taxable year.

If a foreign franchisor is deemed to be engaged in a trade or business in the US, the following rules apply:

- The franchisor will be taxed on its income "effectively connected" with the US trade or business in the same manner as if it were a US corporation. "Effectively connected income" is defined in the tax code. Generally, all US source income of the foreign franchisor (as determined by US tax laws) is considered to be effectively connected with the US trade or business and is subject to US income tax under the progressive US tax rate structure. This may include income that would otherwise be FDAP income. If a US tax return is filed in a timely manner, the foreign franchisor is entitled to offset its gross income by effectively connected deductions.
- Some of the foreign franchisor's foreign source income might also be considered effectively connected to the US trade or business and subject to US income tax. This may be the case if the foreign income was attributable to an office or fixed place of business in the US. Foreign source income that is not effectively connected to the US trade or business is not subject to taxation in the US.
- A foreign franchisor may also be subject to the US branch profits tax on US effectively connected earnings and profits that are not reinvested in the US business. The branch profits tax is a dividend equivalent tax which subjects after tax effectively connected earnings and profits to an additional 30% tax. The branch profits tax can be reduced or eliminated under income tax treaties (see Question 41).
- US source FDAP income that is not effectively connected to the US trade or business, will still be subject to the withholding tax discussed in Question 30.

If the foreign franchisor is deemed not to be engaged in a trade or business in the US, the following rules apply:

- The foreign franchisor is only taxable on its US source income.
- US source FDAP income (such as royalty payments) will be subject to the withholding tax discussed in Question 30.

34. Is it possible to make use of tax haven companies in international franchising?

A foreign franchisor may use a subsidiary company in a low or no tax jurisdiction to enter the US market. Traditional tax haven countries do not have income tax treaties with the US; therefore, treaty benefits that may otherwise be available would be lost. Treaty benefits that may be lost include permanent establishment protection and reduced rates on FDAP withholding and the branch profits tax.

It might also be possible to reduce the withholding rate on payments from US franchisees to a non-US franchisor by routing them through an offshore company organised in a jurisdiction that has a more favorable tax treaty with the US than the tax treaty with the franchisor's home country. However, most US tax treaties limit the ability to do this through so-called "treaty shopping" provisions in the treaty. In many US treaties, treaty benefits are not available if third-country taxpayers hold more than 50% of a corporation's stock (unless the entity is publicly held).

Additionally, many treaties deny treaty benefits if a company's income is used in substantial part to meet obligations owed to non-residents. This prevents the scenario in which incorporation takes place in the treaty jurisdiction and residents of the treaty jurisdiction own the company but the capitalisation of the new corporation comes substantially from loans from non-residents of the treaty jurisdiction.

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35. Is there a withholding obligation on dividends paid to foreign companies/individuals?

Yes. If a foreign franchisor has decided to use a US subsidiary, dividends from the US subsidiary to the foreign parent company fall within the category of FDAP income.

As FDAP income, US source dividends are subject to a default 30% withholding rate. This withholding rate may be reduced by US income tax treaties.

36. Are there any other differences in the tax treatment of dividends paid to foreign companies/individuals as opposed to domestic shareholders?

No differences exist other than the withholding tax on FDAP income for dividends paid to foreign shareholders discussed in Question 30 and Question 35.

37. Are there circumstances in which the (undistributed) profits of a foreign subsidiary can be taxed in the hands of a parent company which is tax resident in your jurisdiction (controlled foreign company legislation)?

If a US corporation owns a "controlled foreign corporation", the US parent must include in its gross income its pro rata share of the subsidiary corporation's "Subpart F" income (Subpart F is a specific subpart of the Internal Revenue Code). The Subpart F income is taxable to the US parent as a deemed dividend whether or not the foreign subsidiary made any actual dividend payments to its US parent. Subpart F covers multiple types of income including passive types of income that are more passive in nature including interest, dividends, rent, royalties, and sales of property that produce such income among others.

For years starting after 2017 a US person that owns a controlled foreign corporation must also include their share of global intangible low taxed income (GILTI). At a high level, GILTI is any income earned in a controlled foreign corporation that is not Subpart F income and that is above a 10% return on depreciable fixed assets.

Additionally, under transfer pricing regulations, the sale of goods and services between a parent and subsidiary, if deemed not to be on arm's-length terms, could create profits in the subsidiary that will be attributed to the parent for tax purposes.

38. Does national law permit a franchisor to make loans to a franchisee? Does national law dictate any terms of such a loan, for example, rate of interest? Does national law/regulation impose any debt/equity restrictions?

Yes, a franchisor may make loans to a franchisee. US tax law requires that the rate of interest charged on the loan must be an arm's length rate of interest at the time the indebtedness arose, in other words, a rate that would have been charged in independent transactions between unrelated parties under similar circumstances. The loan is also subject to state usury laws that rarely come into play. Otherwise, the rate of interest is a matter of private negotiation, as are any debt/equity restrictions.

39. Is there a withholding obligation on interest paid to foreign companies/individuals?

Yes. Interest is within the category of FDAP income (see Question 30) and is therefore subject to the default 30% withholding tax. The withholding tax may be reduced by US income tax treaties.

There are also exceptions within US tax law for bank deposit and portfolio interest which are not subject to US withholding tax. Generally, interest income that is not received from a related party and that is paid based on fixed rates may qualify as portfolio interest if structured properly.

Note that if the foreign franchisor is engaged in a US trade or business (see Question 33), then interest income may be treated as ECI instead of FDAP.

40. Are there any restrictions on the capital structure of a company incorporated in your country with a foreign parent (thin capitalisation rules)?

A corporation capitalised with too much debt may risk that part or all of its debt will be treated as equity for tax purposes. Whether there is too much debt and whether debt will be treated as equity is a very complicated issue for which the franchisor should seek advice of US tax counsel. In addition, under the state franchise laws, if the US subsidiary is financially weak, state franchise administrators may impose a requirement to escrow franchise fees or otherwise assure financial capability as a condition of registering the subsidiary's franchise offering.

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41. How does national law define a "branch"? How are its profits taxes?

The term "branch" is not defined by US tax law. However, a "branch profits tax" is imposed on a foreign corporation's "effectively connected earnings and profits".

Income of a US corporation is subject to two levels of taxation (once at the corporate level when the corporation earns the income, and once at the shareholder level when the corporate dividends are included in the shareholders' income).

Before implementation of the branch profits tax, foreign companies attempted to avoid the second level of tax by opening a branch office in the US without forming a US entity. In order to minimize the tax differences between establishing a US subsidiary or operating through a branch office, the US created the branch profits tax, which adds a second level of taxation to branch profits. The income of a foreign corporation that is effectively connected with conducting business in the US is subject to normal US tax at progressive rates. A second branch profits tax at a flat rate of 30% is imposed on the same income (reduced by the first level of tax) when the income is repatriated from the US to the foreign home office (or deemed to be repatriated because it is not reinvested in the US business). Thus, if a branch continually reinvests its income to help expand the US business, it will not be subject to the branch profits tax until it actually repatriates some of the US income. Tax treaties may also reduce the effect of the branch profits tax.

42. Are there any special tax considerations when a joint venture is used as a franchise vehicle?

The joint venture parties must determine whether they wish the joint venture entity to have flow-through tax treatment. If they wish to have flow-through tax treatment, the parties must use a business form (limited liability company, limited partnership, or "Subchapter S" corporation) that is eligible for such treatment, in which the entity's income is not taxed at the entity level but only at the level of the owners of the entity.

Also, a flow-through entity structure may provide tax advantages by giving the franchisor additional choices as to the form in which it will receive income (for example, as dividends rather than royalties).

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