

TAXATION

Canadian Income Tax Considerations for United States Franchisors Expanding Their Franchise Systems to Canada

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This article will provide an overview of the Canadian tax considerations that are relevant to a United States franchisor considering expanding its franchise system into Canada. The purpose of this article is to provide general information that can be used to determine how to structure a U.S. franchisor's Canadian operations.

Overview of Canadian Tax System

The Canadian federal government levies tax pursuant to the Income Tax Act¹ on the basis of residency rather than citizenship. Residents of Canada are taxed on their worldwide income, while non-residents are taxed only on their Canadian-source income.²

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¹R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

²The term "resident" is not exclusively defined in the Act so that the determination of whether a person is resident in Canada is mainly a common law concept; however, the Act also deems a corporation to be resident in Canada if it was incorporated in Canada after April 26, 1965. Pursuant to common law, a corporation is resident in Canada if its central management and control is located in Canada. The location of a corporation's central management and control is a question of fact; however, a corporation's central management and control is generally the location of the meetings of its board of directors. Consequently, if a

The Act taxes non-residents pursuant to Part I and Part XIII of the Act. A non-resident is subject to income tax under Part I of the Act if the non-resident carried on business in Canada. However, if a non-resident is carrying on business in Canada but is a resident of the U.S., then the treaty known as the Canada-United States Income Tax Convention (the "Treaty") limits the U.S. resident's exposure to tax in Canada by stipulating that a U.S. resident will be subject to tax in Canada only if it carried on business in Canada through a permanent establishment ("PE").³ Accordingly, a U.S. franchisor without a PE in Canada which deals with Canadian franchisees or an arm's length Canadian master franchisee from the U.S. without a PE in Canada will not be subject to Canadian income tax under Part I of the Act.

In addition to the tax imposed under Part I of the Act, Part XIII of the Act levies a withholding tax of 25% if the non-resident receives passive income such as interest, management fees, dividends, rents and royalties from a Canadian resident. Hence, payments made by a Canadian franchisee or an arm's length Canadian master franchisee to a U.S. franchisor on account of royalties, interest and dividends will be subject to Canadian withholding tax. The Treaty reduces the 25% withholding tax imposed by the Act to 5% or 15% for dividends, 10% for royalties relating to a franchise arrangement and to 10% for interest.

corporation is incorporated outside of Canada and the meetings of the board of directors are held outside of Canada, then the corporation should not be considered to be a resident of Canada and generally its active business income will not be subject to taxation in Canada.

³If the non-resident does not have a PE in Canada but carries on business in Canada, then the non-resident is not subject to tax under Part I of the Act; however, the non-resident must satisfy income tax filing requirements. If a corporation carries on business in Canada, then it is required, for federal tax purposes, to file a T2 - Corporate Tax Return, Schedule 91 - Information Concerning Claims for Treaty-Based Exemptions, and Schedule 97 - Additional Information on Non-Resident Corporations in Canada. The T2 and applicable Schedules have to be filed within six months from the end of the taxation year for each year that the non-resident carried on business in Canada.

The amount of tax payable in Canada by a U.S. franchisor will depend on how the Canadian operation is structured and the relationship between the Canadian operation and the U.S. franchisor.

Business Structure

The two most common business structures utilized by a U.S. franchisor expanding its franchise system to Canada are a Canadian branch or a Canadian subsidiary.

Canadian Branch

A U.S. franchisor may wish to conduct business in Canada using a Canadian branch. A branch is not a legal entity; therefore, it will not insulate a U.S. franchisor from legal liability and the U.S. owner of the branch will be fully liable for all liabilities arising out of the operations of the branch in Canada.

A U.S. franchisor that carries on business in Canada through a branch is considered to be carrying on business in Canada through a PE and as such, the U.S. franchisor will generally be taxable in Canada on income attributable to the PE at a combined Canadian federal and provincial tax rate ranging from 32.1% to 38.1% (depending on which provincial tax is applicable).⁴

In addition to the Part I tax, the Act imposes a branch tax of 25%. The 25% branch tax applies to the gross amount repatriated from the branch to the U.S. franchisor. The Treaty reduces the 25% branch tax to 5% with the first \$500,000 of Canadian income repatriated to the U.S. franchisor being exempt from branch tax.⁵

⁴ A branch may be subject to Large Capital Tax depending on the amount of capital invested (see subsection 181.1(1) of the Act). The Act imposes the Large Capital Tax at the rate of .225% on the taxable capital employed in Canada. Note that the federal Large Capital Tax will be phased out over several years and by the year 2008, it should be eliminated.

⁵ The reduction of the branch tax rate pursuant to the Treaty will not be available to U.S. franchisors that are U.S. limited liability corporations ("LLC"). The Canada Revenue Agency ("CRA") is of the view that a LLC is not considered to be a resident of the U.S. and accordingly is not entitled to the benefits of the Treaty.

A U.S. franchisor that carries on business in Canada through a branch must file Canadian tax returns and allocate income and expenses to the branch. For U.S. tax purposes, a Canadian branch is considered a "flow-through" entity for purposes of offsetting Canadian costs against the U.S. franchisor's income and for claiming foreign tax credits in the U.S.

Canadian Subsidiary

As a corporation, a Canadian subsidiary is a legal entity, with the result that the U.S. franchisor's liability for the operations of the Canadian subsidiary are limited.

Pursuant to the Act, a subsidiary incorporated after April 26, 1965 will be deemed to be a resident in Canada and therefore will be taxable in Canada on its worldwide income. Generally, a subsidiary of a U.S. franchisor will be subject to combined federal and provincial corporate tax rates ranging from 32% to 38.1%.⁶ The Canadian subsidiary's exposure to provincial income tax will depend on whether the subsidiary has a PE in one or more provinces. The income earned by the subsidiary will be allocated to that/those provinces in which it has a PE.

In certain situations, the combined federal and provincial corporate tax rate payable by a Canadian subsidiary can be reduced to 14.1% to 21.1%.⁷ For example, if the U.S. franchisor holds shares in a subsidiary that has a PE in Ontario in combination with a Canadian co-shareholder who holds 50% or more shares of the Ontario subsidiary, then the Ontario subsidiary is considered a Canadian-controlled private corporation and the tax rate payable by the Ontario subsidiary will be reduced to 18.6% from 34.1% for the first \$400,000 of active business income.

A Canadian subsidiary is required to file Canadian income tax returns. In addition, the subsidiary is not a flow-through entity and hence all start-up costs are only deductible by the subsidiary against its own income and no

⁶ A Canadian subsidiary may also be subject to Large Capital Tax depending on the amount of capital invested. See subsection 181.1(1) of the Act. Note that the federal capital tax is being phased out over several years and by the year 2008, it should be eliminated.

⁷ Ibid.

U.S. foreign tax credits can be utilized by the Canadian subsidiary to offset its underlying Canadian domestic tax. However, a U.S. shareholder of a Canadian subsidiary is generally not taxed on the Canadian subsidiary's income until it is distributed to the shareholder.⁸

A Canadian subsidiary's income can be distributed to a U.S. resident via a variety of payments such as royalties, dividends, interest and management fees. As mentioned, the general withholding rate on royalties, dividends, interest and management fees paid to non-resident persons is 25%. This 25% withholding rate is reduced by the Treaty to 10% on royalties paid by a Canadian subsidiary to a U.S. franchisor, 5% or 15% on dividends and 10% on interest.⁹ Management fees are not subject to withholding tax.

Unlimited Liability Corporation ("ULC")

A ULC is a type of Canadian corporation and as such is a legal entity. However, the shareholders of a ULC are subject to unlimited liability for all debts and liabilities arising out of the operations of the ULC. Yet, due to its hybrid characterization, a ULC is often the preferred investment vehicle for a U.S. corporation that intends to carry on a business in Canada.¹⁰

⁸ See section 212 of the Act.

⁹ See Article X of the Treaty for dividends, Article XI of the Treaty for interest payments and Article XII for royalties. Note, for purpose of the dividend, if the recipient shareholder owns at least 10% of the voting shares of the corporation, then the recipient qualifies for the 5% withholding rate; in any other case, the 15% withholding rate applies.

¹⁰ This hybrid treatment results in certain advantages from both a Canadian as well as a U.S. tax perspective; some of these advantages are:

- filing of a consolidated U.S. tax return;
- Canadian source losses can be flowed through to the U.S. franchisor;
- Canadian federal and provincial tax will be available as a foreign tax credit to the U.S. franchisor;
- withholding tax at the reduced Treaty rate will be payable only when profits are repatriated to the U.S. (provided that the U.S. franchisor is not a U.S. LLC);
- no liability for Canadian branch tax; and

From a Canadian tax perspective, a ULC is a Canadian resident corporation, is subject to Canadian income tax (federal and provincial) on its worldwide income¹¹ and has to file its own tax returns.

For U.S. tax purposes, the ULC will be regarded as either a "flow-through entity" (if it has more than one shareholder) or a "disregarded entity" (if there is only one shareholder) such that the income earned by the ULC will be taxed in the hands of the U.S. parent.

There are several advantages from a U.S. tax perspective of establishing a ULC. For example, any losses incurred in the ULC can be flowed through to the U.S. parent to offset its income and the U.S. parent can utilize foreign tax credits for Canadian income tax paid. Therefore, for U.S. tax purposes, the ULC will be treated as a branch and for Canadian income tax purposes, the ULC will be treated as a corporation. The result is that the total U.S. and Canadian income tax paid on the ULC's income will be limited to the level of tax calculated in either Canada or the U.S., whichever is higher.

Until recently, Nova Scotia was the only province in Canada that allowed the formation of a ULC ("NSULC"). However, the *Business Corporations Act* (Alberta) was recently amended to make Alberta the second province in Canada to provide for the formation of a ULC. The Alberta ULC ("ABULC") and the NSULC differ in many aspects; some of the more significant differences are indicated on the table that appears on the following page:

- the U.S. franchisor can deduct interest expenses incurred by the ULC.

¹¹ The term "corporation" is defined in subsection 248(1) of the Act as "includes an incorporated company." The CRA in Technical Interpretations 9408195 and 9510435 has espoused that it is of the view that a NSULC is a corporation for Canadian tax purposes. As such, a ABULC should also be treated as a corporation for Canadian tax purposes.

	ABULC	NSULC
Constituting Statutes	Similar to U.S. incorporation statutes, Ontario corporate statute and federal corporate statutes	Based on the United Kingdom <i>Companies Act</i>
Shareholder Liability	Unlimited liability – creditor has direct claim	Unlimited liability – arises at the time of wind up or liquidation if the NSULC's assets are not sufficient to pay the debts and liabilities and wind-up expenses
Director's Residency	1/4 of the directors must be resident in Canada (this means that a minimum of four directors would have to be appointed to the board and one of those directors would have to be a resident in Canada).	No residency requirement
Amalgamation	Provides for short-form and long-form vertical amalgamations	Provides for long-form amalgamations, which requires both shareholder and court approval
Return of Capital	Shareholder approval (2/3)	Court approval required
Continuation	Any corporation can be continued into Alberta as an ABULC	Continuation is not allowed
Incorporation Fees	\$100	\$6,000 (with annual registration fee of \$2,000)

Thin Capitalization Rules

A U.S. franchisor utilizing a Canadian subsidiary, including a ULC, has to be conscious of the "thin capitalization rules." Such rules limit the amount of inter-company debt which can be deducted against Canadian income tax by a Canadian subsidiary. The rules provide that where the debt:equity ratio of a subsidiary is in excess of 2:1, interest on the debt in excess of such limit will not be deductible for Canadian income tax purposes. The thin capitalization rules may apply to any subsidiary, including a ULC, but will not apply to debt owing with respect to a branch operation.

Transfer Pricing

Canadian transfer pricing rules will apply to transactions entered into between a Canadian subsidiary and its U.S. parent franchisor. Under such rules, transactions between a Canadian subsidiary and its U.S. parent must be equivalent to arm's length fair market value terms. Furthermore, the Canadian subsidiary must maintain documentation which demonstrates that the terms of such transactions are at fair market value. The transfer pricing rules do not apply where the U.S. corporation is carrying on business in Canada through a branch.

Ability to Change Business Structure

The Canadian income tax rules permit a U.S. enterprise which has established a branch operation in Canada to transfer its branch operation into a separate Canadian subsidiary or ULC on a tax-deferred basis. Therefore, a U.S. franchisor can expand its franchise system into Canada using a branch and later convert the branch into a subsidiary, without capital gains tax.

Repatriation of Funds by U.S. Franchisor

Repatriation of funds by a U.S. franchisor from a Canadian entity may be subject to withholding tax under the Act. Pursuant to the Act, the payment of royalties, dividends or interest by a Canadian subsidiary to a U.S. franchisor is subject to Canadian withholding tax. The Treaty reduces the withholding tax rate on these payments.

Royalties

Again, while the Act imposes a withholding tax at a rate of 25% on rent, royalty and similar payments made by a Canadian resident to a non-resident, this rate is reduced by the Treaty to 10%. The Act defines the term "royalty" as "any payment for the use of or right to use in Canada any property, invention, trade name, patent, trade mark, design or model, plan, secret formula, process or other thing whatever." Payments to a U.S. resident which are on account of the right to use information, knowledge or intellectual property relating to a franchise system including licensing fees, are deemed part of "rent, royalty or similar payments" and hence are subject to a reduced Canadian non-resident withholding tax at a rate of 10%.

The Act provides for several exceptions to the withholding tax on royalties; for example, royalties for copyrights in respect of the "production or reproduction of any literary, dramatic, musical, or artistic work and payments made under a *bona fide* cost-sharing arrangement, and any payment made to a person with whom the payor is dealing at arm's length to the extent that the amount thereof is deductible in computing the income of the payor for Canadian income tax purposes from a business carried on in a country other than Canada," are not subject to the withholding tax. Pursuant to the Act, treaty payments

for the use or right to use, any patent or any information concerning industrial, commercial or scientific experience is exempt from withholding tax but that exemption does not apply if the payment is provided in connection with a franchise agreement.

The Treaty provides exemptions from withholding tax payments for the use or right to use computer software. This exemption only applies to royalty payments if the royalty relates to the right to use the software. For example, if the royalty relates to the right to take a license in the software, the exemption is not available.

The CRA has taken a broad interpretation of the term "rent, royalty and similar payments" and is of the view that any lump sum payment made under a franchise agreement is subject to withholding tax. Hence, fees should be structured to segregate the non-taxable components from the taxable components. For example, withholding tax is not imposed on payments made on account of management fees or fees for services rendered by the U.S. franchisor outside of Canada and initial lump sum fees paid at the time of an application for a franchise.

Interest

The Act imposes a withholding tax of 25% on every amount that a resident of Canada "pays or credits, or is deemed by Part I to pay or credit, to the non-resident person, as, on account or in lieu of payment of, or in satisfaction of interest." However, the 25% withholding tax rate is reduced to 10% pursuant to the Treaty. Generally, the 25% Canadian withholding tax on interest will qualify for a credit in computing U.S. income tax liability; however, under certain circumstances, for example if the interest is paid between disregarded entities for U.S. tax purposes, the interest will not qualify. It is therefore important that a U.S. franchisor seeks U.S. tax advice that it will be credited for any Canadian withholding taxes on interest.

The government of Canada and the government of the U.S. are currently negotiating an amendment to the Treaty whereby the current 10% withholding tax on cross-border interest payments will be eliminated. The amendment is anticipated to be approved sometime in 2007, effective January 2008.

FRANCHISE AND DISTRIBUTION

The amendment will eliminate the 10% withholding tax to both arm's length and non-arm's length interest payments. For arm's length interest payments, the 10% withholding tax will be eliminated in the first calendar year following the Treaty coming into force. For non-arm's length interest payments, the 10% withholding rate will be eliminated in three stages: (1) in the first year of the amendment, the withholding tax on interest payments will be 7%; (2) in the second year following the entry into force of the Treaty, it will be 4%; and (3) in subsequent years the rate will be 0%.

Dividends

The Act imposes a withholding tax of 25% "on every amount that a corporation resident in Canada pays or credits to a non-resident person as, on account or in lieu of payment of, or in satisfaction of a taxable dividend or capital dividend." Article X of the Treaty limits the withholding tax on dividends to 5% of the gross amount of the dividend if the dividend recipient owns at least 10% of the voting stock of the payor corporation paying the dividend and in all other cases to 15%.

Return of Capital

The return of capital is not subject to withholding tax under the Act and hence a Canadian subsidiary, including a ULC, may return paid-up capital to a shareholder without

triggering withholding tax.¹² If the Canadian subsidiary, including a ULC, is capitalized by way of loan, the repayment of principal of the loan will not be considered as a payment of income and no withholding tax will be applicable. Interest on the loan will be subject to withholding tax in the manner described above.

Withholding Tax if U.S. Franchisor Is a US Limited Liability Corporation ("U.S. LLC") and Utilizes a ULC for Its Canadian Operation

The CRA takes the view that a U.S. LLC formed pursuant to U.S. corporate laws does not qualify for any benefits under the Treaty; consequently, the withholding rate of 25% will apply. Therefore, if funds are repatriated to a U.S. franchisor which is a U.S. LLC, it is recommended that the U.S. franchisor not directly hold the shares of the Canadian ULC. Instead, the U.S. franchisor might contemplate holding the shares in the Canadian ULC via a newly incorporated C Corporation or S Corporation. A C Corporation or S Corporation is not a disregarded entity for U.S. tax purposes and as such the lower Treaty withholding rates will apply. Further, the C Corporation or S Corporation will mitigate the U.S. franchisor's exposure to the liabilities of the Canadian ULC. It is for this reason that U.S. franchisors will typically utilize a subsidiary C or S Corporation to act as a holding company for a Canadian ULC.

¹² A return of capital may give rise to an obligation under section 116 of the Act.