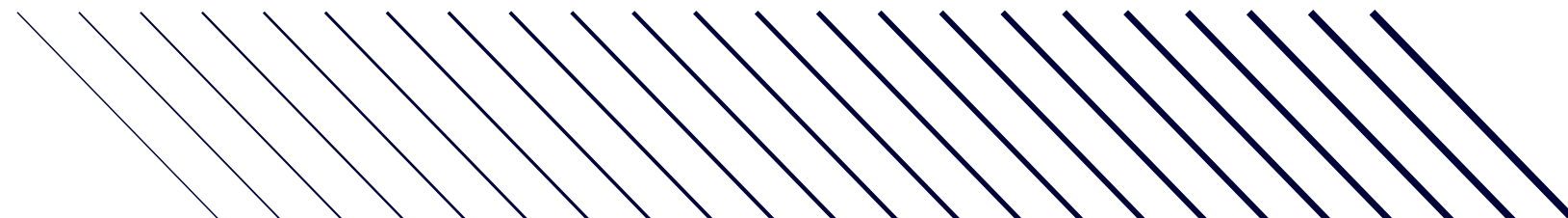




FRANCHISE FRAMEWORK IN KAZAKHSTAN

2023



INTRODUCTION

Franchising has been used as a route to the Kazakhstan market by overseas businesses since the 1990s when brands such as Coca-Cola, Adidas and InterContinental appeared on the market. Over the past years, the country's strong economic growth and rising household incomes have prompted other foreign franchisors to turn their sights on the country, quickly becoming a leading market in Central Asia. International brands such as Zara, Pizza Hut, Debenhams, Mothercare, H&M, KFC, CHARLES & KEITH, Ipekyol, Bobbi Brown and many others are currently represented in the market.

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Foreign and domestic brands use franchising as a business system in nearly every industry that contains small and medium-sized businesses. However, as in other Central Asia markets, it is most common in the fast-food and casual dining, retail and leisure, and services sectors. Many foreign franchisors prefer to work based on subfranchising agreements with master franchisees in other countries rather than contracting directly with Kazakhstani partners. However, the number of direct franchises is growing.



A range of agencies and associations are interested in promoting franchising and foreign business in Kazakhstan. The Kazakhstan Franchise Association (KAZFRANCH) was created with the support of the US Agency for International Development as a non-governmental industry group to promote franchising by offering various services, including consultation, information, matchmaking programmes and other educational events. The Franchise Union of Kazakhstan provides education and referral services and general advice on franchise arrangements and practices. However, associations such as the Eurasian Franchise Association and Central Asian Franchising and Licensing Agency have also previously taken on similar roles.



The Kazakhstan government established the Entrepreneurship Development Fund JSC (EDF) in 1997 to support and promote small businesses in Kazakhstan, providing financial and non-financial support to small and medium-sized enterprises. The EDF also works alongside the state to improve financial resource management and the allocation of funding to small businesses[1].



[1] DAMU Entrepreneurship Development Fund JSC, «National project on entrepreneurship development for 2021-2025»). Accessible from: https://damu.kz/programmi/guarantee/nproject_guarantee/

II. MARKET ENTRY

Franchising in Kazakhstan is regulated by specific franchise legislation and general commercial law that varies between sectors and according to the structure of the commercial relationship.

One of the essential steps for franchisors contemplating entering the Kazakhstan market is protecting their intellectual property – particularly any trademarks or know-how that will be licensed to and used by a local franchisee. Kazakhstan’s intellectual property regime is relatively sophisticated, recognising that exclusivity arises in relation to various types of intellectual property. Kazakhstan is a member of many of the major international organisations – including the Singapore Treaty of the Law of Trademarks, the Trademark Law Treaty, the Treaty on Trademarks, Service Marks and Appellations of Origin of Goods of the Eurasian Economic Union, the Paris Convention, and the Madrid Agreement Concerning the International Registration of Marks – and trademarks, service marks, utility models and other industrial designs are generally capable of being registered.

In most areas of business, Kazakhstan law does not require any approvals and does not contain any restrictions for franchisors to enter the local market. Contrariwise, the law provides for the support and promotion of franchising in the country. Besides, Kazakh legislation is not overloaded with details, nuanced obligations, and restrictions in governing relationships between the parties to franchise agreements. In this regard, there are no specific restrictions or limitations to a foreign entity granting a license, franchise, master franchise, or development rights to a local entity.

In most cases, the laws do not restrict foreign franchisors from owning equity in a local business or owning real property. However, certain restrictions can be specified regarding owning equity, where business is associated with the area being strategic for the state, such as telecom, communications and other issues relating to national security and public safety. In addition, there are some restrictions for foreign nationals and entities in terms of owning real estate in Kazakhstan.

Franchisors should also consider the geographical issues involved in entering the Kazakhstan market. Kazakhstan is a large country with a very low population density, with fewer than seven people per square kilometre[2]. Astana, Almaty, and Shymkent are the largest cities by population but account for a very small fraction of the country’s total population. Franchisors should therefore undertake careful due diligence on the geographic reach of any potential local partner and consider how best to treat any possible exclusive arrangement.

Payments made between Kazakhstan residents (whether entities or individuals) must be made in the local currency, the Kazakh tenge. Under the Law on Currency Regulation and Control No. 167-VI dated 2 July 2018, payments made between residents and non-residents may generally be in any currency. However, certain transactions must be notified to or registered with the National Bank of the Republic of Kazakhstan (the Bank). A franchise agreement falls under currency regulation as an import (or export) of goods (and/or works, services) operation. Depending on the terms and payment obligations of the parties under a franchising agreement (e.g. obligation of a resident to pay more than US\$500,000), the Bank provides for registration or notification regime for the franchising agreement.

[2] Government website, ‘About Kazakhstan’, accessible from <https://www.gov.kz/article/19305?lang=en>.

III. FRANCHISE LAW

Legislation

Franchisors need to be aware of two critical areas of legislation when entering the Kazakhstan market. The Law of the Republic of Kazakhstan No. 330-II on Complex Entrepreneurial Licence (Franchise) (the Franchise Law) was passed in 2002 and is a law specifically regulating franchises in Kazakhstan. The legislation defines a franchise (a 'complex entrepreneurial licence') as an 'entrepreneurial activity, in which a holder of the complex of exclusive rights provides it into use on a paying basis to another individual or entity'. The legislation also sets out the general rights and obligations of a franchisor and franchisee, particularly about the requirement for the franchisor to provide to the franchisee a set of exclusive rights (such as trademark, trade name, service mark, patent, undisclosed information, including production secrets (know-how, etc.) for the franchisee to utilise in its entrepreneurial endeavours.

The Civil Code of the Republic of Kazakhstan also sets out general principles of contract law that apply to every commercial agreement and requires certain businesses to obtain a business licence before commencing operations.

Disclosure

Under the Franchising Law, the franchisor transfers the information about the complex of exclusive rights to be used if concluding the franchise agreement. The law defines the concept of a complex of exclusive rights (licensing complex) as rights to intellectual property objects (trademark, trade name, service mark, patent, undisclosed information, including production secrets (know-how)).

The legislation does not contain further details of the content and data the franchisor must disclose to the franchisee. Thus, the law provides only for sharing information about the complex transferred to franchising (subject, rights, IP objects).

Nevertheless, the law allows the parties to provide more precise terms and data in the pre-sale disclosure agreement. For example, the parties may define the following amount of information to be transferred:

- data on the franchisor, employees, including previous owners of the company;
- a list of franchisees included in this franchise network;
- certain financial aspects (e.g. required investment, mandatory payments);
- information regarding trademarks, patents, and copyrights for which rights are transferred (which constitutes the licensing complex under Kazakh law);
- market analysis.

Despite this, the transmitted information's conditions, limits, and terms are set at the parties' discretion. The franchisor must warn the franchisee about the confidential commercial nature of the transmitted data. The franchisee is only entitled to disclose the information transferred to him with the written permission of the franchisor. In disclosing this information, the franchisee must compensate for the losses caused to the franchisor.

III. FRANCHISE LAW

Registration

Granting the right to use trademarks registered in accordance with the legislation of the Republic of Kazakhstan or protected without registration by virtue of international treaties, under a franchise agreement is subject to registration with the National Institute of Intellectual Property (NIIP). In accordance with the provisions of the Singapore Treaty on the Law of Trademarks 2006 the grant of the right to use trademarks can be expressed in the form of a franchise agreement, a separate license agreement, in the form of an extract from the main franchise agreement, or in the form of another agreement providing for the granting of the right to use trademarks.

Before registration the agreement, the relevant marks must first be registered with the NIIP. With protected trademarks in the Republic of Kazakhstan, the registration of the franchise agreement will be allowed by the NIIP. Failure to comply with the written form and (or) the requirement for registration entails the nullity of the franchise agreement as a whole or in part of granting the right to use a trademark. If the right to use the trademark has not been granted, then the right to use the trademark de jure is not transferred to the franchisee. Accordingly, the state register of trademarks of the Republic of Kazakhstan will have no record of the registration of the franchise agreement. In addition, a franchisee might be restricted from making royalty payments to an overseas franchisor because the bank requires the agreement as evidence for transferring funds as royalty. Kazakh tax authorities might not allow applying the reduced tax rate or tax exemption under the Tax Convention to the royalty payments made under the non-registered franchise agreement.

Mandatory clauses

Franchisors and franchisees are generally free to determine the agreement terms between them under the principle of freedom to contract. This includes the ability for the parties to elect that the agreement is governed by foreign law and subject to a foreign jurisdiction.

There are some restrictions, however, on this general freedom. One key area often found to be of concern to foreign franchisors is the limitation on the scope of the franchisee's indemnity to the franchisor for liability to third parties. This is a standard clause in many international franchise agreements. However, under Kazakhstani law, non-contractual liability to third parties falls on the person responsible for the action causing the third party's loss, which may be the franchisor or franchisee.

Another critical area is provisions in the agreement about intellectual property. As mentioned above, a franchisor may only license a trademark to a franchisee if the trademark itself is protected in Kazakhstan, and the period of protection for such a trademark will determine the term of the agreement. The franchise agreement should also clearly define what intellectual property rights are being transferred or licensed, the scope of any exclusive territory, the specific purposes for which the rights may be used and when the grant of such rights will expire. The franchisor should also be sure to include audit and inspection rights regarding goods and services provided by the franchisee and any premises from which the franchisee operates to ensure they are adequate and comply with brand standards.



IV. TAX

Kazakhstan's tax regime is set out in the Code No. 120-VI of the Republic of Kazakhstan on Taxes and Other Obligatory Payments to the State Budget dated 25 December 2017 (the Tax Code), which was amended in 2023. It provides for a relatively simple framework based on self-calculation with inspections and audits. Franchisors should note, however, that the penalties for non-compliance (such as improper declaration or non-payment) are high – even if unintentional – and that keeping proper documentation to evidence proper reporting and payment is critical. A challenge both residents and non-residents often encounter is the need of coherence between the Tax Code and widely accepted international taxation principles (on which many of the double taxation treaties Kazakhstan is a party to are based). This ambiguity can lead to an inconsistent approach by parties to an agreement and by the relevant tax authorities across the country, causing uncertainty.



Often of most importance to foreign franchisors is the application of withholding tax to payments made by a resident to a non-resident legal entity. In Kazakhstan the withholding tax rate depends on the type of payment in question, although the rules on what rate applies to the different type of source income paid to non-residents are complex and at times inconsistent. Non-residents' business income is generally subject to a 20 per cent withholding tax. This includes (among other things) income from the sale of goods or services or generally for the performance of work in Kazakhstan, income from management, consultancy, legal and audit services performed outside Kazakhstan, and capital gains from a sale of shares or interest in a Kazakhstan registered entity. Royalties^[3] (traditionally the main fee type to be earned by a franchisor), however, are subject to a 15 per cent withholding tax, as are dividends, capital gains and interest. If a franchisor is to provide a level of management or consultancy, or supply goods or services, the franchise agreement should be clear on the anticipated rates applicable to the different fees due, or – for tax efficiency and administrative ease – separate the arrangement into individual agreements.



[3] Defined by the Tax Code as a payment for the use or the right to use copyrights, software, drawings or models, except for the full or partial realization of property (exclusive) rights to an intellectual property object; use or right to use patents, trademarks or other similar types of rights;

IV. TAX

Franchisors should also be aware that different rules apply to non-residents depending on where such a non-resident is tax registered. Any payments being made to a resident of a recognised tax-haven jurisdiction are subject to a 20 per cent withholding tax rate. The List of Tax Haven Jurisdictions approved by Decree of the Government the Republic of Kazakhstan No. 142 dated 21 February 2018 sets out those jurisdictions that are tax havens.

As of 1 January 2023, Kazakhstan had concluded and ratified 57 double taxation treaties (DTTs) -- which typically reduce the applicable withholding tax rate on dividends, interest, and royalties. The royalty rates are reduced provided the conditions in the relevant treaty are met. Such conditions are largely administrative requirements set out in the Tax Code and include ensuring the franchisee has been provided with a tax resident certificate confirming that the franchisor is a tax resident in a DTT country before the end of the year in which the relevant income was paid. The tax certificate must include the franchisor's complete and accurate name and address, state the period in which the franchisor was a tax resident, be signed by an authorised employee of the franchisor, and the signature and company seal must be notarised and apostilled.

The practice shows that the best tax-efficient franchising structure is that implemented through the countries which have the effective double tax treaties with Kazakhstan such as Netherlands, Luxembourg, and the UAE. Such a structure will allow applying reduced withholding tax rate on royalty payments.

Royalty payments are also subject to the value-added tax (VAT) at 12%. Under the Kazakh national tax law, the services are subject to VAT if they are deemed to be supplied on the territory of Kazakhstan under the 'place of supply' rules and if such services are provided by a taxpayer registered as a VAT payer. Under the 'place of supply' rules, services on the transfer of the right to use trademarks, patents, know-how technologies or other similar types of rights are deemed to be rendered at a location of the acquirer's business activity of a purchaser (i.e. the Kazakh franchisee) and, consequently, constitute a VATable operation in Kazakhstan. Hence, the Kazakh franchisee will be required to self-assess and pay VAT in Kazakhstan at 12% on the amount of royalty payable to the non-resident franchisor under the franchise agreement. The franchisee is responsible for retaining and paying withholding tax (acting as a 'tax agent' for the franchisor) and must pay the tax within the strict time frames established under the Tax Code. The franchisee must also receive confirmation from the franchisor of its tax residency status.

V. IMPACT OF GENERAL LAW

Registration

The Civil Code contains a general requirement for citizens and entities to abide by the moral principles of Kazakhstan society and act in good faith, reasonably and fairly when exercising their rights. These requirements cannot be contracted out of or excluded in an agreement, even if subject to a governing law that is not Kazakhstani law. There is no objective test for these terms, however, so in each case their meaning will depend on the circumstances and the interpretation of the courts.

Agency distributor model

Provided the franchise agreement is clearly and expressly stated to be a franchise agreement and is carried out by the parties as a franchise arrangement, then it should not risk being interpreted as a commercial agency agreement. In practice, franchisors – particularly those supplying goods – should be careful when imposing minimum purchase requirements on franchisees and should ensure that franchisees always act on their own behalf and at their own financial risk.

Employment

Kazakhstani employment law is prescriptive and enforces a Labour Code of the Republic of Kazakhstan dated 23 November 2015 no. 414-V, which sets out certain minimum requirements that an employment contract must contain. If the franchisor and franchisee are subjects of entrepreneurial activity, then the franchise agreement cannot be considered as an employment contract. It should be noted that each business entity has its own employees and is responsible only for its own employees. Thus, the franchisee independently compensates for the harm caused by his employee in the performance of labor duties, regardless of the legal relationship with the franchisor.

Consumer protection

Franchisees do not fall under the definition of ‘consumers’ under Kazakhstani consumer law as they purchase goods and services for the purposes of business rather than for their own personal needs. Accordingly, consumer legislation does not apply to franchise arrangements. For additional protection franchisors may consider only entering into franchise agreements with franchisees that are legal entities (rather than individuals) to confirm that it is a business-to-business relationship. However, you should keep in mind that a consumer has the right to proper quality of goods and services, including when buying them from a franchisee. It worth mentioning that the Civil Code provides for a subsidiary liability of franchisor for consumers’ claims against franchisee in respect of the quality of goods and services provided.

V. IMPACT OF GENERAL LAW

Competition law

The Entrepreneurial Code of the Republic of Kazakhstan dated 29 October 2015, No. 375-V (the Entrepreneurial Code) expressly prohibits anticompetitive practices, abuses of dominance and monopolistic activity. The Entrepreneurial Code does, however, generally permit vertical agreements – including franchise agreements – and the Civil Code provides certain restrictive conditions that may be included in a franchise agreement even though they are considered in other circumstances to be anti-competitive. This includes the ability for the parties to agree that the franchisee has the exclusive rights to the franchised business in a particular territory to the exclusion of both third parties and the franchisor, and in-term and post-term non-compete restrictions on the franchisee. Resale price maintenance is prohibited in all agreements, however, as are exclusivity arrangements that seek to share market based on specific categories or types of customers.

Termination

The respective termination rights of the parties will generally be determined by the governing law to the agreement. If the agreement is subject to Kazakhstani law, then the Civil Code provides restrictions and conditions for termination rights. If the agreement is for a fixed term, then it may only be terminated by mutual consent, where one party is in material breach or in circumstances clearly detailed within the agreement. In many franchise agreements, therefore, the parties include a schedule detailing ‘termination events’ or grounds upon which one or both parties may end the arrangement. Franchisors should note, however, that in most cases one month’s notice is required to terminate an agreement.

The Civil Code also provides the consequences of terminating an exclusive right transferred for use. Suppose during the term of the franchising agreement, the validity period of any exclusive right included in the complex transferred for use under the agreement has expired, or such right has terminated for another reason. In that case, the agreement shall be preserved, except for the provisions relating to the terminated right. In this case, the franchisee, unless otherwise provided by the contract, has the right to demand a commensurate reduction in the remuneration due to the franchisor.

Dispute resolution

There is no strict requirement for a franchise agreement to be governed by Kazakhstani law. Under the basic principles of international private law, the contracting parties are free to choose the relevant governing law when entering a deal (or afterwards). Hence, the franchise agreement may be governed by the foreign law.

The law of the country where those properties are located shall apply to the protection of the right of ownership and any other property rights to immovable properties. Concerning property, which is entered into the State Register of the Republic of Kazakhstan, the law of the Republic of Kazakhstan shall apply.

Kazakhstan legislation does not require a particular dispute resolution forum to be used, so the parties may agree on the resolution method that will apply to disputes arising in relation to the franchise agreement.

V. IMPACT OF GENERAL LAW

Arbitration, mediation, and other forms of alternative dispute resolution (ADR) are used in Kazakhstan to varying effect. Arbitration is the most used ADR method, whether through the Kazakhstani International Arbitrage (KIA) or other arbitral regimes. The KIA may be selected as a dispute forum if at least one party is a non-resident of the Republic of Kazakhstan and the parties have agreed in the franchise agreement – by way of an arbitration clause – that the KIA will have jurisdiction.^[4] Mediation is available in Kazakhstan and is offered as a resolution forum by the KIA, although it is not currently as popular as arbitration or litigation.

Kazakhstan is a signatory to several international treaties providing for or relating to the enforcement of foreign court judgments and arbitral awards, including:

- a) the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958;
- b) the European Convention on International Commercial Arbitration (Geneva, 1961);
- c) the Agreement on the Procedure for Settling Disputes Relating to Economic Activities (Kiev, 1992); and
- d) the Convention on Legal Assistance and Legal Relations in Civil, Family and Criminal Matters (Chisinau, 2002).

A foreign judgment may be filed for enforcement within three years of the date the decision became effective, and will only be enforced by a local court if provided for by Kazakhstani law (very limited grounds are detailed in the Civil Procedure Code, mostly relating to family and marital law) or an international treaty.

The Civil Procedure Code provides that a party in receipt of an arbitral award may apply to a Kazakhstani court for its enforcement if the other party does not perform its obligations voluntarily. The court will review the application within 15 days of receipt and provide notice to the parties of the time and date of such a review for the parties' attendance (although attendance is not required). The court may issue an enforcement order that may be used by the claiming party as the basis for initiating enforcement proceedings. The Civil Procedure Code and the Kazakhstan arbitration legislation set out the circumstances in which a court may refuse to enforce an arbitral award, which reproduce the grounds for refusal detailed in the New York Convention.

The franchisee may file a lawsuit against the franchisor for breach of contract (i.e., for violation of contracted disclosure obligations). The franchisee is entitled to seek monetary relief if the court finds that some necessary information or assistance is withheld by the franchisor, or not provided in due course. Damages can be real and must be duly proved to be awarded.

Please note that generally, Kazakh law does not currently recognize indemnities as a legal concept. The closest alternative under Kazakh law would be compensation of damages, whereas we understand that under English law the concept is broader. It is uncertain how Kazakhstan courts would interpret and enforce such provision. Notwithstanding, there is no problem with leaving the provision in the agreements, especially given a foreign choice of law and forum for arbitration.



^[4] KIA Rules of Arbitration. Accessible from: <https://arbitrage.kz/>

VI. CURRENT DEVELOPMENTS

Although franchising in Kazakhstan is still relatively new compared with other jurisdictions, its popularity as a route to market for foreign brands continues to grow. The number of foreign brands currently franchising in Kazakhstan is close to 590, generating an annual turnover of 312 billion tenge (approximately USD 700 million) [5].

The rapidly developing infrastructure of retail outlets – new shopping malls and hypermarkets – is one key element of this growth, as it opens opportunities for franchisors to target more easily large groups of consumers in one space, particularly those with mid-market and premium brands that require quality retail space.

With increased government support for business development and an improving regulatory environment, including stronger intellectual property protection, Kazakhstan looks set to remain an attractive prospect to foreign and domestic franchisors.



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[5] Interview with the head of the Kazakhstan Franchising Association. Accessible from: <https://kapital.kz/economic/112122/beknur-kisikov-lyudi-vse-bol-she-obrashchayut-sya-k-franshizam.html>