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An Important Change for Canadian Franchisors Operating in the United States

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All companies franchising in the United States were required to convert their U. S. franchise disclosure documents from the Uniform Franchise Offering Circular format to the new Franchise Disclosure Document (FDD) format by July 1, 2008. Now that the dust has settled on the great disclosure document conversion, we can reflect on the implementation of the required changes. Of particular note to Canadian franchisors operating in the United States, the Revised FTC Franchise Rule (the Revised Rule) and its new FDD format expand the disclosure obligations for parent entities.

For a variety of tax and other reasons, most Canadian franchisors operate in the U. S. through a separate U. S. subsidiary. Previously, disclosure of the parent’s financial statements was only required if the parent guaranteed the obligations of the U. S. subsidiary. Under the Revised Rule, the FDD must also include separate financial statements for any parent that commits to perform post sale obligations for the U. S. franchisor. All required financial statements must be prepared under U. S. GAAP and GAAS, and the auditor complies with U. S. standards for auditor independence. I know of one case where a Canadian franchisor was successful in meeting these requirements.

The good news is that there is a way to avoid parent financial statement disclosure. For cross-border tax planning reasons it is generally preferable to separate ownership of the Canadian operating company and the U. S. operating company so that there is no parent/subsidiary relationship between them. Under this type of structure, the Canadian franchise operating company that commits to perform post-sale obligations for the U. S. franchisor is not a parent. The FTC staff has made it clear that an affiliate’s financial statements are only required if the affiliate guarantees the franchisor’s obligations, unless the affiliate is a parent.

The FTC staff provides further leeway. It states that the disclosure of parent financials is required only when (i) the franchisor’s parent formally commits to perform post-sale obligations for the direct benefit of franchisees, (ii) the post-sale obligations go beyond administrative and other services for the franchisor’s internal purposes, and (iii) there is more than a single or isolated obligation. In addition, franchisees must be specifically looking to the parent to provide the services (and not simply because an employee of the parent working for the franchisor provides the service).

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This is potentially a problem for Canadian-owned franchise systems for two reasons. One, often the U. S. subsidiary does not function independently of Canadian operations. In the early stages of U. S. expansion, franchisees may be sent to Canada for training, Canadian employees participate in sales and development, and the Canadian entity provides management and administrative services. Two, most Canadian franchisors don’t have their financial statements audited. Under provincial franchise disclosure laws, required financial statements need only be reviewed. Even if audited, they would be prepared and audited under Canadian GAAP and GAAS.

The Revised Rule provides an alternative to the U. S. GAAP requirement. Financial statements prepared under Canadian GAAP may be used if they: (i) explain the material differences between U. S. GAAP and Canadian GAAP, (ii) are reconciled with U. S. GAAP, (iii) provide all additional disclosures required by U. S. GAAP and SEC regulations (See SEC Form 20-F, Part III, Items 17 and 18), and (iv) are audited under U. S. GAAS, and the auditor complies with U. S. standards for auditor independence. I know of one case where a Canadian franchisor was successful in meeting these requirements.

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