

mcmillan

HARRIS
& Partners^{LLP}
Chartered Accountants

Taxation of Franchises: From Home and Abroad

Michael Friedman
Partner, McMillan LLP

Jack Hertzberg
Partner, Harris & Partners LLP

*Canadian Franchise Association
CFA 2012 Legal Day
Toronto, Ontario
February 2, 2012*

Agenda

1. Entering Canada: Planning Considerations for Franchisors
2. New Canadian Treaty Eligibility Documentation
3. GST/HST Considerations
4. Marketing Funds
5. Gift Cards in Co-Marketing Arrangements
6. Divestiture Planning

ENTERING CANADA: PLANNING CONSIDERATIONS FOR FRANCHISORS



mcmillan

HARRIS
& Partners
Chartered Accountants

Threshold Considerations

- Strategic outlook, organizational integration, and administrative capacity should govern the Franchisor's approach

Threshold Question #1: Do I wish to establish an active taxable presence in Canada?

Threshold Question #2: Which facets of the Canadian operations might I wish to directly conduct in the short or long term?

Threshold Question #3: Will it be advantageous for me to be able to recognize my Canadian income/losses for foreign tax purposes?

Basic Canadian Income Tax Principles

- Residents of Canada are subject to Canadian tax on their worldwide income
- Non-residents of Canada are potentially subject to Canadian tax in respect of income from “businesses carried on...in Canada”
- **Treaty protection** – Canadian taxation may be limited to income derived from businesses carried on in Canada through a “permanent establishment”
- Certain payments made to non-residents of Canada (e.g., royalties) may be subject to withholding tax under Part XIII of the ITA

Structure of Canadian Operations: *Franchisor Situated Outside of Canada*

- Franchisor does not “carry on business” in Canada in a manner that attracts basic Canadian income tax
- Franchisor’s income from Canadian operations may be limited to franchise fees, periodic royalty payments, and/or payments for supplies/inventory



Structure of Canadian Operations: *Franchisor Situated Outside of Canada*

- Taxation under the ITA may be limited to (i) Part XIII withholding tax, and (ii) certain regulatory withholdings
 - Management or Administration fees or charges
 - Interest
 - Rent, Royalties or similar payments
 - Regulation 105 – Services rendered in Canada
- Withholding taxes may be reduced/eliminated under an applicable Treaty
- Canadian tax filing obligations and penalty exposure

Structure of Canadian Operations:

Franchisor Operates a Canadian Branch

- Franchisor carries on franchise-related activities in Canada
- Income from Canadian operations potentially subject to:
 - (i) basic Canadian income tax, and
 - (ii) “branch profits” tax

Key Considerations

- Are Treaty benefits available?
- Are business activities carried on through a “permanent establishment” in Canada?

Structure of Canadian Operations:

Franchisor Operates a Canadian Branch

- Requirement to allocate income between Canadian and foreign operations
- Double taxation and foreign tax credit relief
- Canadian tax filing obligations and penalty exposure

Special Considerations

- Part XIII withholding tax exposure
- “Branch profits” tax \$500,000 Treaty exceptions

Structure of Canadian Operations:

Franchisor Establishes a Canadian Subsidiary

- Franchisor capitalizes and licenses a Canadian subsidiary to act as Master Franchisor in Canada
- Subsidiary will be resident in Canada and subject to Canadian tax on its worldwide income

Capitalization

- Debt vs. equity
- Thin capitalization restrictions

Repatriation strategies

- Returns of capital vs. repayment of principal
- Dividends vs. interest vs. royalties

Structure of Canadian Operations: *Franchisor Establishes a Canadian Subsidiary*

Transfer Pricing

- Licensing fees/royalties
- Inter-corporate sale of goods and services

Incorporating the Subsidiary as an “unlimited liability company”

- US “Check-the-box” rules – disregarded entity status
- 5th Protocol to the Canada-US Treaty has introduced complications/traps
- Double taxation and foreign tax credit relief
- Canadian tax filing obligations and penalty exposure

Structure of Canadian Operations: *Other Approaches*

- Partnerships
- Joint Ventures
- Master Franchise Arrangements
- Area Development Agreements



Choosing the Optimal Structure:

Tax Assessment Criteria

- Expected initial loss profile of Canadian operations
- Ability to segregate income attributable to Canadian business
- Relative tax burdens of various alternatives
- Ability/desire to manage additional tax filing obligations
- Exit/Repatriation strategies



Select U.S. Tax Considerations for U.S. Franchisors

Report of Foreign Bank and Financial Accounts (FBAR)

- Must report foreign bank accounts
- Penalty – non-willful violation (\$10,000)

Reporting foreign entities

- Foreign corporations
- Non-compliance penalties



NEW CANADIAN TREATY ELIGIBILITY DOCUMENTATION



mcmilan

HARRIS
& Partners
Chartered Accountants

New Canadian Treaty Eligibility Documentation

- In 2011, the CRA released new treaty eligibility forms to help taxpayers determine when to apply a Treaty-reduced rate of withholding in respect of a particular payment
- Forms NR301-303
- Completion/receipt of the forms is not mandatory; however, represents a practical requirement
- Introduction of the forms signals increased due diligence expectations
- Forms contain certifications and establish updating responsibilities that require close attention

GST/HST CONSIDERATIONS



GST/HST Considerations

What is subject to GST/HST?

- *RC4022, General Information For GST/HST Registrants*
- “Taxable supplies” are supplies of property and services that are made in the course of a “commercial activity” and are subject to GST/HST (including “zero-rated supplies”)
- “Supply” means the provision of property or services in any way, including sale, transfer, barter, exchange, license, rental, lease, gift or disposition

GST/HST Considerations

- Concept of carrying on business in Canada vs. having a permanent establishment in Canada
- Payments for Franchisor's taxable supplies may include:
 - franchise fees
 - royalties
 - purchase price of products/equipment
 - advertising fees

GST/HST Considerations

When is GST/HST registration required?

- If you provide taxable supplies in Canada, unless
 - i. you are a “small supplier”; or
 - ii. you are a non-resident who does not carry on business in Canada (*RC4027, Doing Business in Canada - GST/HST Information for Non-Residents*)



GST/HST Considerations

Small supplier

- Total revenues from taxable supplies (before expenses) are \$30,000 or less in the last four consecutive calendar quarters or in any single calendar quarter
- Total revenues from taxable supplies means your worldwide revenue from your supplies of property and services that are subject to GST/HST (including zero-rated supplies) or that would be subject to GST/HST if supplied in Canada
- Analysis must also consider revenue of “associates”

GST/HST Considerations

GST/HST registration considerations for Franchisors

- Input tax credits (ITC) cannot be claimed by non-registrants
- If you incur GST/HST on fees to prepare legal agreements and disclosure documents in advance of registration, the GST/HST paid may become a non-recoverable cost of doing business
- Importation of property into Canada where GST/HST has been paid at the border – the GST/HST may again become a non-recoverable cost of doing business
- Voluntary registration

GST/HST Considerations

Non-resident registrants

- Requirement to post security with the CRA

Place of supply rules

- Where the goods or services are supplied dictates the applicable GST/HST rate
- *GST/HST Technical Information Bulletin B-103, Place of supply rules for determining whether a supply is made in a province*

MARKETING FUNDS



mcmillan

HARRIS
& Partners CH
Chartered Accountants

Marketing Funds

How should a marketing fund be set up?

(i) *Drafting of franchise agreement provisions*

- Marketing fund contributions are collected by the Franchisor and segregated for special purpose use
 - Contributions are separately accounted for, and are not used by the Franchisor for operating purposes
 - Separate bank account maintained
- Marketing fund contributions are collected by the Franchisor and can be used at the Franchisor's sole discretion with no accountability to the Franchisees

(ii) *Creating a separate entity*

- What type of entity should be established?

Marketing Funds

Income tax considerations

- Do contributions to the marketing fund, net of expenses, represent income of the Franchisor?
- If there are unexpended amounts in the advertising fund, who is responsible for applicable taxes, if any?

GST/HST issues

- How is GST/HST in respect of the marketing fund reported by the Franchisor?
- Is a separate GST/HST registration required?

Marketing Funds

Accounting issues

- Balance sheet vs. income statement presentation
- Can excess expenditures be recovered from the Franchisees out of future contributions?
- Disclosure issues and notes to financial statements

GIFT CARDS IN CO-MARKETING ARRANGEMENTS



mcmilan

HARRIS
& Partners CPA
Chartered Accountants

Gift Cards

- GST/HST is not charged when the gift card is sold
- GST/HST is charged in respect of sales when a gift card is redeemed
- Franchisor issued and controlled gift cards: Relevant accounting considerations
- Do unredeemed or lost gift cards give rise to taxable income of the Franchisor?

DIVESTITURE PLANNING



mcmilan

HARRIS
& Partners
Chartered Accountants

Divestiture Planning

- The manner in which a business is sold by a Franchisor has a direct impact on the Canadian tax implications of the disposition

Asset vs. Share sale transaction

- Income vs. capital gains treatment
- Recapture
- Acquisition of control implications
- Repatriation planning

Divestiture Planning

Tax elections

- Section 22 election (accounts receivable)
- Section 20(24) election (pre-paid obligations)
- Section 167 GST/HST election

Foreign vs. domestic vendor

- Treaty exemptions
- Section 116 compliance

Questions?



mcmilan

HARRIS
& Partners
Chartered Accountants

Cautionary Note

The foregoing commentary is summary in nature and does not address all of the issues and considerations that may be relevant under any particular set of circumstances.

The statements and material presented herein do not represent legal or tax advice.

No transactions should be executed on the basis of the foregoing statements and commentary.

Formal legal, tax, and accounting advice should be obtained prior to making any investment or executing any transaction.



Michael Friedman

McMillan LLP

Toronto, Ontario

416.865.7914

michael.friedman@mcmillan.ca

Jack Hertzberg

Harris & Partners LLP

Markham, Ontario

905.477.8322

jhertzberg@harrisandpartners.com

mcmillan

HARRIS
& Partners LLP
Chartered Accountants