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**A Taxing Situation:  
Addressing Tax Issues for International Franchising**

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# Addressing Tax Issues in International Franchising

## 1. Introduction

For companies in industries that are common franchised industries, such as restaurants, hotels, and retail, international franchising is a key growth strategy for businesses looking to expand both their profit and global footprint. However, tax issues can pose significant challenges, as tax laws and regulations vary widely between jurisdictions and are continuing to evolve, including as a result of the OECD's Pillar 2 initiative and increased transparency requirements. Understanding the complexities of international taxation is essential for structuring franchise operations in a way that aligns with critical business goals, ensures compliance, and maximizes efficiency.

This paper provides an overview of critical tax considerations for franchisors operating across borders. Key topics include mitigation of double taxation (including tax treaties), the concept of a permanent establishment (PE), transfer pricing aspects, withholding taxes, and practical tax matters (including the taxation of intellectual property ("IP") rights). Addressing these issues proactively helps franchisors reduce risk, improve operational efficiency, and maintain a competitive edge in global markets.

## 2. Background: U.S. and International Tax Systems

### 2.1. U.S. Tax System Overview

Historically, the United States federal tax system has operated on a worldwide taxation system, meaning that U.S. corporations and individuals are taxed on their worldwide income, regardless of where the income is earned.<sup>1</sup> Additionally, this income may be subject to state taxes and in some instances local taxes.

In 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted in part to transition the U.S. federal tax system to a quasi-territorial system in which some income earned offshore is taxed currently, some is deferred or exempt, and some is eligible for lower tax rates intended to incentive behaviors by companies that U.S. tax policy wanted to encourage.

Key components of the U.S. tax system relevant to U.S. headquartered franchisors are described below.

#### 2.1.1. Subpart F Income

Subpart F limits the ability of U.S. companies to defer U.S. tax on certain types of income earned by its foreign subsidiaries that are considered a controlled foreign

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<sup>1</sup> Under a "territorial system," in contrast, the resident country only asserts taxing rights over income earned in that country. Certain provisions of the 2017 Tax Cuts and Jobs Act ("TCJA") attempted to move the United States tax system to a more territorial system by providing for the section 245A dividends received deduction ("DRD").

corporation (“CFC”).<sup>2</sup> Subpart F income is taxed at the ordinary U.S. federal tax rate which for corporations is 21%. Subpart F income may be subject to state taxes as well.

Subpart F income includes certain types of low-taxed passive income (like dividends, interest, rents, and royalties) and income from related-party transactions that are easily movable to low-tax jurisdictions. This income is taxed in the U.S. even if it is not distributed to the U.S. shareholders. In the franchising industry, it is important to note that royalties paid by third parties to a CFC can be subject to Subpart F income unless the active marketing exception is met. The active marketing exception applies to royalties where a CFC, through its own officers or employees, operates an organization that regularly engages in marketing the licensed property and the marketing activities are substantial in relation to the amount of royalties received.<sup>3</sup>

### ***2.1.2. Global Intangible Low-Taxed Income (“GILTI”)***

Like subpart F, the Global Intangible Low-Taxed Income (GILTI) rules require U.S. shareholders owning more than 10% of any stock in a CFC to report and pay tax on their share of net tested income (calculated under U.S. tax principles) of the CFC. However, GILTI is taxed at a reduced rate compared to subpart F income. Currently, the maximum rate of tax for GILTI is 10.5%, but the rate is set to increase to 13.125% starting January 1, 2026 under current law. There are ordering rules to determine which character of income is taxed under either Subpart F or GILTI with Subpart F income being taxed first and the remainder of income subject to GILTI.

The purpose of GILTI is to tax income created by assets that generate high returns compared to their tax basis, which generally relates to income earned on intangible assets. GILTI also provides exceptions for high-taxed income (income taxed at higher than 18.9%) and for “qualified business asset investments” (“QBAI”) in fixed assets like equipment, machinery, and buildings (tangible assets).

### ***2.1.3. Foreign Derived Intangible Income (“FDII”)***

In order to encourage retaining functions and assets (including IP) in the U.S., FDII was enacted to provide for a reduced rate of tax on certain types of income received by U.S. corporations from foreign parties (both related and unrelated). The FDII regime works by providing for a deduction under Section 250 against the eligible FDII income.

The FDII rate applies to income earned directly by U.S. corporations for services, sales, and licenses for foreign use. Currently, FDII is taxed at a statutory rate of 13.125%

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<sup>2</sup> A foreign corporation is a “CFC” if at least 50% of the vote or value is owned by U.S. shareholders, which may be corporations or individuals. See Internal Revenue Code § 957(b). A U.S. shareholder is a shareholder that owns at least 10% of a corporation.

<sup>3</sup> See Treasury Regulations § 1.954-2(b). To meet the active marketing exception, the CFC must maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the licensed property. The marketing activity must be performed by the CFC’s own officers and employees and substantial in relation to the amount of the royalty.

rate, but the rate will increase on January 1, 2026 to 16.406%. In this respect, the FDII rate moves in tandem with the GILTI rate, thereby discouraging U.S. companies from moving functions or assets (including IP) offshore. It should be noted that the method for allocating expenses against various categories of income can result in a higher effective rate for both FDII and GILTI.

FDII is of particular importance to U.S. franchisors who receive royalties from non-U.S. parties for the use of IP utilized outside the U.S. but the IP is owned in the U.S., as it allows those royalties to be taxed at less than the current 21% federal rate.

#### **2.1.4. Base Erosion Anti-Abuse Tax (“BEAT”)**

Similar to FDII, BEAT was generally enacted as US tax policy to discourage US companies from making excessive deductible payments to foreign parent companies or to related entities within foreign-parented multi-national groups, but was written broadly enough to capture payments made to any foreign related party, including subsidiaries of US parented multi-nationals. BEAT is a complex calculation that effectively results in a minimum tax on U.S. companies that are members of multinational groups that have large deductions for cross-border payments to related parties.

The BEAT applies to U.S. companies with \$500 million or more in gross receipts if the sum of their base erosion deductions (e.g., deductions for cross-border payments to related parties that fall under the rules) in a year exceeds 3 percent of their total deductions.

The BEAT is calculated as a percentage of modified taxable income. Modified taxable income is calculated by taking ordinary taxable income and adding back expense related to base erosion payments made to related foreign corporations (in effect, disallowing the deduction for these costs). Foreign base erosion payments generally include payments for services, interest, rents, and royalties, and deductions for depreciation and amortization, but do not include expense related to cost of goods sold and costs that fall under the services cost method.

Through 2025, the BEAT tax rate is 10% of modified taxable income, increasing to 12.5% starting in 2026.

Example: In 2024, a U.S. corporation made \$520 million gross receipts and had \$500 million in deductible expenses. Its net taxable income would be \$20 million. Under the current 21% corporate rate, its U.S. tax liability would be \$4.2 million. However, the corporation also made \$50 million in payments to its CFCs which are considered base erosion deductions. These payments comprise 10% of total deductions, well over the 3% threshold. So, BEAT applies and will be paid to the extent it exceeds the U.S. corporation’s ordinary corporate tax liability (\$4.2 million).

	Regular Tax	BEAT Tax
Gross Receipts	\$ 520	520
Normal Deductions	\$ (450)	(450)
Base Erosion Payment Deductions	\$ (50)	
Taxable Income / Modified Taxable Income	\$ 20	70
Tax Rate	21%	10%
Tax Due	\$ 4.2	\$ 7

In this example, the BEAT payment deduction is disallowed, and as a result, the \$7 million BEAT tax exceeds the \$4.2 million regular tax, therefore, the U.S. corporation's total federal tax liability for 2024 \$7 million.

### **2.1.5. Section 245A Dividend Received Deduction**

This deduction allows U.S. corporations that own at least 10% of any shares of a CFC to exclude the foreign-source portion of dividends they receive as long as they qualify under 245A (i.e., meet the holding period requirement, etc. and other requirements). While 245A is taxpayer-favorable, its application is usually limited in practice in franchising operations, as the vast majority of CFC income is likely to be subject to GILTI provisions, thus will be taxed regardless, thus outside the 245A benefit. However, for companies with lower GILTI income/significant QBAI in GILTI calculations, This provision provides greater flexibility to repatriate cash back to the U.S.

### **2.1.6. The U.S. Foreign Tax Credit**

As discussed above, the U.S. federal tax system generally taxes U.S. corporations and individuals on their worldwide income, or now on a quasi-territorial basis. Because foreign earned income has usually been taxed by a foreign government, this can result in double taxation of the same income. However, the U.S. allows for a credit for the foreign taxes paid on foreign income, including withholding taxes imposed on foreign dividends and royalties.

The U.S. foreign tax credit calculation is complex, but the general notion is that the foreign tax credit reduces the U.S. tax imposed on a U.S. corporation's foreign income by crediting foreign taxes, subject to impacts of expense allocation and apportionment, taxable income limitations and overall basketing of income. As a point of reference, for franchisors, the common baskets of income include the US Basket, General Basket (can include Subpart F), Passive Basket (can include Subpart F), the GILTI basket, and Branch basket, among others. . Further, to calculate the foreign tax credit on a before tax basis, Section 78 requires that the relevant CFC taxes are added back to each category of income (i.e., Section 78 gross up).

All income includible on a U.S. tax return is first categorized into the appropriate basket to arrive at gross US and/or foreign source income by basket and then all

expenses on the U.S. tax return are allocated and apportioned amongst these baskets to arrive at net foreign source income or (loss) by basket.

A U.S. corporation’s annual foreign tax credit is then computed by comparing the amount of foreign taxes paid on its foreign income to the amount of U.S. tax that would have applied to its foreign income in that year. The resulting foreign tax credit allowed is based on the “foreign tax credit limitation”, which allows a credit for the lower of taxes paid or the US tax due on each basket’s income. Any unused current year foreign tax credits can be carried forward 10 years, with the exception of GILTI excess credits, which are forfeited.

Below is a simplified calculation for the maximum foreign tax credit available to a U.S. corporation in a given year and assumes only one foreign basket of income:

$\text{U.S. tax liability} \times (\text{Foreign Taxable Income} / \text{Worldwide Taxable Income})$
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As shown in the example, increasing the foreign source income (reducing foreign expenses) increases the amount of the available foreign tax credit limitation. Decreasing foreign taxable income reduces the amount of the foreign tax limitation, reducing the amount of credits that can be used in that year.

Example: A U.S. Corporation has \$200 million dollars of U.S. taxable gross receipts comprised of \$50M U.S. source royalties and \$150M foreign source royalties (gross), and \$150 million dollars of expenses incurred in the US. Thus, U.S. Corporation’s taxable income is \$50 million. It paid \$30 million withholding taxes in Country A on the \$150M royalty. Of the \$150 million in expenses, \$100 million is allocable to foreign income.

	<i>Calculation key</i>	<b>US Source</b>	<b>General Basket</b>	<b>Total</b>
Gross Receipts	<i>a</i>	\$ 50.0	\$ 150.0	\$ 200.0
Expenses	<i>b</i>	\$ (50.0)	\$ (100.0)	\$ (150.0)
Taxable Income	<i>a-b=c</i>	\$ -	\$ 50.0	\$ 50.0
U.S. Tax Rate	<i>d</i>	21%	21%	21%
U.S. Tax/Simplified FTC Limitation	<i>\$50/\$50*\$10.50</i>	\$ -	\$ 10.50	\$ 10.50
FTCs Available	<i>f</i>	0	30	\$ 30.0
FTCs Allowed	<i>Lesser of e or f=g</i>	0	\$ 10.50	\$ 10.5
Net US Tax	<i>e-g</i>	\$ -	\$ -	\$ -
FTC Carryforward (10 years)	<i>f-g</i>		\$ 19.50	\$ 19.5
<i>***Ignores impact of certain FTC technicalities, such as Sec. 904 (b)(4)</i>				

As the example above shows, the use of FTC is limited in this example. The \$19.5 million is available to carry forward for 10 years.

## **2.2. Tax Systems in Other Countries**

As mentioned above, many countries utilize a territorial taxation system, meaning they only tax income earned within their borders. Note that some countries proactively seek to attract multinational companies through more competitive corporate tax rates although tax competition has been mitigated in part following the OECD's Pillar 2 initiative (discussed below) with the agreement of a global minimum tax of approximately 15%.

Additionally, some countries offer tax incentives or exemptions for foreign investors to encourage international business expansion.

Understanding how these tax systems interact with U.S. tax laws is crucial for U.S. based franchisors expanding abroad. The use of local subsidiaries (i.e., legal entities), licensing agreements, or joint ventures can influence the tax treatment of franchise-related revenue and expenses, impacting overall tax efficiency.

### **2.2.1. Legal Entity Accounting and Transfer Pricing**

In order to calculate the correct tax liability, it is necessary to allocate the appropriate items of income and expense to each legal entity of an organization (i.e., legal entity accounting). For multi-national organizations this will require a transfer pricing analysis is done to ensure the correct economics of a transaction and/or income flow are accounted for in each jurisdiction. Transfer pricing is the price of transactions between related parties (i.e., transactions between a parent and subsidiary or between subsidiaries) and OECD and local country rules require that the price of goods or services between related parties be computed as if the parties are unrelated (i.e., arm's length).

### **2.2.2. DEMPE Framework for Transfer Pricing**

In 2015, the OECD introduced a framework known as DEMPE as part of its Base Erosion and Profit Shifting ("BEPS") initiative for global tax policy of aligning the taxation of income with the location of value creation. Specifically, DEMPE is a set of guidelines covering the IP support functions of Development, Enhancement, Maintenance, Protection, and Exploitation, and is a crucial concept across the global landscape, particularly in allocating income from intellectual property assets. Many tax authorities worldwide, including those in the EU, Australia, and Canada, have adopted DEMPE principles to scrutinize multinational companies' profit allocations.

Under DEMPE guidelines, companies must demonstrate that the jurisdiction receiving IP-related revenue has the appropriate personnel and resources responsible for creating and managing that IP.

For franchise networks, this means: (a) ensuring that IP ownership structures reflect the actual contribution of entities within the group; (b) aligning royalty payments with the jurisdictions where IP-related functions, such as brand development, operations support, marketing support, software enhancements, and other IP-related support

functions are performed; (c) demonstrating sufficient economic substance in a jurisdiction to justify income allocation; and (d) avoiding artificial structures that could be challenged under anti-abuse provisions. Failure to properly align DEMPE functions with the appropriate jurisdictions could result in tax authorities reallocating profits, leading to increased tax liabilities (including double taxation) and potential penalties, and significant tax controversy costs.

### 2.2.3. **The OECD's Pillar 2 Initiative**

In 2019, the Organization for Economic Co-operation and Development (OECD) embarked on a process to establish a global minimum tax for the world's largest companies.

The Pillar 2 part of the BEPS initiative is designed to ensure that large multinational companies (those with annual global revenues of at least €750 million) pay a minimum tax of 15 percent on taxable profit in each jurisdiction in which they operate.<sup>4</sup> To the extent the countries where they operate impose a tax rate of less than 15 percent, either a domestic minimum top-up tax or a parent company top up tax would be required to be paid to ensure minimum 15% taxation.

Under the Pillar 2 guidelines, the minimum tax would be implemented with two main mechanisms: the income inclusion rule (IIR) and the undertaxed profits rule (UTPR). The IIR is a top-up minimum tax applied to the parent company where it is incorporated or the direct shareholder if the parent jurisdiction has not adopted an IIR. If any of the parent's company's subsidiaries are not subject to the requisite 15% tax, the parent company jurisdiction would impose a top-up tax to ensure the minimum threshold is satisfied.

The UTPR is a backstop to the income inclusion rule. It allows a jurisdiction to increase taxes paid by a multinational company if the company pays less than the minimum tax of 15 percent in another jurisdiction in which it operates (typically by disallowing

The Pillar 2 rules also permitted each country to introduce a qualified domestic minimum top up tax (or "QDMTT") of up to 15% to collect tax revenues locally, thereby preventing the application of the IIR and UTPR (and ensuring the minimum tax threshold intended by the Pillar 2 rules is satisfied).<sup>5</sup>

While many countries have adopted Pillar 2 rules into their local legislation effective January 1, 2024, as of the date of this article, the United States has not adopted Pillar 2. Nevertheless, U.S. companies with subsidiaries overseas are required to comply

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<sup>4</sup> See generally, *Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (2021), available at <https://doi.org/10.1787/782bac33-en>.

<sup>5</sup> See, e.g., EU Minimum Tax Directive (*entry into force* Dec. 23, 2022); Australian Global and Domestic Minimum Tax Imposition and Assessment Acts (Dec. 2024); Canada Global Minimum Tax Act (June 2024, with retroactive application of the QDMTT to fiscal years beginning on or after Dec. 31, 2023.).

with the rules and compliance obligations in the offshore jurisdictions in which the rules are currently active.

### **3. Categorization of Fees and Tax Implications**

#### **3.1. Categorization of Payments**

A key component of any tax analysis is properly categorizing payments to ensure proper compliance and avoid misclassification that could trigger unexpected tax consequences. A franchising model can make this analysis complex depending on what type and bundle of IP and services are being charged in cross-border transactions. Different classifications of payments can be subject to different types of income tax and other tax provisions, including withholding tax rates, Value Added Tax (“VAT”)/ Goods and Services Tax (“GST”), and digital services tax (“DST”) rules.

Common categories of payments in a franchising business include:

- **License and Royalty Payments:** Payments for trademark and brand usage, are often subject to withholding taxes, which can vary significantly by jurisdiction. For example, withholding tax rates on royalties can range from 0% to 30% (depending on the statutory rate or a lower rate under a relevant tax treaty).
- **General Services:** Payments for consulting or operational support. Most jurisdictions treat service fees differently from royalties, applying lower (or no) withholding tax rates or VAT.
- **Technology Services:** Payments for proprietary software or digital services (sometimes software as a service or SaaS). These may be taxed as service fees in some jurisdictions but could also fall under royalty payments subject to withholding tax in others. DST may apply on these services as well and need to be analyzed individually.
- **Marketing and Advertising Services:** If a franchisor provides marketing services to a franchisee, these fees may be subject to VAT in the jurisdiction where the services are performed.
- **Supply Chain Fees:** Franchisor may provide access to supply chain contracts for pricing or may be involved in the supply chain itself and charge fees to franchisees for such services and value provided.

##### **3.1.1. Why Categorization Matters**

The categorization of payments can significantly impact the franchisor’s effective tax rate and overall compliance burden.

For example, there may be:

- **Withholding Tax Differences:** A royalty payment may attract a withholding tax in some countries, whereas a service fee might not. A franchisor may or may not be

able to credit these withholding taxes (see discussion above regarding the US foreign tax credit regime).

- **VAT and Indirect Taxes:** Software as a Service (“SaaS”) and digital service fees as well as royalties may be subject to VAT in the country where the recipient of the respective services or licenses is resident. Assuming that such recipient of the services or licenses is a taxable person for VAT purposes (which should be the case for most franchisees), the European VAT system applies the so-called reverse-charge procedure, in which the recipient of the licenses or services is required to account for VAT. Such VAT may or may not be recoverable depending on the VAT treatment of the franchisee’s output services. If the franchisee’s output services are VAT exempt (e.g. in case of a franchising in the financial industry), the respective VAT (currently ranging between 17% and 27% in Europe) becomes a definitive cost for the franchisee.
- **Transfer Pricing Compliance:** As mentioned above, most jurisdictions require that payments between related party entities are made at “arm’s length” (i.e., the same payment terms that would have to be utilized had the parties been unrelated). Incorrect categorization can lead to tax audits and adjustments, especially if tax authorities determine that payments do not reflect the arm’s-length standard.

### **3.1.2. Practical Considerations**

From a purely economic perspective as well as from a general transfer pricing perspective, the absolute revenue stream under a franchise agreement is much more important than its segregation into different types of income. The OECD acknowledges that by stating in the 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: <sup>6</sup>

“One situation where transactions involving transfers of intangibles or rights in intangibles may be combined with other transactions involves a business franchise arrangement. Under such an arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee. If the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.”

As a result, franchise agreements often provide for a single fee to be paid for a bundle of licenses and different types of services. However, if the withholding tax, VAT, GST, DST or other tax treatment is different for different licenses and/or services

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<sup>6</sup> [https://www.oecd.org/content/dam/oecd/en/publications/reports/2022/01/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022\\_57104b3a/0e655865-en.pdf](https://www.oecd.org/content/dam/oecd/en/publications/reports/2022/01/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_57104b3a/0e655865-en.pdf); mn. 6.100.

provided, it is necessary to segregate the various parts of the package even if there are reliable comparables for the package as a whole.

Against this background it is recommended from a practical perspective to explicitly split the respective fees for different types of licenses and/or services already in the respective inter-company agreement, if the respective tax treatment is different. While doing so does not prevent tax authorities from challenging the split of the fees, it may in combination with a proper transfer pricing documentation of the different licenses and/or services materially improve the taxpayer's position in a tax audit.

#### **4. Double Taxation and Tax Treaties**

##### ***4.1.1. The Problem of Double Taxation***

One of the most significant tax challenges in international franchising is double taxation, where income is taxed in both the country from which it is paid and in the franchisor's home country (i.e. – the receiving country). Without proper planning, a franchisor could end up paying taxes twice on the same income, significantly reducing profitability.

For example, a U.S.-based franchisor earning royalties from a franchisee in Germany will generally face German withholding taxes of 15.825% on each royalty payment to be withheld by the German franchisee, however, this could be 0% under the U.S.–German double income tax treaty. As the United States will also tax the royalty income, the franchisor must rely on the application of tax treaties or utilize foreign tax credits under U.S. law to mitigate double taxation.

##### ***4.1.2. The Role of Tax Treaties***

Tax treaties help mitigate double taxation by providing reduced tax rates and ensuring that income is taxed only once. The U.S. has treaties with over 60 countries, allowing for lower withholding tax rates on royalties, service fees, interest and dividends.

However, tax treaties vary widely, and franchisors must review each country's specific treaty provisions. Some treaties exempt royalties from withholding tax altogether, while others set specific limits (e.g., 10% instead of 30%). Ensuring proper treaty application requires qualifying under the tax treaty, including the limitation of benefits clause, obtaining certificates of residency and filing the necessary documentation with tax authorities.

### **4.1.3. Claiming Tax Treaty Benefits**

Franchisors seeking to reduce withholding tax burdens must navigate the process of claiming treaty benefits. The process typically involves the following steps for U.S. based franchisors:<sup>7</sup>

- Obtain a U.S. Tax Residency Certificate (Form 6166): U.S.-based franchisors must apply for a residency certificate from the IRS by filing Form 8802 (Application for United States Residency Certification). This document proves that the franchisor is a tax resident of the U.S. and is eligible to claim treaty benefits. Processing times can vary, so franchisors should apply well in advance of needing the certificate.
- Determine Treaty Benefits and Required Documentation: Review the applicable treaty between the U.S. and the franchisee's country to determine the reduced withholding tax rate. Some countries require additional local forms to be completed alongside Form 6166. Certain jurisdictions may impose conditions, such as a local presence (substance), to claim treaty benefits.
- Submit the Residency Certificate to the Franchisee: Provide the certificate to the franchisee or local tax authority in the franchisee's country. Some countries require the franchisor to complete a local tax form or affidavit confirming treaty eligibility. The franchisee must file the required paperwork with the local tax authority to ensure the correct withholding rate is applied.

Monitor Compliance and Renew Certificates Annually: Residency certificates often expire at the end of the calendar year and must be renewed annually. Franchise agreements should outline the responsibility for obtaining and submitting these certificates to avoid unnecessary withholding tax payments.

There is current a trend in many countries and in modern tax treaties to more closely scrutinize the business substance in the jurisdiction of the payee entity for purposes of permitting treaty benefits. For example, many multinational companies may have an intermediate holding company in its organizational structure to hold the shares of related party operating companies. Dividends are routinely paid by the operating companies to the holding company, which then pays dividends to the parent company. Similarly, multinational companies often centralize the ownership of intellectual property in a particular jurisdiction, charging royalties to related parties for the use of the IP. Some jurisdictions have recently adopted more rigorous rules to ensure the payee company of the dividends or royalties have sufficient operations, personnel or other substance to support its claim of residency to mitigate withholding tax.

In Germany, for example, a licensee is generally required to withhold 15.825% tax from royalties paid to a non-Germany resident licensor. A German subsidiary is generally required to withhold 26.375% tax on dividends paid to a foreign parent company. If the licensor or parent company is resident in the US, the withholding tax on royalties and dividends may be reduced to 0% under Art. 12 para 1 or Art. 10 para. 3 of the US-German

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<sup>7</sup> The same process generally applies for non-US to non-US treaty qualification.

double tax treaty (“US-GER-Treaty”). However, this requires that the requirements of the so-called limitation of benefits (“LoB”) clause in Art. 28 of the US-GER-Treaty are met. The LoB-clause contains a variety of standardized test, which shall ensure that the respective structure is not artificially put in place to enjoy the benefits of the treaty. Apart from Art. 28 of the US-GER Treaty, Germany has a so-called Anti-Treaty Shopping Provision (“ATSP”) in its national tax laws, which used to be applied to cases, where the applicable double tax treaty (unlike Art. 28 in the US-GER-Treaty) did not contain a specific limitation of benefit clause. The ATSP is also meant to have standardized tests in order to ensure that the respective structure is not artificial, in particular, that the payee has sufficient substance at its place of residence. The ATSP was tightened materially in 2021. Currently, the requirements of the ATSP must be met in addition to potential limitation of benefits clauses in applicable double tax treaties, such as Art. 28 of the US-GER-Treaty. While it is still disputed in German literature, whether this is the case, since the wording of the law does not mention the applicability in addition to a limitation of benefits clause in a treaty, both provisions serve the same purpose and a provision in an applicable double tax treaty must therefore prevail the ATSP, the German tax authorities since then require both provisions to be met in order to benefit from a double tax treaty.

Practically, there are two ways to obtain the respective treaty benefits in Germany:

1. The payee may apply for a so-called “certificate of exemption” from the German tax authorities. In order to obtain such certificate, the payee not only has to provide the tax authorities with a certificate of residence (in case of the US: Form 6166); the payee also has to prove that the requirements of an applicable LoB-clause such as Art. 28 of the US-GER-Treaty, and that the requirements of the ATSP are met. For that reason, the payee has to answer questionnaires of the German tax authorities and provide a variety of documents such as utility bills or payroll documents to the German tax authorities in order to prove that the LoB-clause and the ATSP are met. Once the payee has obtained the certificate of exemption, it must be handed over to the payor. Only if the payor is in possession of a certificate of exemption from the payee, the payor may refrain from withholding taxes (or withhold at a reduced rate) based on a double tax treaty. The payee must withhold the full withholding tax of 15.825% or 26.375% for any payment made before the payee is in possession of a certificate of exemption, even if the payee is entitled to treaty benefits.
2. If a payment was made before the payor was in possession of a certificate of exemption and, hence, the full withholding tax was withheld, the payee may apply for a refund of such tax based on a double tax treaty. During this refund procedure, the burden of proof for the payee is practically the same as in case of an application for a certificate of exemption.

The practical difficulty for these procedures is time, effort and cash flow considerations. Due to the change of the ATSP in 2021 and a lack of sufficient staff, an application for a certificate of exemption currently takes on average 15 months and an application for refund takes on average 21 months until the tax is refunded. It is therefore necessary to start the proceedings for obtaining a certificate of exemption well in advance

of any payment to be made in order to avoid a material impact on the cash-flow due to late refunds.

#### ***4.1.4. Importance of Reduced Withholding Tax Rates***

Securing a reduced withholding tax rate under a treaty has significant financial and operational benefits for both franchisors and franchisees.

As already discussed, it reduces unnecessary double taxation on royalties and fees, increasing net income, avoids cash flow disruptions due to over-withholding by foreign tax authorities, and improves competitiveness by making U.S. based franchise models more attractive to foreign franchisees.

On the other hand, for franchisees, lower withholding taxes may mean lower costs on payments to the franchisor in a gross-up clause for withholding taxes exists. This also encourages compliance by reducing the complexity of tax payments and enhances profitability by keeping more funds available for local business growth.

For example, a U.S. based quick-service restaurant franchisor expanding into France may face a 25% withholding tax on royalties paid by its French franchisees. By claiming treaty benefits, the franchisor may reduce this rate to 0%, significantly improving profitability. Likewise, an Australian software franchise expanding into the U.S. may reduce U.S. withholding taxes on technology licensing fees by obtaining an Australian residency certificate.

By understanding and properly executing the process of claiming tax treaty benefits, franchisors can optimize international tax efficiency, reduce administrative burdens, and enhance the attractiveness of their franchise models worldwide.

## **5. Permanent Establishment (PE) Considerations**

### ***5.1. What is a Permanent Establishment?***

A permanent establishment (PE) occurs when a franchisor has a physical presence or business activity in a foreign country, triggering local corporate tax obligations. Most tax treaties define a PE as a fixed place of business, such as an office, warehouse, or dependent agent with contract-signing authority.<sup>8</sup>

If a franchisor is deemed to have a PE, local taxation applies to all income attributed to that establishment. A PE can create additional tax liability, including the potential for double taxation, disputes with taxing authorities and compliance burdens. This can be a major concern for franchisors sending employees or executives abroad, as their activities might unintentionally create a PE. Franchisors need to be mindful of this as they establish their brand in a new market which may require more on-the-ground involvement.

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<sup>8</sup> See, e.g., Article 5 of the OECD Model Tax Convention (2017); Article 5 of the U.S. Model Tax Convention (2017).

### **5.1.1. How to Avoid Unintended PE Status**

Franchisors should structure their international operations carefully to avoid unintended PE classification. Strategies include:

- Ensuring that local sales representatives do not have the authority to sign contracts
- Limiting the duration and frequency of visits by franchisor staff
- Structuring agreements so that services are provided outside the franchisee's country

Failure to manage PE risks can result in unexpected tax liabilities, penalties, and increased compliance costs.

## **6. Transfer Pricing in Franchising**

### **6.1.1. The Importance of Transfer Pricing**

As noted above, transfer pricing refers to how transactions between related entities (such as a U.S. franchisor and its foreign subsidiary) are priced. To prevent tax avoidance, most countries require intercompany transactions to be priced at arm's length, meaning they should reflect what unrelated parties would charge under similar conditions.<sup>9</sup>

In franchising, royalty payments, service fees, interest payments and other intercompany arrangements must be structured properly to comply with transfer pricing regulations. If authorities believe a taxpayer is not transacting on an arm's length basis, they may adjust taxable income and impose penalties.

### **6.1.2. Common Transfer Pricing Methods**

Franchisors with cross-border related party transactions must document their pricing using OECD-approved methods, such as:

- Comparable Uncontrolled Price ("CUP") Method – Comparing fees with third-party agreements
- Resale Price Method ("RPM") – Ensuring resale markups align with market rates
- Cost-Plus Method ("C+M") – Adding a profit margin to service costs
- Profit Split Method ("PSM") – Dividing profits based on value contributions

Maintaining proper transfer pricing documentation is generally required before a tax return is filed or within a short time frame of a tax authority request and is essential to avoid disputes with tax authorities.

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<sup>9</sup> Most tax treaties between OECD countries adopt the arms-length attribution approach or "AOA" Authorized OECD Approach to attribute profits on an arms-length, separate entity basis.

### **6.1.3. Transfer Pricing Disputes**

Transfer pricing disputes can result in significant burden on franchisors. When a jurisdiction claims a related party payment is not arm's length, they assert additional tax is owed. This creates the potential for significant risk of double taxation. For example, assume a U.S. franchisor licenses certain franchise rights to a related party Germany company in exchange for a royalty. Assume the company takes the position that the payment should be \$100 for a given year. The U.S. entity has included \$100 into its income and the Germany entity has claimed a \$100 deduction against its income in Year 1. In Year 4, the German tax authorities are auditing the Year 1 tax return and assert the royalty payment should be \$75 (rather than the \$100 reported by the company), there is the potential double taxation on \$25 of income since the US has already taxed the \$100.

The company can challenge the assessment in Germany under local law. When under local audit, the franchisee can try to invoke the tax treaty because generally tax treaties provide a mechanism to resolve such issues in an effort to mitigate double taxation. Specifically, in these cases a taxpayer can seek relief under a Mutual Agreement Procedure or "MAP." Utilizing MAP relief under a tax treaty, a taxpayer can request the two taxing authorities (here, the U.S. and Germany) work to resolve the dispute in a manner that mitigates the double tax. While the MAP procedure can be effective to eliminate double tax, the process can often take significant time to resolve. The OECD published statistics in 2023<sup>10</sup>, according to which the average duration of a MAP procedure relating to transfer pricing is about 32 months. Since in most treaties, there is no obligation for the taxing authorities to reach an agreement that fully eliminates double taxation, the 2023 report also shows that only 62% of the MAP procedures end with an agreement fully eliminating double taxation. Companies should carefully consider the benefit of utilizing MAP relief under tax treaties as a tool in resolving transfer pricing disputes.

## **7. Volatility in International Tax Issues**

The international tax landscape is undergoing significant transformation due to global initiatives such as OECD's Base Erosion and Profit Shifting (BEPS) project (resulting in concepts of DEMPE and the minimum tax of Pillar 2 discussed above), Digital Services Taxes (DSTs), domestic legislative changes in key markets like the U.S., EU, and Asia-Pacific regions.

### **7.1.1. Pillar 2**

As discussed above, the Pillar 2 legislation adopted by many countries (including EU countries, the UK, Australia, Japan and Canada) seeks to impose a minimum tax on the profits in each jurisdiction in which global franchisors operate. The Pillar 2 rules are now effective in most jurisdictions, although interpretations of the rules are continuing to

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<sup>10</sup> See "2023 Mutual Agreement Procedure Statistics," OECD, *available at* <https://www.oecd.org/en/data/datasets/mutual-agreement-procedure-statistics.html> (last accessed: April 30, 2025).

be developed. This significant development has caused franchisors to evaluate their operating structure to quantify the tax impact of Pillar 2, consider modifying structures to the extent the burden of Pillar 2 is significant and undertake meaningful effort to ensure compliance.

As noted above, the United States has not adopted Pillar 2 and there is no intention under the current Administration or Congress to do so.<sup>11</sup> Further, the U.S. is considering certain measures to increase the tax burden on countries that have adopted Pillar 2 (including increased withholding taxes). The efforts of the U.S. to mitigate the impact of Pillar 2 on U.S. companies is part of larger trade disputes, which include tariffs and other economic measures.

### **7.1.2. Digital Services Taxes (DST)**

Digital Services Taxes (DST) have emerged as a significant consideration for international franchisors. These unilateral measures imposed by various countries target revenue generated from digital business models, often affect franchisors with significant digital operations. DSTs typically apply to online advertising, digital marketplaces, and streaming services, but they may also capture revenue streams such as franchise fees, online training, and marketing support provided digitally.

Franchisors operating internationally must assess their exposure to DSTs and consider structuring options to mitigate tax risks. As DSTs continue to evolve, with the OECD seeking a unified global framework, franchisors should monitor developments to avoid unexpected tax liabilities.

### **7.1.3. Changes in U.S. Domestic Legislation**

Significant regulations have been issued by the Treasury Department interpreting the TCJA provisions. Franchisors must continue to evaluate the impact of the TJCA provisions on their operating structures.

This evaluation has become more complex in light of the Pillar 2 rules adopted by other countries as the interaction of the distinct rules can create uncertainty and the potential for double tax.

### **7.1.4. EU and Global Trends**

Inspired by the OECD's BEPS project, the European Union in 2016 adopted the Anti-Tax Avoidance Directive ("ATAD I") to harmonize the adoption of anti-BEPS

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<sup>11</sup> See Executive Order, *The Organization for Economic Co-operation and Development (OECD) Global Tax Deal (Global Tax Deal)* (Jan. 20, 2025), available at <https://www.whitehouse.gov/presidential-actions/2025/01/the-organization-for-economic-co-operation-and-development-oecd-global-tax-deal-global-tax-deal/> (last accessed: April 30, 2025).

measures into local laws across EU Member States. This directive was amended in 2017 (“ATAD II”), in particular with respect to hybrid mismatch measures. It contains an interest limitation rule, exit taxation rules, a general anti-avoidance rule, CFC rules as well as an anti-hybrid mismatch rule. EU members were required to implement these rules by 31 December 2021 at the latest, noting that ATAD II explicitly states that these rules are only minimum standards, therefore each EU member state may therefore implement more restrictive measures if they so choose.

At the end of 2022, the EU commission presented yet another initiative, known as “Unshell” or “ATAD III”, which targets shell companies to ensure sufficient substance for companies in their country of residence. So far, the member states could not agree what “sufficient substance” means and after some reworks of the draft directive, the latest information available is from December 2024, when the European Council reported that further discussions among the member states are necessary. As of the writing of this article, it is unclear how and when ATAD III will be implemented in final form.

All these measures were accompanied by increasing information exchanges among the tax authorities of European member states and reporting obligations for taxpayers. These started with the directive on administrative cooperation in the field of taxation (“DAC 1”) in 2011. The directive was amended and extended several times, inter alia in 2018 with the introduction of reporting obligations for cross-border arrangements which meet a hallmark of (potential) tax avoidance (“DAC 6”), in 2023 with introducing further reporting obligations for sellers using digital platforms for certain supplies of goods or services (“DAC 7”) and further reporting obligations as of 2026 for transactions involving the buying, selling, exchange or other acquisitions and disposals of cryptocurrency and other digital assets (“DAC 8”).

Understanding how these developments impact cross-border franchise operations is crucial. 

## **8. Practical Strategies for Franchisors**

It is critical that global franchisors evaluate the tax impacts of their operating structure to ensure compliance and mitigate unnecessary costs and burdens. Key strategies will include:

- Choosing the right entity structure – subsidiaries, joint ventures, or licensing models
- Optimizing revenue streams – structuring franchise fees, royalties, and service fees to accurately determine tax exposure
- Managing presence abroad – avoiding PE risks through careful workforce planning

Staying compliant with evolving tax laws – staying current on new legislation (such as Pillar 2 or U.S. tax law changes)

Franchisors should work closely with tax advisors and legal experts to develop a customized tax strategy that aligns with their global expansion plans.

## **9. Conclusion**

Tax issues in international franchising are complex but manageable with proper preparation and planning. By understanding double taxation risks, permanent establishment rules, transfer pricing compliance, and withholding tax implications, franchisors can optimize their global structures while ensuring full compliance. Proactive tax planning allows businesses to expand internationally with confidence.

## Biographies

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Robert Clary is a tax partner at Baker McKenzie LLP. Rob advises multinational enterprises with respect to their global tax positions, including tax aspects of cross-border acquisitions, financing transactions, corporate restructurings, joint ventures, and other corporate activities. His practice also includes advising clients in international transfer pricing and controversy matters relating to global operations, investments, and transactions.

### **Amelia John, Senior Director, International Tax, YUM! Brands**

Amelia is currently the Senior Director of International Tax at YUM! Brands, Inc., which is the parent company of KFC, Taco Bell, Pizza Hut, and the Habit Burger & Grill. Amelia has over 20 years of tax leadership experience in both industry and public accounting navigating the complex and evolving global tax rules and reporting requirements including transfer pricing, international tax, US and non-US tax compliance, M&A and global tax controversy. Amelia is a Certified Public Accountant.

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