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Key Issues, Decision Points For International Expansion

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By Kenneth Levinson, Little Caesar Enterprises, Inc; Lee Plave, Plave Koch PLC; Donald Wray, Starbucks Coffee Co.; and Michael Fink, Faegre Baker Daniels;

Kenneth Levinson Lee Plave Donald Wray Michael Fink

Editor's Note: The Forum's International Division held a panel discussion on international expansion at the annual meeting in Seattle last October, featuring Donald Wray, of Little Caesar Enterprises, Inc.; Michael Fink, of Starbucks Coffee Co.; and Kenneth Levinson, of Faegre Baker Daniels. Program moderator Lee Plave, of Plave Koch PLC, conducted a follow-up interview with the panelists concerning key issues and decision points. The text of that interview is excerpted below. Thanks to Meg Loveless of Plave Koch PLC, who played an invaluable role in preparing the notes of the panelists' interview.

Plave: The threshold question for many franchisors is whether to establish a separate entity for international expansion or simply use the domestic franchisor. What issues does that present?

Levinson: A franchisor expanding internationally through a U.S.-based, wholly-owned entity would generally face the same type of risks and issues as franchising directly. However, using a U.S.-based specially established subfranchisor entity (a special purpose vehicle, or "SPV") interposes additional limited liability protections for the "parent" U.S. franchisor. The franchisor could use this SPV as its structural "international subfranchisor" entity going forward, thus simplifying its life substantially by consolidating international expertise, personnel,

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licensing/franchising documentation, even IP/trademark rights, and other administrative and systemic programs and policies into a single entity. The franchisor should ensure that the SPV is part of the "consolidated" U.S. tax return with its parent entity or otherwise as a flow-through entity (such as an LLC) for overall U.S. tax efficiency.

Plave: If the franchisor opts for a separate international franchising entity, should that entity be domestic (U.S.) or international? What financial and corporate considerations stem from whether the franchisor establishes a separate entity or expands from the domestic entity?

Levinson: A franchisor could consider expanding internationally through a wholly-owned foreign subsidiary as its subfranchisor. In this case, the local (foreign) subfranchisor entity would be required to meet any regulatory requirements and make all other locally-required disclosures, recordings, and filings. It would insulate the "parent" U.S. franchisor from legal liability locally, although in some countries it may be necessary for the disclosure document to use the financials or other business history of the U.S. "parent" anyway.

Two key differences with this structure are worth noting. First, the local subfranchisor entity would constitute a controlled foreign corporation ("CFC") for U.S. tax purposes, meaning that the U.S. parent franchisor will have to report the fact that it owns that CFC and confront various U.S. tax rules on whether the types of income earned by that CFC are subject to "deemed taxation" in the U.S. to that parent entity. Further, there would likely be foreign bank account reporting ("FBARs," now filed electronically in the U.S. on FinCEN 114), and other required forms, by both the U.S. parent entity and various officers and directors of that entity.

The second key difference is that the relationship between the U.S. parent and the CFC will be subject to transfer pricing scrutiny, potentially by both the IRS and local-country tax authorities. Because these entities would be related, they would be expected to deal with each other at arm's length. Hence, any intercompany transactions or documents would need to adhere to transfer pricing guidelines and may require contemporaneous documentation to be made available at the time of filing or disclosed on tax returns.

Plave: Where should the franchisor expand? Selecting a base country involves more than tossing a dart at a map! What political considerations and legal issues may the franchisor face?

Wray: Geographic preferences are usually driven by business considerations and the anticipated operational synergies offered by a particular country or region. But it's important to remember that what makes sense to the business team may be flatly prohibited under U.S. or other law. For example, the U.S. Treasury Office of Foreign Assets Control ("OFAC") sanctions lists – the list of

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specially designated nationals ("SDNs") – may prohibit doing business in the target country or with certain individuals. The risk is particularly acute in perceived hot markets where U.S. government restrictions may recently have been relaxed (such as Myanmar). Foreign Corrupt Practices Act ("FCPA") risks are particularly thorny where local partners are likely to be state-owned enterprises or have government affiliation, as is often the case in China. Recent U.S. Justice Department investigations indicate that even U.S. companies' recruiting of local talent may present FCPA risks. And of course local anti-corruption laws must be taken into account.

The franchisor also may need to consider whether export controls or U.S. anti-boycott laws might obstruct entry into the target country, limit key actions (such as trademark registration), or otherwise compromise the financial and operational model. In short, considering the possible extra-territorial impact of U.S. law as it may apply to the franchisor's business should be an important first step in any analysis of a potential base country.

Franchisors also are wise to conduct a sober, high-level assessment of the geopolitics of the target country or region. Despite the commercial peace of mind that may be afforded by a free trade agreement or tax treaty, local or regional political instability can quickly disrupt the franchisor's operations in unanticipated ways. For example, while the Middle East continues to be fertile commercial ground for U.S. franchise systems, the Arab Spring turmoil prompted many regional governments to tighten visa and immigration restrictions, severely limiting the mobility of expat employees.

In other parts of the world, a particular country's affinity for U.S. brands may be threatened by the local government itself if the government has a history of using heightened regulatory scrutiny as an instrument of foreign (and domestic) policy. Consultation with the U.S. Embassy and U.S. Commercial Service in a particular country is often a good starting point for assessing such risks.

Of course, many legal and cultural considerations at the local level may argue for locating in one country over another. The brand identity for any franchise system is embodied in its trademarks, and it is vital to know whether a franchisor's trademarks are likely to qualify for registration in a particular country. (In some countries, many well-known U.S. marks are considered too generic or descriptive to be eligible for registration.) It also is essential to know whether a particular trademark (or transliteration, as in China) has negative connotations in the country or is being infringed by a prominent and politically-connected local operator.

It will be important to know whether the target country's legal system will reliably, transparently, and promptly enforce contracts and facilitate the pursuit and enforcement of legal remedies that U.S. companies may take for granted. Key components of this analysis are surveying all treaties to which the local country is a signatory and consulting with experienced local counsel.

Plave: What are some of the issues to consider in establishing company-owned units in the local target market?

Levinson: Sometimes the franchisor must decide whether it should open its own stores first in the country to establish, for example, brand awareness and proof of concept. Key points to consider regarding this strategy include the following:

• There may be franchise disclosure and registration issues if the intention is to sell franchises over time.

• The franchisor cannot escape liability with respect to local operations or employees by directly operating businesses in the local country, even if it uses a U.S. SPV.

• From a tax perspective, a franchisor operating local stores will be deemed doing business in that country, under either local law or the standard tax treaty provisions relating to having a permanent establishment ("PE"). This would result in a local tax nexus and corporate tax reporting and tax payment requirements for the franchisor.

• The franchisor would be directly subject to compliance with local labor and employment laws and employer/employee wage and social welfare withholding.

• Local activities may expose the franchisor to double taxation, at the local country level and in the U.S. This triggers a separate tax issue: planning for and using U.S. foreign tax credits.

A different international expansion pattern, seen often in the more populous foreign locations, involves franchisors proceeding with multiple franchisees in a country or territory. But these multiple-franchisee structures create additional stresses, paperwork, and administrative complexities for the franchisor. For example, multiple-franchisees structures entail multiple franchise fee collection and accounting requirements. Franchisors also must work with each franchisee on filing required tax-treaty forms, so that each franchisee's separate fee payments are qualified for the tax treaty's reduced withholding tax rates. Then there are multiple administrative efforts to secure separate tax and foreign exchange clearances so that each franchisee may actually remit fee payments from the foreign country.

These multi-franchisee structures also require more management, training, and servicing by the franchisor. The needs of separate franchisees and the activities of the franchisor's employees locally can, in turn, increase tax risks to the franchisor itself. Tax treaties and local laws may provide that the frequent or elapsed presence in-country of a franchisor's employees or agents may generate a finding that the franchisor is "doing business" or having a PE locally. That may trigger direct corporate tax liability for the franchisor, as well as risks of personal taxation to the franchisor's employees dispatched to that country.

Plave: What are the key issues and decision points to consider when establishing operations in the base country? Are there wage and employment requirements?

Fink: Depending on the type of business operations and the products and services provided, the franchisor may want to consider entering into intercompany services agreements. If the scope of services to be provided in-country will require leveraging resources and support from a related or affiliated company, and if that company will be compensated for the services provided, the details must be spelled out in order to address and support transfer pricing challenges.

The franchisor must conduct a thorough due diligence analysis of the country's local employment and wage and hour regulations before entering the market. Almost every other country lacks the familiar U.S. concept of at-will employment. Many jurisdictions have laws and regulations that make it difficult, costly, and time consuming to terminate employees. Many countries have legal formulae for compensating terminated employees – often based on tenure and/or age. Almost all of the franchisor's employment manuals and policies will need to be rewritten and tailored to local laws, regulations, and customs.

Some countries, such as Australia, have strict and costly overtime rules that can seriously affect the profitability of a franchisor's typical business model. If a franchisor plans to have key employees sign non-competes, it must be aware that in many countries these covenants are not enforceable, and in others they are enforceable only if the employee is paid additional compensation. If the franchisor plans to transfer employees into the market, it must analyze the country's immigration policies and rules, which are flexible in some countries and restrictive in others.

Many countries (particularly in continental Europe) mandate "works councils" when a company has a certain number of employees. Understanding whether a works council should be national, regional, or local and understanding which workplace issues require approval by the works council are important, because those questions may have a significant impact on operations. Also, in some markets, unions are required, while in others, companies must negotiate with specified unions, and in still others, companies must join a particular industry group that negotiates with a union on behalf of everyone in that industry. It is critical to understand the landscape before entering a market.

The FCPA risks of operating in a country through a wholly-owned subsidiary are much greater than when operating through a licensee or franchisee (or even a non-controlled joint venture).

Countries that pose particular risk include the “BRIC” markets – Brazil, Russia, India, and China. Areas of particular heightened concern include businesses that sell products to the government, that must procure many permits and licenses from government agencies, or that import or export products through customs.

Plave: Are there special cross-border considerations?

Fink: The franchisor should analyze the target country’s customs and duties as part of its due diligence. Some countries impose tight restrictions and high tariffs on imports. This can have a significant impact on the cost of goods and the profitability of the franchisor and its franchisees alike. The franchisor should research the availability of local suppliers as an alternative source of key products – both from a cost perspective and as a back-up source of supply in case key products cannot get cleared through customs.

Plave: What do you consider when it comes to the financial aspects of choosing a “base country”? Is the local currency stable? Are there any issues with regard to exchange or repatriation of funds? Are there banking or accounting standards that should be considered? What about geopolitical issues that are inevitably a part of international operations?

Wray: These are among the most critical elements of any target country analysis. Much will depend on what organizational model the U.S. franchisor chooses and whether the franchisor’s goals favor deferral and deployment of funds and capital offshore or, alternatively, swift repatriation of funds to the U.S. Also relevant are the franchisor’s level of sophistication and its tolerance for foreign currency exchange risk.

A good starting point is a straightforward examination of how difficult it is to repatriate funds from the target country. Although the number of countries with oppressive exchange controls has decreased in recent years, certain bureaucratic requirements and obstacles (such as central bank filings and tax certificates and caps on remittances) remain in all corners of the globe. Some U.S. franchisors may find such requirements incompatible with their business model. Another consideration is whether differences in accounting standards between the U.S. and the target country will necessitate adjustments to the franchisor’s business model or increase its administrative expenses and professional fees.

The geopolitical assessment of the target country should consider the effect of political instability and economic volatility on exchange rates, capital markets, and the likelihood of adverse government intervention. If swings in the exchange rate beyond a certain point would have an unacceptable impact on operations and earnings, the franchisor obviously may want to consider alternative locations. Similarly, the prospect of a government lockdown on remittances (as occurred recently in Venezuela) should be taken into consideration when the target country has a history of such instability. Careful drafting of relevant agreements with local partners (to include, for example, a termination provision in the event of adverse government intervention) can help mitigate such risks.

Plave: Are there other tax or foreign exchange considerations that must be taken into account?

Levinson: Repatriation of funds to the franchisor is a key issue. And, it extends not only to the question of whether and how the funds get remitted, but also when. Many foreign countries have some form of pre-approval or foreign exchange conversion requirements in order to remit funds. In some countries, such as China, there is a two-step process: a required tax clearance (to ensure proper accounting and withholding tax payments) and a separately required foreign exchange conversion and remittance approval (to control the amount of hard currency being remitted and the conversion at what may be a government-controlled exchange rate). The franchisor must consider whether it, or the local franchisee, will have the obligation (and cost responsibility) of securing all such required approvals. Further, the franchisor must consider how the local country’s required processes may affect the conventional provisions in franchise agreements relating to timeliness of payments and late fees or penalties.

Plave: What other considerations affect the franchisor’s choice of a vehicle for international expansion?

Fink: The final considerations for a franchisor’s international expansion should be concurrent review of: the franchisor’s culture and the nature of its product or service; the ability to commit resources and make capital investments; and the characteristics of the target country. If the franchisor’s concept is resource-intensive, it will face serious challenges expanding into a country where those resources are not available and tight import restrictions exist. If the franchisor’s core product or service is repugnant to a target country’s cultural or religious beliefs, the franchisor might need to throw the dart at the map again.

If the franchisor’s system favors franchisor control over operations, such as supply chain/distribution, training, and advertising, it may face issues with the PE status (and resulting tax liabilities), visa and work permits, and vicarious liability-type issues that may arise as franchisors become more and more involved in franchisee operations. A “turn-key” franchise concept would be ideal, but successful international franchising might require intensive training and close monitoring of local operations. In that case, the franchisor should consider the target market’s geographic proximity, as well as the franchisor’s ability to commit sufficient resources to the concept.

Regarding financial resources, a franchisor must first research whether local commercial considerations disfavor, impede, or flatly prevent direct investment, and whether local parties enjoy preferential treatment. And, because showing a profit from international expansion may take longer than a franchisor's shareholders are willing to wait, the return-on-investment timeframe must be clearly understood and spelled out from the start. The more complex the franchising relationship – whether the company will have one master franchisee/area developer in a target country, or several operators covering several countries – will all depend on how much capital and time the franchisor can commit to fully research the expansion opportunity and implications, but also to administer the system once there.

Finally, although everyone hopes the international franchising expansion will be successful and long-lived, the franchisor should consider and prepare an exit strategy.

Editor's Note: As this issue went to press, the White House announced that the United States will take steps toward normalizing relations with Cuba. How will this affect U.S. franchisors' plans for international expansion?

Plave: There will be significant challenges, both legally and commercially. Beyond assessing the market for U.S. franchise concepts in a country where we have neither conducted regular trade nor had commercial influence for more than half a century, franchisors must consider nuts-and-bolts questions of how to comply with laws and regulations under a markedly different form of government and legal system, as well as how to determine the tax implications of doing business in Cuba.

President Obama's announcement heralds a significant change in diplomacy, but the White House is limited in what it can do under current law. The Administration may revisit past Executive Orders and examine the possibilities for changing regulations such as the 1963-vintage Cuban Asset Control Regulations and the OFAC regulations. But it is up to Congress to reconsider the statutes that impact U.S.-Cuban relations, such as the Helms-Burton "Libertad" Act of 1996, the Cuban Democracy Act of 1992, the Trade Sanctions Reform and Export Enhancement Act of 2000, and the Trading with the Enemy Act of 1917. Congressional action will likely take time, given the significant political implications involved.

It remains to be seen how law and policy in the U.S. and Cuba will change over the short- and long-term, whether the grant of licenses for the use of trademarks and know how (at the core of franchising) will be permitted, and which U.S. franchisors will find there is a viable market for their concepts in Cuba.

Levinson: From a tax perspective, normalization of relations with Cuba, including expanded opportunities for trade, services, licensing, and franchising, will result in more revenue opportunities for each country, and hence, more taxes. There is no current tax treaty between the United States and Cuba, but in time, one would expect that to be considered. Until then, the rules on taxation will be strictly subject to local law.

In general, Cuba will impose tax on income earned from Cuban sources by businesses and individuals. For example, parties who sell goods and services in Cuba are subject to a monthly 10% income tax, and there are no special tax benefits for capital gains, which are subject to regular tax rates. U.S citizens who travel to Cuba (such as trainers or management personnel sent by franchisors) will be subject to Cuban income tax personally if they are present for 180 days in-country during the tax year, regardless of their "tax residency" status. And their days in Cuba do not count for purposes of the U.S. "foreign earned income exclusion" rules.

The normalization process for U.S. relations will undoubtedly have a far-reaching effect on Cuban law, society, and commerce, including the evolution of its rules concerning franchising and taxes.