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Franchisor considerations when establishing a brand fund

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JUNE 5, 2023



An essential element in the long-term success of a franchise is establishing a brand fund, but it comes with several potential issues that require diligence and research from both franchisors and franchisees.

Most franchisors require their franchisees to contribute a certain amount of money to a system-wide advertising, marketing and/or brand fund. This brand fund contribution generally ranges from 1% to 4% of the franchisee's monthly or weekly gross revenue. These contributions are collected by the franchisor and then spent on advertising, marketing and promotional items on behalf of the franchise system. By pooling funds, a franchisor will have the resources needed to create a successful nationwide campaign with long-term brand recognition and goodwill that

will benefit not only the franchisor, but also all the franchisees.

However, in the first few years of the franchise system, new and emerging franchise brands may not establish a brand fund on day one or require its franchisees to pay brand fund contributions at the outset. Instead, franchisors reserve the right in its franchise agreement to establish, maintain and administer a brand fund in the future. As the franchise system grows, a franchisor may find that a brand fund is necessary to efficiently promote its brand at a regional and/or national level with a unified campaign.

When a franchisor establishes a brand fund and requires franchisees to begin contributing to it, there are a couple items to keep in mind.

Taxation of a brand fund

The Internal Revenue Code of 1986, as amended does not specifically address whether the receipt of contributions to a brand fund is includible as gross income. Taxpayers have argued that the receipt of contributions by taxable organizations that are specifically dedicated to future use and subject to certain obligations such as advertising are held “in trust” and therefore, should not be included in gross income and subject to tax. Historically, the IRS has rejected this trust fund theory. However, the courts have consistently held in favor of the taxpayer and support the trust fund theory.

The seminal case in this area is *Seven-Up Co. v. Commissioner*, 14 TC 965 (1950). The U.S. Tax Court in this case held that contributions received by Seven-Up from its bottlers for advertising were *not* includible in Seven-Up’s gross income because the amounts contributed by the bottlers constituted a trust fund for advertising purposes which Seven-Up administered as an agent for the bottlers. The court further explained that Seven-Up did not receive the bottlers’ contributions as its own property, but instead it was burdened with the obligation to use such contributions for national advertising. Therefore, no gain or profit was realized by Seven-Up upon the receipt of the contributions because of this offsetting obligation.

More recently, the IRS determined in PLR 9834003 that the promotion funds the taxpayer, a food broker, received from food manufacturers were includible in gross income, except where the taxpayer was required by oral contracts to keep the funds in a separate bank account. The IRS rejected the taxpayer’s argument that it had received the funds as a trustee or as a custodian/agent for the food manufacturers, since the taxpayer consistently used the promotion funds for its general operating expenses. However, an enforceable trust existed where the taxpayer was required to keep the promotion funds in a separate account. This 1998 PLR seems to hint that the IRS maybe softening its stance towards the trust fund theory.

To bolster a franchisor’s position that receipt of contributions to a brand fund is not includible as gross income, the franchisor should:

- Maintain the brand fund in a separate account or entity.
- Restrict in form and operation the use of the brand funds to advertising, marketing, promotional activities and other related activities.
- Clearly document all brand fund payments especially if the payments are made to the franchisor for

permitted services.

- Establish policies so the franchisor does not benefit from the brand fund except from improved brand recognition generally and/or goodwill.
- Make sure the franchisor has a clear obligation to spend the contributions to the brand fund within an established timeframe.

Drafting brand fund terms

A franchisor should make sure the franchise agreement (or in other related agreements) clearly set forth how the brand fund contributions are to be collected and spent. That reduces not only the risk of taxation, but also reduces any misunderstandings that may occur between the franchisor and its franchisees with respect to the use of the brand fund contributions or the purpose of the brand fund. For example, the franchisor should always disclose that the brand fund contributions may not benefit any specific franchisee directly and also may not be spent in each franchisee's territory equally. Such misunderstandings could elevate to a costly lawsuit that would have been avoided with some foreplanning.

Instinctively, a franchisor may be tempted to set forth its authority to use the brand fund contributions as broadly as possible and include specific authority for reasonable expenses, such as costs of administering the brand fund, litigation expenses, and other overhead expenses for maintaining the brand fund. However, be careful that this authority is not overly broad as to risk taxation. As set forth above, the use of a brand fund should be subject to clearly defined limitations and restrictions to reduce the risk of taxation. For example, the franchisor can list, as applicable, that the brand fund contributions will be used for national television ad placement, social media content production, and/or email marketing content. The franchisor may also want to include explicit authority to use the brand fund in non-traditional or emerging forms of advertising or marketing, or even in ways that are not currently in existence. Such a broad provision is permitted so long as the contemplated activities are directly related to advertising or marketing.

The establishment of a separate brand fund necessarily results in administrative duties and maintenance responsibilities. A franchisor may want to shield itself from some of the liabilities that arise from these duties and responsibilities by including written disclaimers to the fiduciary duties in the administration and maintenance of the brand fund. Such disclaimers may be included in the franchise agreement or in other related agreements.

Transparency and accounting

Based on the currently available guidance, for a franchisor to be in the best position to avoid taxation of its brand fund, the contributions to the brand fund should be held in a separate account or entity. Due to this separation, regular accounting of the brand fund is recommended as best practice. Regular accounting will provide comfort to interested franchisees that the contributions are being properly used, and no commingling or unjust enrichment has occurred. Also, it is proof of separate treatment for federal income tax purposes.

A franchisor should frequently communicate with its franchisees not only as to the brand fund's current financial

status through regular accounting, but also about its advertising, marketing and promotional goals and long-term strategy. This transparency will help ease any anxiety the franchisees may have as to the necessity and purpose of the brand fund. Also, a franchisor may even consider soliciting input from its franchisees as to the preferred goals and strategies of the brand fund.

Conclusion

Establishing a brand fund is a key step for a franchisor and should not be taken lightly. There are different structural and administrative issues to consider at the outset, but once those are resolved, the buying power of a pooled brand fund outweighs the downside. Being able to understand and anticipate these different issues prior to establishing a brand fund and collecting contributions will help ensure the brand fund established by the franchisor is in the best position to avoid taxation and reduce franchisee litigation.

If you have any questions about brand funds for franchisors or their tax treatment, please contact [Pauline Markey](#)

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