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FOR MORE INFORMATION

For more information on Dickinson Wright's Franchise and Distribution practice, visit http://www.dickinson-wright.com/practice-areas/franchise-and-distribution. Dickinson Wright is a full service firm with over 300 lawyers and officers in offices in Toronto (Canada), Arizona, Michigan, Nevada, Ohio, Tennessee and Washington DC.

DW PRACTICE NEWS

by Ned Levitt, Toronto Office

Exciting things are happening at Dickinson Wright LLP. We welcome the arrival of Paul Fransway, who will be working on U.S. franchise and distribution matters out of our Ann Arbor office. As a senior, highly experienced and highly respected, practitioner, Paul will bring a powerful new dynamic to our team and allow us to offer seamless franchise and distribution law services between the U.S. and Canada. Paul will co-chair our franchise and distribution law group with me. For those of you attending the International Franchise Association's annual convention in Las Vegas next month, please contact either Paul or me to arrange a meeting. We will be sponsoring the International Lounge again this year and look forward to hosting you there during the convention.

TAKE ACTION NOW TO AVOID UNEXPECTED STATE TAX LIABILITIES

by Paul R. Fransway, Ann Arbor Office

Traditionally, nexus for state income tax liability has required some type of physical presence or continuous contacts by the franchisor/distributor with a particular state. With the advent of taxing authorities asserting that all that is needed is "economic nexus," franchisors are now increasingly exposed to income tax liability based upon royalty revenue they receive regardless of its bricks and mortar in the state.[1] Furthermore, budget deficits in many states cause many states to become increasingly aggressive in the assessment and collection of taxes from nonresident franchisors. After all, it is more politically expedient to raise revenue from nonresident businesses than to impose new taxes on resident businesses. Considering this, franchisors should assume that they owe taxes not only in their home state but also in any state where they have franchisees, regardless of whether they have a physical presence in the state. Only through a proactive approach can tax liabilities be quantified and minimized. These include:

1. ***Conduct an overall review of current operations and relationships.*** A careful analysis should be conducted to determine the exposures that exist, returns that have been filed, states in which you have not only paid taxes, but also those with franchisees where you have not. This review should consider not only locations, but also the applicable law and franchisor activities that are conducted in a state.

2. ***Take action to limit risk.*** Examine where you have franchisees and have not filed a return even if you've received advice in the past that it was not necessary. As more states continue to adopt an economic nexus approach, it may only be a matter of time before these states begin to assert liabilities that were thought unlikely before the advent of the assertion of economic nexus theories. This review should also be conducted by foreign franchisors and distributors that do business in the U.S. For example, a Canadian franchisor may not be required to file a U.S. federal income tax return if they do not have enough physical presence in the U.S., but such franchisors may still be required to file returns and pay taxes to the states where they have franchisees if their franchisees are located in states where economic nexus is the law.

   Consider also whether the states where franchisees are located have unfavorable law or are aggressive in asserting liability on out of state franchisors. The danger is obviously greater with a state where the applicable law is favorable to the state and where the state has indicated a willingness to use it. If so, the problem is not going to go away by ignoring it. It will only get worse. It is important to remember that if there is no return filed, the statute of limitations will typically never run. If the state involved does assert liability for income taxes at a later date, the assessment will also usually require the payment of interest and penalties for not filing the required returns. These assessments can quickly become significant enough that the cost of even a valid challenge to the existence of sufficient nexus and the application of the tax will force a franchisor to consider an unfavorable settlement.

3. ***Determine if there are any voluntary compliance programs and examine total tax exposure in all states.*** A number of states have programs to encourage voluntary compliance with tax laws. While these programs vary from state to state, they will often include provisions that limit how far back the state will assert liability and that reduce or minimize penalties and interest. This may limit exposure. Conversely, the examination should also determine if there are any opportunities that could come from such a filing. For example, while the ability to apportion income and to claim credit for taxes paid to other states will vary depending upon the states involved, a franchisor in a high tax state may be able may be able to file amended returns reducing their taxation in their home state by apportioning income to the remote state. This may reduce or even eliminate the impact of the taxes paid to the franchisee's state.

4. ***Consider revisions to franchise agreements.*** An obvious partial solution is to include a provision that has the effect of passing the state income tax back to the franchisees in that state on a pro-rata basis, either through a tax indemnity or a "gross up" provision. This solution is not, however, without its problems. First, franchise agreements are long term agreements and it will often take 10 years or longer to have all contracts revised.[2] In addition, the gross up of the payments made to the franchisor increases the revenue received by the franchisor thereby further increasing the taxes due. Such a provision would also require disclosure of the franchisor's tax return that would not normally be available to the franchisee. Finally, but hardly less important, there is the potential for not only impaired goodwill with the franchise community but also adverse impacts upon their profitability as well. While the latter effect is not completely unfair considering that not all states have these tax regimes, that may be of little solace to the franchisee who is likely to think that this is nothing more than shifting the franchisor's tax to them.

   The evolution of the law and the need for states to increase revenue is likely to increase the risk associated with not proactively addressing these potential liabilities. The exposure, if not proactively addressed, will probably increase. To assure that all contingent liabilities that could impair the franchisor's balance sheet are addressed (and potentially it's marketability if a sale is ever considered), the sooner the issue is addressed the more manageable it is. Only a thorough examination of the facts and law of the states involved will limit risks that could affect the profitability of the company.

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[1]*See* KFC Corporation v. Iowa Department of Revenue, 792 NW2d 308 (Iowa 2010) *cert. den.* 132 S. Ct. 97, 181 L. Ed. 2d 26 (U.S. 2011).

[2] A discussion of whether such a change is a material change to the agreement and whether the franchisor has the ability to make such a unilateral change, even on renewal, is beyond the scope of this article.

NUTRITION INFORMATION COMING TO BOTH U.S. AND CANADIAN MENUS SOON

by Wendy G. Hulton, Toronto Office

The U.S. Food and Drug Administration (FDA) recently finalized two rules requiring calorie information on menus and menu boards in restaurants and retail food establishments that are part of a chain of 20 or more locations, doing business under the same name, and offering substantially the same menu items. The FDA rules will also require establishments to provide, upon consumer request, written nutrition information about total calories, total fat, calories from fat, saturated fat, trans fat, cholesterol, sodium, total carbohydrates, fiber, sugars and protein. Restaurants and similar retail food establishments will have one year from the date of publication of the menu labeling final rule to comply with the requirements.

In Canada, the province of Ontario is moving forward with similar requirements. On February 24, 2014, the Liberal government introduced Bill 162 Making Healthier Choices Act, 2014. Like the FDA's rules, Ontario's proposed legislation will require restaurant chains and other food service providers with 20 or more locations operating under the same or substantially the same name in Ontario to display the number of calories of all standard food or drink items on their menus, menu boards, displays and on one or more signs. It is worth noting that the legislation specifically includes a franchisor of a restaurant chain or other food service provider in the definition of a "person who owns or operates a food service premise" that is caught by the legislation. While the manner in which the definition is drafted creates some uncertainty on this point, the inclusion of franchisor in the definition of "person who owns or operates a food service premise" may mean that both the franchisor and its franchisee could be found liable for failure to display the number of calories of all standard food or drink items on their menus, menu boards, displays and on one or more signs. Bill 162, is now at second reading stage.

FDA: Food Labeling; Nutrition Labeling of Standard Menu Items in Restaurants and Similar Retail Food Establishments
https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-27833.pdf

Ontario: Bill 162 and its status:
http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&Intranet&BillID=2939

AODA IN BRIEF

by Christopher G. Graham, Toronto Office

The Accessibility for Ontarians with Disabilities Act, 2005 ("**AODA**") which serves as the framework for the Accessibility Standards for Customer Service (the "**Customer Service Standard**") and the Integrated Accessibility Standards (such standards, together, the "Standards"), exists to promote accessibility for Ontarians with disabilities with respect to goods, services, facilities, accommodation, employment, buildings, structures and premises. Each of the Standards apply to every organization with at least one employee in Ontario that provides goods or services to members of the public or other third parties. As such, both franchisors and franchisees are caught by the AODA and the Standards. The Customer Service Standard requires that certain policies and practices are prepared and implemented in the provision of goods and services to persons with disabilities, and requires training for employees.

The Integrated Accessibility Standards covers information and communications, employment, transportation and the design of public spaces. This Standard requires, *among other things*, certain policies to be implemented, training for employees and implements technical standards for websites. Most provisions under this Standard will apply to organizations with at least fifty employees by December 31st, 2014. Compliance with the provisions by organizations with fewer than fifty employees and other elements of the Standard in respect of employers with at least fifty employees will be phased in over the next several years. Amendments to the Ontario Building Code also take effect January 1st, 2015.

Organizations with at least twenty employees were required to file an accessibility compliance report on December 31st, 2012. A second accessibility compliance report is due from employers with at least 20 employees by December 31st, 2014. Thereafter, reports are due every three years.

For more information contact Ned Levitt or Andrae Marrocco.

FOOD SAFETY IN CANADA – MORE WORK FOR FRANCHISORS WHO IMPORT FOOD PRODUCTS

by Wendy G. Hulton, Toronto Office

The *Safe Foods for Canadian Act* (the Act) received Royal Assent in November 2012 and is anticipated to start taking effect at the beginning of 2015. Health Canada and the Canadian Food Inspection Agency (CFIA) have been busy consulting with stakeholders to develop new Regulations to support the Act.

The key goal of the Safe Food for Canadians Action Plan is to achieve the highest possible level of food safety for Canadians. As part of this effort, CFIA is in the process of developing a risk-based approach to its inspection activities on food commodities and establishments that pose the greatest risk for consumers. CFIA will also require all food manufacturers, including processed food manufacturers, to be licensed and have preventive control systems such as Hazard Analysis Critical Control Points. The Act includes provisions to register or licence importers, holding them accountable for the safety of the food commodities they bring into the country. Under the proposed regulatory framework, franchisors who import food products will need to implement the regulated food safety requirements and develop, maintain and retain Preventative Control Plans (PCPs). They will also have to develop systems to meet the new "one step forward one step backward" traceability requirements and will need to ensure compliance with new record-keeping requirements.

http://www.canlii.org/en/ca/laws/stat/sc-2012-c-24/latest/sc-2012-c-24.html

NAVIGATING THE CYBER LIABILITY STORM – PART II

by Andrae J. Marrocco, Toronto Office

Franchisors are facing a precarious three-way intersection of increased accountability and regulation over consumer privacy, the growing volume and sophistication of cyber-attacks on consumer data, and the expanding boundaries of franchisor liability for matters arising at the franchise unit level.

Two recent cases (*Aaron's, Inc.*[1] and *Wyndham*[2]) have raised awareness of the risky climate for franchisors in the realm of cybersecurity and privacy compliance. For a summary of these cases see *"Navigating the Cyber Liability Storm – Part I."*

Weathering the storm

In light of the *Aaron's*, Inc. case (notwithstanding the Privacy Commissioner of Canada's decision not to pursue franchisors) and the *Wyndham* case (which is yet to be finally determined), it would be wisdom of the most doubtful kind that would prevent franchisors from taking immediate action to develop information governance programs to protect their brands from potential data security breach liability.

Understandably (and yet in this case ironically), franchisors typically refrain from interfering with franchisee level operations (including as in this case providing services and guidance on matters such as cybersecurity) for risk of liability. This is part of the delicate balancing act that franchisors face in protecting their brand while avoiding direct and vicarious liability. Add to this the fact that addressing information governance across a franchise system is complex, time consuming and costly, and no governmental authority or court has to date offered guidance on how franchisors should develop information governance programs.

However, those issues and concerns are outweighed by the following factors that militate in favour of the franchisor taking action with respect to cybersecurity and information governance: (i) first and foremost, the reputational harm and economic impact of addressing cyber-attacks can be formidable (one study put the average financial expenditure in dealing with after effects at $5.5m); (ii) franchisees do not have the necessary financial or human resources to develop and maintain appropriate information governance programs on their own; (iii) it is apparent from the cases above that the computer systems of franchisees and franchisors are often interconnected, making cybersecurity a joint responsibility; (iv) the cases articulate an obligation imposed on franchisors to create cybersecurity policies and programs for franchisees and to oversee and monitor their practices; and (v) taking a proactive approach in developing robust policies and procedures and monitoring compliance will provide increased protection against cyber-attacks and will also provide a defence in circumstances of data security breach liability.

Practical steps

Franchisors should take the following steps in developing their information governance program.

Invest human capital. The best intentions will not develop or implement a robust information governance program. Franchisors need to dedicate the requisite human resources to the project by identifying people that are responsible for data management and privacy compliance, complement as necessary (perhaps with management level officers), and assemble a functional project team to address information governance.

Audit and risk assessment. Undertake a review of existing policies and procedures with respect to information governance together with current practices relating to the collection and maintenance of data and cybersecurity. Take time and care to identify vulnerabilities, and potential risks; Canvass and consider alternative industry practices (including current hardware and software applications used).

Develop an information governance program. This is an expansive project. It incorporates the entire process by which the franchise system collects, uses, stores and ensures the security of data (including the approach to privacy and data compliance). Part of the program will involve determining the apportionment of financial and practical responsibilities between the franchisor and the franchisee. In certain circumstances, it may be justifiable for the franchisor to impose a fee for services provided as part of the program (e.g. in setting up systems for the franchisees).

Training and monitoring. Determine the appropriate level of training required and whether such training will be provided internally or outsourced. The same consideration applies to monitoring of the information governance program. Organizing external training/ monitoring periodically provides opportunity to have ongoing independent assessment of your information governance program. It is critical that franchisees are provided with all possible resources to ensure the success of the program.

Compliance. Include in the franchise agreement a provision requiring compliance and commitment to the information governance program (referenced as being part of the operating manual). The details of the program should be included in a separate chapter or segment of the operating manual to allow for more efficient and practical updating.

Updating. Given the increasingly rapid pace at which technology continues to advance, and the sophistication of cyber-attacks, the information governance program should be reviewed and updated on a regular basis. Undoubtedly, policies, procedures, systems, hardware, software etc will require updating across the franchise system.

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[1] Aaron's, Inc., 122 FTC 3264 (2014) (Docket No. C-4442)

[2] Federal Trade Commission v Wyndham Worldwide Corporation, No. 13-cv-01887, (U.S. District Court of New Jersey, April 7, 2014)

NON-RESIDENT FRANCHISORS MAY PAY WITHHOLDING TAX ON RENEWAL FEES RECEIVED FROM CANADIAN FRANCHISEES

The Canadian Revenue Agency's Income Tax Rulings Directorate published a ruling on March 27, 2014 which may have significant implications for franchises. The CRA was asked to consider whether a franchise renewal fee paid by a resident to a non-resident was subject to withholding tax. The CRA determined that, at least in the circumstances it was considering, a cross-border franchise renewal fee ***is*** subject to a withholding tax under subsection 212(1)(d)(i) of the Income Tax Act (the "Act"). Subsection 212(1)(d)(i) of the Act provides for an income withholding tax of 25% on all amounts paid or credited to a non-resident person by a resident as, on account or in lieu of payment of, or in satisfaction of "rent, royalty or a similar payment." The terms "rent" and "royalty" are not defined by the Act, but generally speaking, a rent or royalty represents payment made to the owner of property for the right to use the property for a given period of time. The CRA determined that a renewal fee paid by a franchisee to a franchisor for the right to use a franchise in Canada for a given period of time is considered rent, royalty or a similar payment for the purposes of the Act. Therefore section 212(1)(d) applies, and the non-resident recipient of the renewal fee is required to pay a withholding tax.