How franchising arrangements could apply in transfer pricing

Franchising may be an appropriate framework for analysing intra-group transactions, including potentially in industries where third-party franchising is generally not observed, believe Emmanuel Llinares of NERA Economic Consulting in Paris and Nihan Mert-Beydilli of NERA Economic Consulting in Chicago

Franchising offers an interesting context and potential source of valuable qualitative and quantitative information for transfer pricing analysis. It may provide an appropriate framework for analysing intra-group transactions, including potentially in industries where third-party franchising is generally not observed.

The economics of franchising

In economics terms, franchising can be defined as a vertically integrated relationship between a franchisee and a franchisor. In its most common application, the franchisor provides the franchisee a proven method of doing business in return for a fee and a percentage of sales or profit. This type of franchising is commonly referred to as a business format franchise and is observed frequently in the fast food industry. Under this type of franchising arrangement, the franchisor offers a complete toolkit including, in general, services and rights to use intangible assets owned and developed by the franchisor. In this context, the mere licensing of trade marks can also be viewed as a form of franchising.

Business format franchising has found wide application over the past couple of decades in a number of industries. A brief review of the economic literature may help explaining the context in which franchises are more likely to occur, and is a good starting point for evaluating potential use of franchising arrangements in transfer pricing analyses.

Economists identified several reasons to explain the varying degree of reliance on business format franchising in various industries:

- Franchisors face difficulties in monitoring the performance of the franchisee. Empirical evidence suggests that when it is easier to monitor the performance of a store/outlet, that is, when the outlet is located closer to the franchisor's headquarters, the franchisors generally tend to own the store/outlet. In contrast, when performance is harder to monitor, then, the franchisor tends to franchise the operation to a third-party;
- Franchisees tend to be more motivated to perform well than self-operated or owned stores/outlets because typically, the franchisees are compensated based on the profits of their own stores/outlets, which provides incentives to the franchisee to maximise profits by, for example, training and monitoring employees, controlling costs and improving customer service. A company manager employed by the franchisor, on the other hand, may not be as motivated since his compensation consists, usually, of a flat salary and perhaps a performance-based bonus;
- Franchising may be viewed as a low-cost way of raising capital and thus, may offer growth alternatives to otherwise constrained franchisors; and
- Value of brands/trade marks affects franchisor behaviour. Empirical evidence suggests that some franchisors with relatively more valuable brand names have higher rates of company ownership. In fact, such franchisors have additional incentives to

exert control and to protect their brand names from franchisee free riding. In practice, incentives for franchisors to own their stores/outlets are amplified when there are information asymmetries. Information asymmetries include, for example, different access to information on the franchisee's costs: while the franchisee should have a clear and precise estimate of its own costs, the franchisor may only have access to less precise estimates.

Opting for the franchising model appears to be the result of a trade-off between the need for (or lack of) high degree of control, which is particularly important when reputation and maintenance of brand equity are essential to the success of the franchisor, and the importance of incentives to achieve long-term growth in profits.

Intangible assets observed in the market

Most franchises relate to business to consumer (B to C) operations. The most popular franchising sectors in terms of number of franchisees in the US are food, representing about one-third of total franchisees; automotive repair, retail, and cleaning and maintenance. There are also a large number of franchisees which operate at least partially in a business to business (B to B) environment. This is particularly the case in industries such as employment and personnel, packaging and mailing, printing and publications and security and safety systems. A significant proportion of franchisees in these sectors are able to serve both B to B and B to C markets.

While franchising arrangements are less frequent in B to B markets than in B to C markets, franchising-like arrangements may still offer a suitable paradigm for appreciating the arm's-length nature of intra-group transactions in B to B markets with vertically integrated players. Even in industries where third-party franchising arrangements are rare, the transfer of intangibles assets and services provided by franchisors in other industries may still offer a qualitative comparison basis for controlled transactions. For example, the arrangements between franchisor and franchisee may provide information on the principles governing risk allocation between third parties. This information can in turn be used in an intra-group context and may help structuring intercompany transactions.

From a transfer pricing perspective, franchising may offer a suitable basis for analysing intra-group relationships dealing with intellectual property (IP) and services. While business format franchising has not been common in many industries, trade mark arrangements, which may be viewed as a reduced form of franchise, are quite common. Many companies have some type of IP, such as know-how, business processes, reputation and brand awareness, that can be bundled with services and put together under some type of franchising arrangement.

Therefore, analysing franchising relationships between third parties is an area of investigation from which transfer pricing practitioners may draw useful conclusions. In particular, franchising may provide an appropriate qualitative and/or quantitive basis for valuing intercompany transactions that involve provision of services and use of intangible assets.

Franchising data availability

Franchise fees are typically stipulated as a percentage of sales, with, sometimes, an upfront annual minimum payment. The use of sales (rather than profits) as a metric for the performance of the franchisee is justified by ease of monitoring; it is easier to monitor sales than profits. In addition, it is also argued that the franchisor has greater incentives to monitor franchisees with a sales-based remuneration that it would with a profits-based remuneration.

Franchising data in the US can be obtained from a variety of sources. Bond's Franchise Guide contains data on franchising arrangements including the key terms of the agreements in 23 different sectors. Uniform Franchise Offering Circulars are another source of data in the US. A good source of preliminary information on franchising in Europe is the European Franchise Federation (www.eff-franchise.com), which is a centralised association of national associations in Austria, Belgium, Croatia, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, the Netherlands, Portugal, Slovenia, Sweden, Switzerland, Turkey, and the UK. These national associations typically provide a list of members that may serve as a good starting point.

Use of franchising data in transfer pricing analysis

Franchising arrangements typically involve bundled provision of intangible assets and services. Transfer pricing issues that require valuing transactions involving IP and services can be addressed using such franchising data. The transfer pricing methods that are used to value intangible assets are the comparable uncontrolled transaction method (CUT), the transactional net margin method (TNMM) (or the comparable profits method (CPM) in the US), the comparable profit split method (CPSM), and the residual profit split method(RPSM).

The CUT method

The CUT method is commonly used for valuing intangible property by identifying uncontrolled transactions involving transfer of similar intangible property with similar profit potential. It can also be used to value arrangements that bundle intangible property and services provided by the franchisor. The method relies on transfers of the same or similar intangible property and services between uncontrolled parties under comparable circumstances. In addition, under the US regulations, it requires comparisons of intangible property with similar profit potential. Other key comparability criteria include comparable circumstances of intangibles' transfer, time and terms of transfer, duration of the licence, stage of intangibles' development, uniqueness of the property, risks incurred and services provided as part of the intangibles being licensed.

This method is particularly reliable when there is reasonably high comparability with respect to the IP and services being franchised. This implies that any factor that can substantially affect the price at which the intangible assets and services are being franchised and for which no adjustments can be made, provides a reason for rejecting the use of the third-party franchising data. The reliability of the method decreases as comparability diminishes.

Two types of comparables can be used to apply this method: internal comparables including transactions entered into by one entity of the group with an independent third-party and external comparables that relate to transactions between third parties. In general, the CUT method is often used with success when internal comparables are available; the transactions entered into by one group entity with an independent third-party usually provide a reliable benchmark and comparability can be assessed much more reliably due to access to internal data. Any differences between the potential comparable transactions and the tested transactions which may affect comparability (such as, market differences and political risks) should be examined carefully to assess whether it is possible to make adjustments for them. Considerable care and attention should be given to documenting the approach used and justifying the reasons for comparability. In practice, however, transactions involving intangible assets and services licensed or provided to a third party (bundled or unbundled) are not common.

In applying the CUT method to franchising arrangements, the key data item is the pricing data (typically as a percentage of sales plus and a flat upfront payment). While this method is attractive in principle since it may offer a straightforward benchmark, it may be difficult to obtain sufficient information on the nature of the contractual arrangement between the uncontrolled franchisee and franchisor, which is required to reliably assess comparability. Nevertheless, franchising data on the franchise fees are publicly available. This information can be used as a first indication. Ideally, information relating to the transaction in addition to the fees and a short description of the franchise should be identified for the analysis to be reliable. The data on franchising fees may serve as a good starting point for the analysis.

The main shortcoming of the CUT method is that it relies on strict comparability criteria. There is limited publicly available third-party data for applying the CUT method to pricing intangible property and services. As a result, comparability is likely to be an issue. Hence, the CUT method is unlikely to be used on a stand-alone basis, and its results would need to be confirmed by other methods. The alternative methods that can be used in the context of benchmarking franchisor/franchisee type relationships are the profit based methods, including the profit split methods and the TNMM (or the CPM).

Biography

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Llinares has also managed several advance pricing agreements for multinationals in the automotive, financial services, consumer electronics, and consumer products industries. He has managed the transfer pricing aspects of numerous tax audits. He holds a PhD in economics from the University of Delaware and has taught managerial and international economics at business schools in the US and in France.

The TNMM (or CPM)

The TNMM involves identification of a number of functionally comparable companies to determine arm's-length returns that a controlled company should earn. In the context of bundled provision of intangibles and services in a franchise-type arrangement, it may be possible to identify comparable companies to benchmark functional returns that a franchisee should earn. Application of the TNMM in this context assumes, however, that the controlled franchisee does not have any intangible assets of its own and that it does not have access to any other valuable intangible assets or services.

Applying the TNMM requires identifying companies that are functionally comparable to the franchisee but that do not have access to the intangible assets similar to those provided by the franchisor to the franchisee. Once these functional returns are determined, the franchisor is entitled to all or a part of the residual profits earned by the franchisee. Whether the franchisor captures the entire residual profit or only a portion of it ultimately depends on the relative bargaining power of the parties. There are a number of circumstances where the competition on the franchisee's side is significant: for example, the acceptance ratio to become a McDonald's franchisee is around 1%. In such cases, it may not be unreasonable to use the TNMM on a stand-alone basis and argue that the franchise fee should capture the entire residual profits.

If residual profits are to be split between the franchisor and the franchisee, a simple benchmarking analysis is not sufficient; one should resort to the profit split methods, which are discussed below.

The comparable profit split method

Similar to the CUT method, the application of the CPSM relies on identifying comparable transactions. Unlike the CUT method, the analysis is based on the realised profits of the franchisee and franchisor in uncontrolled transactions rather than relying simply on the face value of the franchise fee. In practice, combined operating profits of the controlled franchisee and franchisor are split based on data from observed comparable transactions between third-party franchisees and franchisors. This split of profits is then applied to the tested transaction from which an intra-group franchising fee can be inferred.

The comparability under this method is dependent on the same factors that are important for the CPM as well as the degree of similarity in the contractual relationship between the controlled and uncontrolled parties. Moreover, the combined operating profits (as a percentage of the combined assets for example) of the uncontrolled transactions should not vary significantly from that of the controlled taxpayer.

For reliable application of this method, comparable transactions should satisfy comparability criteria and state how the profits are divided between the parties. The main difficulty in application arises from lack of reliable and detailed third-party data. In practice, both the profits of the franchisee and the franchisor in a number of uncontrolled transactions are needed for applying this method. If the franchisee is sufficiently specialised and only operates one franchise, its statutory financial reporting may include the required information. On the franchisor side, it tends to be more complex; the profits attributable to franchising activities per se are needed at a minimum to perform the analysis, which may be difficult to obtain unless the franchisor has engaged in an uncontrolled transaction.

The residual profit split method

The RPSM may be a particularly well-suited solution to the valuation problems associated with intangibles and services bundled together. The main advantage of this method is that its application requires internal group data only after determining the residual profits. It can, therefore, be applied even when there are no reliable third-party franchising data.

The RPSM relies on a categorisation of functions, risks and assets according to which routine functions are distinguished from non-routine, entrepreneurial functions. Once arm's-length returns are attributed to the routine functions, residual profits are split between the parties based on the relative contribution of each party to the non-routine, entrepreneurial functions and assets that generate the residual profits.

The determination of the arm's-length franchising compensation is based on a split of profits between the franchisor and the franchisees, in line with their respective functions, risks and assets. This method, unlike the CUT method, does not rely on external trade mark agreements, but on internal financials of the group. Since the split of residual profits does not rely on external data, it inherently reflects the dynamics of the group. The key issue is to define the bundling of services and intangibles that are part of the franchising package and determine remuneration for them.

In practice, the first task in the application of the RPSM is the identification of system profits. System profits include the profits of the controlled franchisee and the profits of the controlled franchisor relating to their arrangements with each other, which usually requires working with segmented financial data. Once system profits are identified, functions are categorised into two groups:

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- functions that contribute to the development of intangibles; and
- routine functions of the franchisor and support services provided by the franchisor to the franchisee. The routine functions are valued first based on transaction- or profit-based methods such as the TNMM or CPM. The residual profits are then determined as the combined system profits net of remuneration for routine functions.

The next step is the identification of a principle to split the residual profits between the franchisor and the franchisee based on their relative contribution to residual profits. A number of approaches can be used for this analysis; which are discussed in detail in Approaches to Contribution Analyses under the Profit Split Method, Sebastien Gonnet and Pim Fris' article in this guide. Based on this split, it is possible to identify the compensation that the franchisor should earn for giving the franchisee access to its intangibles.

Then, the franchise rate can be based on the sum of:

- the arm's-length compensation for the franchisor for its support services in accordance with the applicable regulations governing the intra-group services transactions; and
- the arm's length compensation for the franchisor for giving the franchisee access to its intangibles. Based on budgeted financials, these two values can be bundled together as a percentage of sales to define an intra-group franchise like arrangement.

Alternative solution

Franchising arrangements may offer an alternative solution to transfer pricing problems related to franchise-like intra-group arrangements. Before relying on evidence drawn from franchising arrangements in a transfer pricing analysis, one should examine closely the reasons affecting the relative bargaining power between the franchisor and the franchisee, including incentives and control issues that might have led the franchisor to enter into franchising.

Franchise-type arrangements can be analysed using the transfer pricing methods that are typically used to determine an arm's-length remuneration for transfers of intangible assets. To apply these methods reliably to franchising data, the same comparability criteria that each method requires must be satisfied. In many cases, even if franchising data are not sufficient to infer an arm's-length consideration for the intangible assets and services, they often provide a good starting point for the transfer pricing analysis.