

TIP 114 - Franchises

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Warning

These notes are not intended to provide an exhaustive or definitive picture. Any tactical tips must be treated with a 'health warning' as the BIU cannot test or validate theories or ideas submitted to it, but merely supplies information to be used with **common sense and discretion**.

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Links to the Internet

There are a number of **references to Internet** addresses scattered throughout this note. These are not linked and need to be accessed separately from this TIP.

Reference to commercial organisations and products

This TIP may contain references to commercial organisations, together with reference to specific products or services. Please note these are included for example purposes only and are not endorsements of the organisations, products and services.

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Introduction

Franchising is essentially where one person (the franchisor) gives permission to another (the franchisee) to use the franchisor's trade name, trade marks and business system, in return for an initial payment and further regular payments. The franchisor exercises control over the franchise and provides assistance to the franchisee. Some businesses choose to grow by granting franchises rather than in the conventional way. Companies may put out all or some of their outlets to franchise. The vast majority of franchisors have single unit franchisees. Most franchisees operate as a single unit but some franchisees may take on several outlets and in turn sub-franchise these to others.

Each business outlet is owned and operated by the franchisee but the franchisor retains control over the way in which products and services are marketed and sold, and controls the quality and standards of the business. The franchisee has to purchase all goods and/or services from the franchisor.

Compared with other small businesses, franchising has proved to be successful and trade sources suggest that franchises are less likely to fail than other types of small business organisation.

The nature of franchising lends itself to the service industries, with catering and retail particularly well represented. Whilst it is difficult to generalise about the type of individuals attracted to franchising, recurring features have been found to include no previous experience of self-employment and little direct experience of the sector in which the franchisee chooses to operate. The required start up costs frequently determine the final choice with capital often coming from a combination of personal savings (possibly redundancy payments) and loans facilitated by the franchisor.

The British Franchise Association conducts an annual survey in association with NatWest. The survey provides an in-depth analysis of franchising in the UK. The key findings from the 2005 survey are reproduced at Appendix 1.

First and Second Generation Franchises

First Generation Franchises

The car and brewing industries were the first to regularly use commercial marketing agreements resembling modern franchise agreements. The brewing industry developed tied house agreements between brewers and pub landlords, whilst the car industry developed dealerships between vehicle manufacturers and dealers. These supply dealership arrangements are referred to as “first generation” franchises because they lack the two essential elements of modern “second generation” franchises.

Second Generation or Business Format Franchises

The two essential elements of second generation franchises are:

- the franchisee operates the business under the franchisor’s trade name or trade mark so that to the outside world the franchisee is the franchisor
- the franchisor must be able to exert substantial influence and control on the way that the franchisee operates its business.

It is with second generation franchises, which started in and since the franchise boom of the 1950s, that this TIP is concerned.

Other Commercial Marketing Agreements

Franchising should be distinguished from other similar marketing arrangements, details of which are given below.

Distribution Agreements

A manufacturer or a supplier of goods appoints an independent third party distributor to market its goods. The distributor buys the goods on their own account and trades under their own name. The distributor may be appointed by one or any number of manufacturers or suppliers. Their business name will usually have no connection with the name of the supplier of the goods. Nor will the supplier regulate the way in which the distributor operates other than, perhaps, to require the distributor to reach minimum turnover levels, advertise, maintain a minimum stock of goods and spare parts and to meet servicing criteria. The distributor does not pay royalties. The manufacturer or supplier makes its profit solely on the mark-up on the goods it supplies to the distributor.

Although there are essential differences between franchising and distribution, franchising has developed from distribution agreements.

Licensing Agreements

Intellectual property rights or know-how may be licensed to enable another manufacturer to produce and/or sell goods. While most franchise agreements contain a licence to use the franchiser's trademark, brand name and know-how, franchise agreements are unlikely to relate to the manufacture of products. A licensor simply imposes quality control restrictions in relation to the goods to be produced according to the licence and does not regulate the way in which licensees operate their businesses.

Agencies

A manufacturer or supplier appoints an agent to act on its behalf in exchange for commission on sales. The agent never buys products on their own behalf, but arranges purchases by a third party who will usually make payment direct to the agent.

Multi-Level or Network Marketing

Self-employed distributors sell goods on a manufacturer's behalf, gaining commission on their own sales and on sales made by secondary distributors they have recruited.

This area of guidance had been withheld because disclosure would prejudice the assessment or collection of taxes/duties or assist tax/duty avoidance or evasion.
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Franchise Fees

Franchisees generally make the following types of payments to franchisors:

- The initial franchise fee, a capital payment which entitles the franchisee to trade under the name of the franchisor subject to adherence to the restrictions and guidelines set out in the contract. There will also be other initial business costs such as premises and equipment, stock and other supplies, usually bought from the franchisor.
- Continuing, usually annual or monthly, management payments, usually based on a percentage of annual turnover or mark-ups on supplies. These are known as royalties or monthly management fees.
- The franchisor may also require ongoing payments in respect of further training, marketing and research. Advertising levies are quite common, not just to enable the franchisor to undertake national advertising, but also for the franchisor to advertise for prospective franchisees. Some franchisors may also demand a contribution towards the cost of training, while others include this in the initial franchise fee.

In return the franchisor supports their franchisees by providing training, product development, advertising, promotional activities and various management services.

The distinction between capital and revenue payments is of course crucial and some information and reference points can be found at Technical Considerations.

The Franchise Contract

This is the legal agreement between the franchisor and the franchisee which sets out the terms under which the franchisee operates the business. Whilst contracts vary from franchise to franchise, the basic contract normally includes:

- the right to use the trade name
- the franchisee's obligations
- the franchisor's obligations
- the premises and the territory
- duration of franchise contract
- exclusivity
- financial aspects such as the initial franchise fee, ongoing royalties (including method of calculation and payment), advertising fee
- renewal terms
- control of standards and training
- performance targets
- records and accounts
- insurance
- equipment and products
- marketing, advertising and promotion
- rights of sale
- termination
- effects of termination.

Contract terms are normally between 5 and 10 years although some run for 15 years.

The franchisee is usually given an Operations Manual which sets out how the franchisee should operate. This is the system that the franchisee has bought and must follow. It is based on the franchisor's experience, best policy and procedures.

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Costs and Profitability

Initial and recurring costs vary significantly between franchisors and to some extent are determined by the sector in which the franchisee operates. Requirements in terms of premises, equipment and staff are the main variables, and most franchisors will insist on a minimum level of working capital to ensure that the trader can operate effectively. As the franchisee is largely buying the reputation of the company, which may be a household name, the franchisor has a vested interest in ensuring the success of each operation. Failures and a drop in standards will clearly have a detrimental effect on the good name of the brand or product.

Regulation of Franchising

Trading Schemes Act 1996

Nearly all franchise agreements fall within the scope of the Trading Schemes Act 1996. This relates to the practice of pyramid selling which arises when franchisees are encouraged to appoint, or find it more profitable to use, sub-franchisees (who in turn may also use sub-franchisees) to sell goods or services that are the subject of the franchise. Agreements must comply with the Trading Schemes legislation unless they fall within one of two exclusions:

- single tier trading schemes under which all UK participants/franchisees operate at a single level except for the franchisor – this excludes many UK franchisees
- if all the franchisees in the network are registered for VAT.

If a franchise agreement falls within the scope of the Act:

- the franchisor will be subject to advertising restrictions which regulate the content of advertisements promoting trading schemes, breach of which constitutes a criminal offence
- new franchisees joining trading schemes are entitled to a 14-day cooling-off period before they are bound by agreements with franchisors, and agreements must contain specified information, including warnings.

Self-regulation

The British Franchise Association requires its members to comply with the European Code of Ethics for Franchising. As such the franchisor must:

- have operated a pilot operation before launching the franchise
- be the owner of all relevant brand names and trademarks
- provide both initial and continuing training.

A pilot operation is a company-owned outlet operated as if it were a franchised outlet. Such operations are normally open for one or two years.

The Code also implies obligations on both the franchisor and the franchisee to deal fairly with each other and on the franchisor in relation to recruitment, advertising, disclosures, franchise selection and the franchise agreement.

The British Franchise Association

The BFA, www.british-franchise.org, is the single regulatory body for franchising in the UK. It is a voluntary organisation representing principally the franchisor, but as membership requires certain minimum standards to be met, it acts to some extent as a safeguard for franchisees. It is a non-profit making body responsible for developing fair and ethical franchising through its member franchisor companies. The BFA's aims are:

- to develop and continuously improve standards of good practice in franchising
- to accredit franchisors who meet those standards
- to promote good franchising, as represented by accredited franchisors, to the general public, the business community, government and the media
- to provide to the public, as prospective franchisees, information and education to help them make effective judgements in choosing the best franchise for them.

To be a member of the BFA, a franchisor must:

- demonstrate that the business itself is viable
- demonstrate that the operating units in the business can be successfully replicated
- demonstrate that the contractual terms to be offered to prospective franchisees comply with the BFA's Code of Ethical Conduct
- demonstrate that the offer documents to be used with prospective franchisees present a full and realistic picture of the franchise proposition.

A full list of Full and Associate members can be found on the BFA's website: www.british-franchise.org/members.asp.

The National Franchise Forum

The National Franchise Forum, www.british-franchise.org/franchiseeforum/index.asp, is the part of the BFA representing the franchisees. The forum has a key role in contributing to the formation of BFA policies and meets to discuss issues affecting franchising.

BFA Survey

The BFA conducts an annual survey in association with NatWest. The survey provides an in-depth analysis of franchising in the UK. The key findings from the 2005 survey are reproduced at Appendix 1.

This area of guidance has been withheld because disclosure would prejudice the assessment or collection of tax/duties or assist tax/duty avoidance or evasion.

Useful Addresses

<p>British Franchise Association</p> <p>Thames View Newtown Road Henley on Thames Oxon RG9 1HG</p>	<p>Business Franchise</p> <p>20 Ashbourne Road Warrington WA5 1LW</p>
<p>The Franchise Business</p> <p>6 Wight View Bembridge Drive Hayling Island Hampshire PO11 9LU</p>	<p>Franchise Development Services Ltd</p> <p>(Publishes The Franchise Magazine and The UK Franchise Directory)</p> <p>Franchise House 56 Surrey Street Norwich NR1 3FD</p>
<p>Franchise World</p> <p>(Publishes Franchise World and Franchise World Directory)</p> <p>Highlands House 165 The Broadway Wimbledon London SW19 1NE</p>	<p>International Franchise Research Centre</p> <p>University of Westminster 35 Marylebone Road London NW1 5LS</p>

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Technical Considerations

The basic premise is that the initial payment insofar as it secures the right to trade under the terms of the contract, is capital in nature. The question is dealt with in greater detail at CG68100 to CG68109, and BIM57600 to BIM57620.

Any claim that the initial payment wholly or partly represents a payment for know-how and therefore attracts capital allowances is unlikely to be valid - see CA70030.

See also CG68600 to CG68619 regarding franchises and goodwill and CG76724 regarding wasting assets.

Glossary

Area Developer	A regional-size franchisee who has the rights to expand a region by either appointing sub-franchisees or managed outlets.
Block Exemption	The European Union concessions to franchising which bypass the normal EU anti-restrictive trade practices legislation seeking to protect competition which, for example, exclusivity clauses can be deemed to contravene.
Business Format Franchise	See 'second generation franchise'.
Disenfranchise	The withdrawal of the rights of the franchise.
Ethical Franchise	A franchise that is operated according to ethical business standards usually referring to the ethics as promoted by the British Franchise Association.
Exclusive Area	A territory assigned to franchises with undertakings that the franchisor will not trade in the area nor will other franchisees be appointed or allowed to trade within the area.
Franchise Agreement/Contract	The agreement between the franchisor and the franchisee describing the terms of the agreement, the rights and obligations of both parties.
First Generation Franchise	Usually used to identify early franchises – car manufacturers, oil companies and soft drink bottlers who used franchising principally as a means of distribution.
Fractional Franchise	Where the franchise is only part of the franchisee's interest. Usually related to premises e.g. a franchise shop within a department store.
Franchisee	The individual, company or partnership which buys a franchise or licence from the franchisor.
Franchise Package	The sum total of franchise system rights licensed to the franchisee, including branding, know-how, systems, territory and initial training for which the franchisor charges an Initial Franchise Fee.
Franchising	Method of marketing goods and services via a proven business formula licensed for others to copy.
Franchisor	The company which operates the franchise and sells franchises to franchisees. In some cases the franchisor can be a franchisee of a franchisor i.e. an intermediary franchisee.
Job Franchise	A franchise type in which the franchisee is a hands-on owner-operator rather than a manager, usually linked with van-based services such as cleaning, maintenance and supplies.
Joint Venture	Operation where the franchisor also takes a financial stake in the project.
Know-how	The intellectual property i.e. the systems, methods and expertise of the franchisor.
Location Franchise	A franchise operating from fixed premises where the premises tend to be an important part of the business operation i.e. retail premises where customers visit.
Management Franchise	A franchise in which the owner manages the operation and co-ordinates operatives to do the actual work while the owner focuses on business-building.
Master Licence	A franchisee who usually has responsibility for more than one outlet

	and is commonly totally responsible for the development of the franchised business (through other franchisees) in an area.
Mobile Franchise	Usually a vehicle-operated franchise which goes out to serve customers e.g. car tuning, windscreen replacement and cleaning services.
Multiple Franchising	A franchisee who operates more than one, of a specific franchise, outlet.
Network	Usually applied to the whole franchise organisation.
Operations Manual	The detailed manual provided by a franchisor to a franchisee to operate the business. It will include administrative as well as actual operational instructions.
P&L Projections	The calculations, based on the franchisor's pilots or franchisees' experiences, which try to predict how soon franchisees can expect a return on their investment.
Pilot Unit	The test model or outlet set up by the franchisor.
Pyramid Selling	A marketing system, erroneously associated with franchising in the past, which involves selling distributorships through a tiered structure. The founders of such schemes rely primarily on selling distributorships rather than products. Several Acts of Parliament govern pyramid selling in the UK.
Regional Franchise	Another term for 'Area Developer'.
Re-sale	A franchised area already developed by a franchisee, offered for sale. More expensive than a completely new franchise area, but with the advantages of an ongoing customer base, referrals, goodwill and income from day one.
Return on Investment	The calculations or expectations which franchisees work on to assess when they can break even on their initial investment in the franchise and start earning profits.
Royalties	Ongoing fees paid to the franchisor by franchisees in respect of ongoing training and support services provided, usually a percentage of turnover.
Second Generation Franchises	A form of franchise in which the franchisee buys into a total system of brand, know-how, training, methodology and support. Also known as Business Format franchise.
Term	The agreed period of years for which a franchise is granted through the franchise agreement.
Termination	The legal provision by which either party in the relationship may terminate the contract e.g. for breach of contract.
Tie-ins	Where part of the agreement is for the franchisee to buy product from the franchisor, often justified in terms of quality control or cost.

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Appendix 1 – British Franchise Association Survey 2005

General

There are 718 franchise systems in operation in the UK.

There are an estimated 327,000 people employed in franchising.

The average initial cost of starting a franchise is £42,200 (including franchise fee, working capital, equipment and fittings, stock and materials).

88% of franchisees claim to be profitable.

The average turnover for franchised businesses is £291,000.

On average franchisees pay an estimated 7.7% of their sales in recurring fees to their franchisors.

The two biggest sectors are Business & Commercial Services and Property Services.

Training is provided by 100% of franchisors, with 73% conducting in-house training and 26% providing a mix of in-house and external training.

Relationships

39% of franchisors report that a lack of suitable franchisees continues to thwart their plans.

Relationships between franchisees and franchisors are healthy, with 86% reporting satisfaction in their dealings.

International Presence

The number of British-run franchise systems with an international presence has risen to an estimated 222 (31% of total).

Amongst franchises that have been established for seven or more years, 35% have overseas operations.

35% of franchisors have plans to expand abroad.

Profile of Franchisees

Self-motivation remains the most important attitude sought (59%), followed by sales and marketing experience (45%).

80% of all franchisees are married.

79% of franchisees are male.

The average age for a franchisee is 45.

Two-thirds (65%) of franchisees were in salaried employment immediately before taking out their current franchise.

This area of guidance has been withheld to protect third party data.
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