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Pizza Hut and Cross-Border Franchising: Deemed royalty assessment on marketing expense

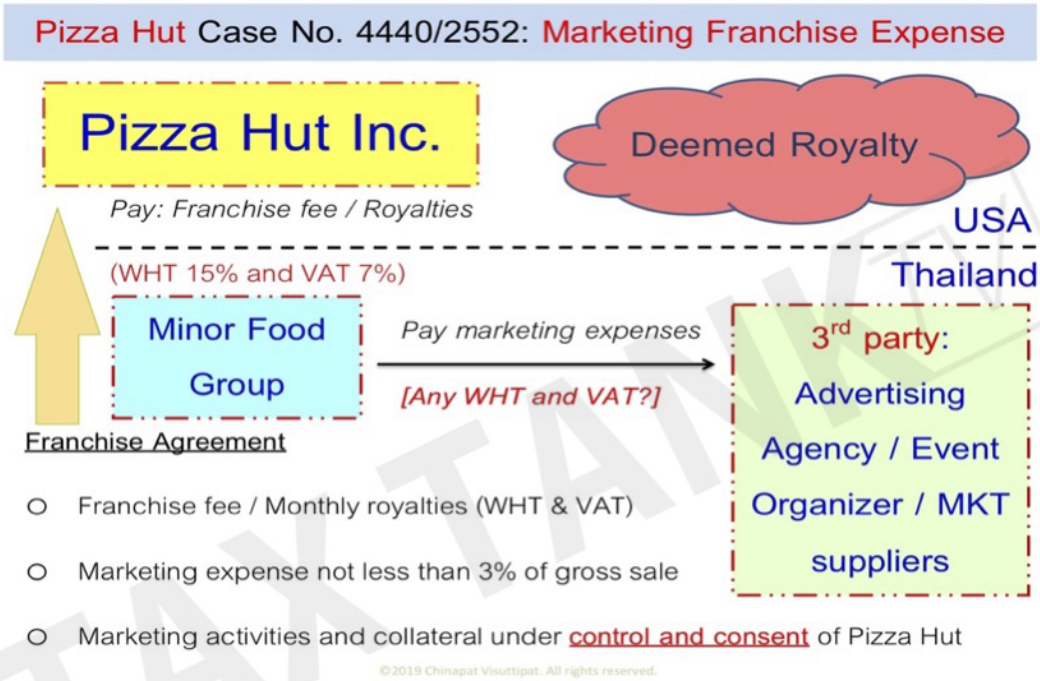
Franchise business is nowadays still one of the popular business models across the world. It was estimated that there was over 759,200 franchise establishments in the US in 2018, generating over 760 billion U.S. dollars and leading to over 8,000,000 people being employed.

In Thailand, there is going to be more than 500 business operators, as local franchisors, granting the right to use their brand, products and processes to over 100,000 franchisees. We believe that the substantial economic output in this industry is driven by ***cross-border franchise arrangements*** between the foreign franchisors in the US or Europe and the local Thai franchisees in the past years.

Franchise agreement with deemed taxable income

When considering cross-border franchise arrangement in the respect of ***tax planning***, the Thai Supreme Court case in 2010 (*The Minor Food Group Plc. v Thai Revenue Department*) continues to be invoked as there is still no clear subsequent cases overruling the notion rendered by the Supreme Court in such case for the past 10 years. In such 2010 case, the Thai franchisee (The Minor Food Group Plc) was obliged spend at the minimum 3% of its gross sale for the marketing activities in Thailand under the franchise agreement with its US franchisor (Pizza Hut) which was found to be a typical franchise contract where the franchisor will control and supervise all marketing activities including advertising and promotion schemes of products in the franchising territory. Please note that no financial benefits deriving directly or indirectly by the franchisor (Pizza Hut) from the marketing expenses that the franchisee (The Minor Food Group Plc) incurred in this case as they were paid only to third party suppliers. The Supreme Court ruled in favor of the Thai Revenue Department ("TRD") to force The Minor Food Group Plc to deduct withholding tax and self-assess value added tax (VAT) from such marketing expenses.

The notion was that the US franchisor gained a "deemed franchise fee" on the ground of "*other benefits derivable which can be into monetary value*" where such marketing expenses being paid by the franchisee for the benefit of the franchisor's brand without any costs to the franchisor.



It is suggested in the Remark of the Supreme Court Decision as an opinion given by one of the judges in this case that if the franchise agreement is silent on:

(i) the minimum requirement of the marketing expenses; and

(ii) the manner on which the franchisee shall comply in conducting marketing activities:

then, the marketing expenses would not be considered as the 'deemed franchise fee' of the franchisor.

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ONE Law Office Limited, 12th Floor, Mitrtown Office Tower

Unit 1204 – 1205, 944 Rama 4 Road, Wangmai, Pathumwan, Bangkok, 10330

It is our belief that such contractual conditions suggest by the judge above will not put a franchisor in a 100% safe zone since the underlying notion of this 2010 case is that the franchisor gains "something" indirectly from the calculatable expenses (marketing expense) paid by the franchisee. Thus, the concept of deemed royalty income could also apply even where no written agreement/requirement is made similar to subsequent tax case on deemed royalty in 2014 (*Electrolux Thailand Co., Ltd. v Thai Revenue Department*). We would say that that whether or not an expense be considered as a deemed income would be a 'case-by-case basis' issue.

ONE Law's Comments

A cross-border franchise contract may be revised to mitigate tax risks arisen from the interpretation adopted in this case. We advise the key terms and conditions in the contract be adjusted to be as follows:

1) Marketing expenses should not be relied on the gross sale of products.
2) Calculation basis of marketing expenses should be changed into other basis e.g. lump sum or fixed amount basis, reasonable cost allocation.
3) Franchisor should be altered to be a marketing consultant rather than marketing controller to approve all marketing activities.
4) Separate entity of franchisor providing marketing advisory services may be adopted.
5) Franchisee should be provided the freedom to share and lead in local marketing activities.

In the light of the above bullet point numbers 3) and 4), the service fee paid to the franchisor or its nominated entity for ***marketing consultancy/advisory services*** shall generally not be subject to withholding tax. The service provider, however, should note that the fee arising from such marketing consultancy/advisory service agreement could be considered as a 'royalty' under the position adopted by the TRD. In the TRD position, if the taxpayer cannot clarify that

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the services rendered under such agreement is more than making available to the service recipient the marketing materials used by the service provider for its own marketing activities, the service fee is likely to be treated as the nature of royalty.

Impact on local franchise arrangement

Although the Supreme Court Decision we refer to is in connection with cross-border franchise arrangement, the principle it established also applies to ***local*** franchises. A marketing expense may be a part of taxable income derivable by the local franchisor in terms of corporate income tax and VAT. It is advisable local franchise arrangement are reviewed in order to restructure or revise, if necessary, to avoid foreseen tax liabilities.

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Article Keywords: Franchise, Marketing Expense, Cross-Border Franchise, Franchise Marketing Fund, Franchise License, Franchise Fee, Franchise Agreement, License Tax, Deemed Royalty, Royalty Tax, Pizza Hut Tax Case

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ONE Law: In-charge of this article

Piyapat Pattanakitruang piyapat@onelaw.co.th

Apichon Sutthiphongkait apichon@onelaw.co.th

Areeya Ananworaraks areeya@onelaw.co.th

Chinapat Visuttipat chinapat@onelaw.co.th

For any further information, please contact:

Email: info@onelaw.co.th

Phone: +66(0)8-0554-8111