Franchising business model in intra-group services

In the fourth in a series of 10 articles on tax-effective intellectual property management, Emmanuel Llinares and Stuart Harshbarger of NERA explain how franchising offers a pragmatic solution for intra-group services.

Franchising is a commonly used business model for many companies. While franchising is naturally associated with retail and consumer oriented industries, the format can be applied to a wide range of situations and may take different forms. This article considers how the franchising paradigm may be applied in transfer pricing. Franchising refers to the provision of valuable intellectual property and centralised services by one entity (the franchisor) to another (the franchisee) for a franchise fee.

Economic related issues

The fundamental issue is to define the functional nature of such arrangements. The first step is to identify the nature of the relationship between the franchisor and franchisee – their functions, assets and risks profiles, their roles and responsibilities and ultimately their contribution to joint value creation. The compensation structure (such as fixed, and/or variable fees) and value of the franchise fee should be based on this analysis.

In terms of transfer pricing methods, the comparable uncontrolled price (CUP) method may apply where sufficiently robust comparable transaction data are available. However, identifying robust and functionally similar comparables is generally difficult: franchises can be considered as one extreme on a continuum of licensing relationships where a bare patent is at the other extreme. The transactional net margin method (TNMM) may also apply where there is significant competition to obtain a franchise in the marketplace.

Imputing a related party franchise fee from this data should consist of the sum of services and intellectual property remunerations. The franchise fee can be expressed as a percentage of sales, some measure of profits, or in other ways. It is not uncommon for such arrangements to include a fixed (lump sum or per year) and a variable fee. Ultimately, the fee structure should be based on the circumstances of the transactions and the nature of the relationship between the related parties. Yet, the fee structure impacts the sharing of the financial risks between the fran-

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chisor and franchisee. Such sharing should be consistent with the roles and responsibilities of the transacting parties.

Other issues

Such structures pose a number of tax issues. For example, a portion of an imputed franchise fee might be subject to withholding tax, a portion might be included as part of the calculation of customs duties. In some countries, legislation requires that each element of the franchise fee is priced separately. In our opinion, answers to these technical issues should be grounded in a thorough mapping of the elements that are being franchised out.

Implementation

Applying the franchising paradigm to define related intra-group arrangements may require several phases. In the basic design phase, a comprehensive list of the intellectual property and services that may be included in the intra-group franchising arrangement is produced. This phase also includes a functions, assets, and risks analysis, and a description of the value creation process and of the roles and responsibilities of the franchisees and franchisor. Possible fee structures should emerge from these analyses. The economic analysis should then enable the derivation of reliable estimates of the franchise fee and complete the basic design phase. The detailed design phase, the second phase, involves customising the above analyses to the specificities of the relationship between franchisor and franchisees.

Ultimately, the franchising paradigm may offer a pragmatic solution for intragroup arrangements where one entity provides access to both intellectual property and services. It provides an attractive framework to simplify the administrative business models of multinational with somewhat centralised intellectual property and services.