CHAPTER 1

Structuring an Expansion to Canada

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I. Introduction[1]

A non-Canadian franchisor planning to expand its franchise system to Canada must make important decisions on the type of legal entity to use for the expansion and the method by which the expansion will be implemented. In addition, important tax issues must be dealt with: income tax, withholding tax, sales tax, harmonized sales tax, goods and services tax, and custom duties are all potentially relevant.

At the outset, it is important to understand the division of powers in Canada between the federal and provincial levels of government. This division is set forth in Canada's *Constitution Act*, a federal statute. Powers given to each level of government in Canada are similar to those in the U.S., but with important differences. For example, there is only one federal trademark statute in Canada. Residual power resides with the federal authority in each country, but residual federal power is invoked much less in Canada. Canadian courts have given a broad interpretation to key provincial powers: in particular, power to govern over "property and civil rights." In the result, Canadian provinces sometimes enjoy greater autonomy than U.S. states, for example, in the fields of trade and commerce.

In Canada, regulation of franchises and consumer protection are matters of provincial jurisdiction and often vary significantly between individual provinces. Canada has no federal enactment equivalent to the FTC Rule in the United States.

Practice Note

At present, six out of ten Canadian provinces—Alberta, Manitoba, Ontario, New Brunswick, Prince Edward Island and British Columbia—have franchise legislation. None of them require franchisors to register. Canada has no federal franchise legislation. British Columbia's *Franchises Act* is the newest franchise legislation, coming into force on February 1, 2017.

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II. Options for Expansion to Canada

A. Branch or Subsidiary

Initially, a non-Canadian franchisor may decide to maintain direct control over a Canadian expansion by opening and operating one or more franchise units in Canada on its own. This "direct franchising" may use a branch or subsidiary structure. Once the franchisor has established itself in Canada, it may find it easier to expand further by contracting with one or more Canadian Master Franchisees or Area Developers.

While tax considerations will be critical in deciding between a branch or subsidiary structure, non-tax factors are important as well.

In considering expansion options, a non-resident franchisor may wish to engage one or more experts, including a Canadian franchise lawyer, accountant and consultant, to assist with various aspects of the following:

- penetrating the Canadian market and reducing "rookie mistakes" in a cost-effective manner;
- facilitating incorporation of a subsidiary, Canadian trademark application and preparation of legal documentation (including, where required, a franchise Disclosure Document);
- "Canadianizing" the franchisor's concept, marketing materials, franchise agreement, operations manual and related documents;
- using a consultant's premises as an initial Canadian sales office and the consultant's sales team to locate and qualify potential Canadian franchisees;
- franchise site selection, lease negotiation and financing of franchisees; and
- recruiting, training and supporting new Canadian franchisees.

Practice Note

When a non-resident franchisor decides to maintain direct control over its Canadian expansion by opening and operating franchise units on its own, it will generally need to choose between a branch or subsidiary structure. Both tax and non-tax factors should be considered in making this decision.

1. Branch

(a) Structure

Rather than forming a separate corporate entity through which to operate, a non-resident franchisor may decide to develop its system in the Canadian market by operating from its home office or by establishing a branch office in Canada to provide a local base from which to administer the expansion. In either case, the franchisor will maintain direct control over the selection, training and administration of franchisees in Canada.

> **Practice Note**
>
> **Establishing a branch operation in Canada does not require the formation of a separate subsidiary or other legal entity.**

(b) Tax considerations of a branch

Income tax considerations of operating from a home office outside of Canada vs. setting up a branch office in Canada must be considered carefully. On the one hand, if the new Canadian operation is to be run by an arm's-length entity that is granted master franchise rights or area development rights, with the franchisor having little involvement in day-to-day operations, then income earned by the franchisor through initial franchise fees and royalties would likely be treated as 'passive.' In that case, gross franchise payments made by Canadian resident franchisees will only be subject to a withholding tax. Canada's general withholding tax on royalty payments is 25% but, by the Canada-U.S. Tax Treaty, is reduced to 10% for U.S. franchisors entitled to treaty benefits.

If, on the other hand, the franchisor actively administers the Canadian operation, its compensation would be treated as business income which would not be subject to withholding tax. Instead, the franchisor would be taxable in Canada on a net income basis at rates varying from 25% to 30%, depending on the province or territory of Canada in which the income is earned.

In addition, the Canadian government imposes a "branch tax" on a non-resident operating company equal to 25% of its net after-tax income in Canada that is not reinvested in the Canadian branch operation. The branch tax is designed to provide the Canadian tax authorities with revenue similar to what they would receive when a franchisor operates in Canada through a subsidiary. However, this rate is reduced by tax treaty to just 5% for U.S. resident corporations, with the first C$500,000 of after-tax Canadian income of the U.S. corporation being exempt from the branch tax.

Canadian income tax of a branch operation, including withholding tax and branch tax, will normally qualify for a foreign tax credit for the non-resident franchisor in the computation of its income tax liability at home.

When income derived in Canada is business income instead of passive royalty-type income and is not earned through an office or other permanent establishment in Canada (which may occur if all business locations in Canada are operated by independent franchisees), the provisions of most of Canada's tax treaties, including its tax treaty with the U.S., will provide an exemption from Canadian income tax, including branch tax. However, the absence of an office in Canada will likely suggest to the Canadian tax authorities that fees earned by the franchisor from Canadian operations are passive and therefore should be subject to withholding tax. The franchisor must be prepared to deal with this issue with the Canadian tax authorities; it will need to demonstrate that it has actively participated in the Canadian franchise operation to avoid paying withholding tax.

(c) Tax advantages of a branch

Some of the tax advantages of a non-resident franchisor operating through a branch in Canada are:

- if the non-resident franchisor has no permanent establishment in Canada, there will be no Canadian income tax liability, provided the income is determined to be "active";
- if the non-resident franchisor does have a permanent establishment in Canada, then, by treaty, Canadian income tax paid by it will usually qualify for a foreign tax credit when computing its home income tax liability;
- in the case of a U.S. corporation, the first C$500,000 of after-tax income earned in Canada is exempt from Canadian branch tax;
- losses from a Canadian branch operation will typically reduce taxable income in the franchisor's home jurisdiction; and
- if Canadian income is determined to be passive and subject to Canadian withholding tax, then non-resident franchisors in most jurisdictions will receive a foreign tax credit for such tax paid in Canada when calculating their home jurisdiction tax liability. If the Canadian operation has limited expenses, then the amount of the withholding tax payable may be substantially less than the Canadian tax that would have been payable by a subsidiary.

(d) Tax disadvantages of a branch

There are some tax-related disadvantages of using a branch in Canada, namely:

- at the point when the non-resident franchisor becomes subject to the branch tax, it will be payable annually as income is earned (accrual basis), rather than when income is paid to the foreign jurisdiction. On the other hand, withholding tax on a dividend distribution by a Canadian subsidiary to its parent will not be payable until the dividend is actually paid (cash basis); and
- there is a risk that tax authorities will assert that payments to the non-resident franchisor are passive income subject to a withholding tax on gross income paid (rather than tax at regular corporate rates and potential branch tax on the net income payment). If expenses are significant and the tax rate is not reduced by a tax treaty with Canada, a flat withholding tax on the gross payment (even though it might be reduced) could eliminate all profit. Additional withholding tax will apply if any portion of the payments to the non-resident franchisor is in respect of services performed by it in Canada. If a Canadian subsidiary is used, however, tax will only be payable on its net Canadian income.

Practice Note

The tax consequences of establishing a branch operation in Canada should be carefully considered before proceeding with the branch.

(e) Registrations required for a branch

A franchisor establishing a branch operation in Canada must register with a number of authorities, including:

- the corporate registry in each province and territory of Canada where the franchisor will "carry on business," generally interpreted as any place where the franchisor has a place of business, resident agent, is listed in a telephone directory, conducts advertising, or in some other way carries on business. Registration is effected by reservation of the franchisor's name, registration of an information form (which differs from province to province or territory) and, in some cases, filing of certified copies of the franchisor's charter documents. In the province of Québec, where French is the official language, a foreign corporation must choose a French name to be used in carrying on its business activities;

- Canada Revenue Agency (Canada's federal tax authority) for a "business number" for remittances of corporate income tax, employee payroll deductions, goods and services tax, or harmonized sales tax and import/export authorization (as applicable);
- authorities in each city and province or territory where the branch carries on business for a business licence and for licences related to sales tax and workers' compensation insurance (as applicable) and possibly other matters; and
- employees of the non-resident franchisor moving to Canada to work for the franchisor will need to obtain Canadian work permit visas.

Practice Note

Several registrations at various governmental levels are required to be obtained by a franchisor when establishing a branch operation in Canada.

2. Subsidiary

(a) Structure

As an alternative to the branch structure, a non-resident franchisor may choose to establish a wholly-owned Canadian subsidiary to operate its franchise system in Canada. In this case, the franchisor will have full operating control of the subsidiary as a separate corporate entity through ownership of the subsidiary's shares and appointment of its board of directors and managers. This structure may provide an effective shield against creditors for a non-resident franchisor seeking to avoid liability for potential start-up losses and other liabilities that may arise in a new Canadian operation. In deciding whether to operate through a subsidiary, some additional costs will need to be taken into account—for example, the costs associated with the incorporation and maintenance of a separate legal entity and annual preparation and filing of financial statements and Canadian income tax returns for the Canadian subsidiary.

Practice Note

Establishing a subsidiary requires the formation and maintenance of a separate Canadian legal entity having its own actual and potential liabilities.

(b) Jurisdiction of incorporation of a subsidiary in Canada

A subsidiary may be incorporated federally or in any province or territory of Canada. Some considerations in making a decision where to incorporate are:

- federal incorporation offers stronger name protection in that a franchisor will have the right to use its incorporation name in all ten provinces and three territories of Canada, even if another entity is using the same or a similar name in a province or territory;
- the federal jurisdiction and some of the provinces and territories have requirements that a certain number of directors be Canadian residents. Jurisdictions that do not have director residency requirements include the provinces of British Columbia, New Brunswick, Nova Scotia, Prince Edward Island and Québec, as well as the Nunavut Territory, the Northwest Territories and the Yukon Territory; and
- the initial and ongoing costs of federal incorporation and corporate maintenance generally exceed those of incorporating provincially.

A special category of incorporation known as an "unlimited liability company" (ULC) is available in the provinces of Nova Scotia, Alberta and British Columbia. ULCs are treated in the same way as other corporate entities for Canadian tax purposes, but as flow-through entities for U.S. tax purposes. Unlike normal federal and provincial corporations where the liability of shareholders is limited to their payment for shares, the liability of shareholders of ULCs is unlimited; for this reason, in a typical ULC structure, the ultimate U.S. shareholder may establish a "liability blocker," such as an intermediate subsidiary, to be the ULC's sole shareholder. Due to their treatment under the Canada-U.S. Tax Treaty, distribution of profits from a ULC to a U.S. parent corporation requires a two-step distribution process in order to avoid adverse tax consequences. This two-step process involves a stated increase in the paid-up capital of the shares of the ULC, followed by a payment that reduces the paid-up capital. Note that the two-step process does not provide relief where the ULC's shareholder is a U.S. limited liability company (LLC) that is a flow-through entity for U.S. tax purposes.

Practice Note

A franchisor seeking to form a Canadian subsidiary will need to decide between incorporating the subsidiary federally or in a particular province or territory. A U.S. franchisor may wish to consider incorporating a ULC in Nova Scotia, Alberta or British Columbia for U.S. tax-planning purposes.

(c) Tax considerations of a subsidiary

No distinction is made between passive and active income in the case of subsidiaries; income tax on all net income is calculated at corporate rates which would be applicable if the non-resident parent carried on business directly in Canada (i.e., tax at 25% to 30%). Furthermore, no branch tax would be payable on the subsidiary's income.

Dividends paid by a subsidiary would be subject to withholding tax of 25% (or any lower rate established by an applicable tax treaty, such as 5% for a U.S. franchisor parent that qualifies for benefits under the Canada-U.S. Tax Treaty). The Canadian tax liability of a subsidiary does not usually qualify for a tax credit in the foreign jurisdiction. However, a U.S. parent would receive a foreign tax credit in computing its home tax liability for the 5% withholding tax payable on dividends (percentage reduced from 25% by the Canada-U.S. Tax Treaty) but again, not for regular Canadian income tax paid by the subsidiary.

A non-resident parent is entitled to charge a fee for providing assistance to its Canadian subsidiary to carry out its business activities. The fee, if reasonable, will be a deductible expense in calculating the Canadian subsidiary's income. If the franchisor is resident in a country that has a tax treaty with Canada, such fee payment will be exempt from Canadian income tax if the parent does not have a permanent establishment in Canada. It is important to deductibility that the fee not exceed the amount that would be payable if the subsidiary and parent were unrelated and were dealing on an arm's-length basis.

It may be possible for a subsidiary to carry on business solely from a foreign country and therefore not "carry on business" in Canada at all. In this case, some Canadian registrations may be avoided.

(d) Tax advantages of a subsidiary

The tax advantages of a non-resident franchisor operating through a subsidiary include the following:

- The risk of withholding tax on passive income is avoided. This is an advantage if taxation of gross revenue would result in a higher level of tax than the Canadian income tax payable (25% to 30% of net income).
- Dividends are not taxed until paid, whereas a branch tax would be payable when earned.

(e) Tax disadvantages of a subsidiary

Tax disadvantages associated with a non-resident franchisor parent carrying on business through a subsidiary include:

- any losses incurred by a Canadian subsidiary may not be used to reduce the parent's home income tax liability;
- Canadian income tax usually does not qualify for a foreign tax credit in computing the parent's income tax liability in its home jurisdiction—only withholding tax on dividends paid to the foreign parent will qualify; and
- no withholding tax option is available if income is passive (the flat withholding tax on gross income might have resulted in less tax).

Practice Note

As in the case of operating through a branch, the tax consequences of establishing a Canadian subsidiary should be considered and reviewed with a tax advisor prior to implementing such a structure.

(f) Potential shareholders' agreement for a subsidiary

If at any time a franchisor allows a third party to acquire shares in its subsidiary (for example, in exchange for the transfer of business outlets owned by the third party that are converted to units in the franchisor's system), then preparation of a shareholders' agreement is strongly recommended. A shareholders' agreement may (among other things):

- describe what types of shares each shareholder owns and any shareholder loan(s) each is to make;
- set out the expectations and obligations of the parties in a wide variety of circumstances;
- provide a means of dispute resolution;
- provide protection to a minority shareholder and minimize any inequality of key voting positions caused by differing percentages of voting shares held;
- set out the agreement of the parties on the percentages of votes required to approve major matters when a particular resolution or set of circumstances is presented;
- control who might become an additional shareholder of the subsidiary;
- provide for what will happen when one or more of the shareholders (or a principal of a corporate shareholder) dies, divorces, becomes disabled, becomes inactive in the franchise business, or becomes in some other way unable or unwilling to contribute to the business;
- set out circumstances when a shareholder in default may be removed; and

- provide a method for the shares of a shareholder to be repurchased by the subsidiary upon his/her retirement, disability or death (or that of a principal of a corporate shareholder).

> **Practice Note**
>
> **If there are one or more arm's-length shareholders of a subsidiary, then a shareholders' agreement is strongly recommended. It may cover many important matters.**

(g) Registrations required for a subsidiary

If a subsidiary (including a federally incorporated subsidiary) intends to carry on business in several Canadian jurisdictions, it must register with the corporate registries in all of those jurisdictions (except for its jurisdiction of incorporation) in order to carry on business in such jurisdictions. A subsidiary is required to complete the same registrations as a non-resident franchisor setting up a branch operation (see earlier discussion).

> **Practice Note**
>
> **As in the case of a branch, a subsidiary will be required to complete a number of regulatory registrations in Canada.**

B. Special Rules for an Unlimited Liability Company (ULC)

Special tax benefits applicable to a ULC generally apply only when the ULC is owned directly or indirectly by a U.S. parent.

1. Tax Considerations of a ULC

A ULC is treated as an ordinary Canadian company for Canadian income tax purposes, so it must pay tax at normal corporate rates in Canada. As with an ordinary Canadian company, a ULC does not pay branch tax. Due to a ULC's unlimited liability, U.S. tax rules generally treat the ULC as a flow-through legal entity and will treat Canadian tax payable as a debt owing by its U.S. parent. The income of a ULC is taxable in the U.S., where Canadian income tax paid by the ULC qualifies for a foreign tax credit. Tax benefits of a ULC are generally restricted to the U.S. and are not available in other countries.

2. Tax Advantages of a ULC

The tax advantages of a ULC (in contrast to a conventional branch or subsidiary) include:

- a ULC avoids the question of whether franchise agreement payments are passive income (and subject to withholding tax) or business income taxable on a net income basis—as is the case for Canadian resident taxpayers. Payments to a ULC will be taxed on a net income basis;
- there is a U.S. foreign tax credit for a ULC for Canadian income tax paid that is not available when a conventional subsidiary is used; and
- there is no Canadian branch tax payable by a ULC.

3. Disadvantages of a ULC

The disadvantages of a ULC are:

- the exemption of a branch from Canadian tax based on the absence of a permanent establishment in Canada is not available. As a ULC is treated as a Canadian resident for Canadian income tax purposes, it does not qualify for relief from Canadian tax available to a branch under the Canada-U.S. Tax Treaty;
- in some provinces, a ULC is more expensive to incorporate and maintain than a conventional limited liability business corporation; and
- making distributions from a ULC to a U.S. parent without adverse tax consequences requires additional planning steps involving a stated increase in the paid-up capital of the shares of the ULC, followed by a payment that reduces the paid-up capital. This relief is not available where the direct parent is a U.S. LLC that is itself a flow-through corporation for U.S. tax purposes.

Practice Note

A U.S. franchisor may wish to consider establishing a subsidiary as a ULC rather than a conventional limited liability corporation.

C. Joint Venture

Another alternative for the non-resident franchisor is to enter into a joint venture to establish and develop the Canadian market for its franchise system. Two or more parties may engage in a joint venture whereby they agree to collaborate in a business venture. The term “joint venture” has no precise meaning, but generally denotes an association of two or more parties, typically governed by a written contract, pursuant to which such parties agree to combine their resources in furtherance of a desired venture with a goal of maximizing profits.

The elements of a joint venture often include: (i) a contribution of money, property, effort, knowledge, skill or other assets to a common undertaking; (ii) a joint property interest in the subject matter of the venture; (iii) mutual control or management of the enterprise; (iv) an expectation of profit; and (v) a right to participate in those profits. Joint ventures are attractive, as they enable parties to combine resources in a synergistic manner that creates a value from the venturers' working together which may exceed the value that they could realize independently as stand-alone businesses. Joint ventures are also useful for acquiring and sharing knowledge and experience and diversifying risk.

While joint venture formation is similar to an acquisition transaction in many ways, there is at least one fundamental difference: a joint venture marks the beginning rather than the end of the relationship between the parties. As a result, a sense of balance and a long-term perspective is crucial, with collaboration and cooperation between the parties being paramount. Accordingly, effective governance and dispute-resolution procedures play an important role in any joint venture agreement. In addition, the arrangement must be mutually beneficial to all venturers to enjoy a prospect of long-term viability.

A non-resident franchisor contemplating a joint venture will usually want to select a Canadian co-venturer that can contribute local franchise knowledge, operating experience, human resources and industry contacts, together with a reasonable amount of capital. One commonly identified source of joint venture failure is poor partner selection. Without the right co-venturer and an alignment of interests and objectives between the parties, no amount of legal contract drafting can solve irreconcilable differences between the parties that may arise. This is particularly true with respect to a joint venture that will operate for an indefinite term, as a longer term increases the risk that unforeseen problems may arise as markets evolve or the strengths and weaknesses of the parties and the brand of the venture change over time.

Practice Note

While joint venture formation is similar to an acquisition transaction in many ways, there is one fundamental difference: a joint venture marks the beginning rather than the end of the relationship between the parties.

Various legal forms may be utilized to form joint ventures. Generally, the formation of a joint venture may take one of three forms:

- equity joint venture;
- co-ownership; and
- contractual joint venture.

Each form will determine the nature of the joint venture agreement to govern the parties' relationship and the manner in which the joint venture will be operated, as described in further detail below. Tax considerations will often determine which form the joint venture will take (as discussed above and below).

Practice Note

The tax consequences associated with a joint venture should be reviewed with a tax advisor; they will often determine the type of structure to be used by the joint venturers.

1. Equity Joint Ventures

An equity joint venture typically has the following attributes:

- contribution of capital by each party; and
- each party having an ownership interest entitling it to participate in control of the joint venture and to share in its profits or losses.

The forms of equity joint ventures include general partnerships, limited partnerships, limited liability corporations and ULCs, as described below.

(a) Partnership

A common definition of a partnership is ". . . the relation which subsists between two or more persons carrying on business in common with a view of profit." Similar wording is used in various provincial partnership statutes in Canada. There are generally only two kinds of partnership that a franchisor and co-venturer may use—namely, "general" or "limited" partnerships. The legal relationship between partners is typically governed by a partnership agreement, which addresses, among other things, their respective rights and obligations, their intended management and operation of the joint venture business, the allocation of profits and losses among the partners, and the mechanism and requirements relating to bringing on a new partner or an existing partner leaving the partnership.

Because of its flow-through nature, a partnership might be appropriate if a joint venture business is expected to generate disproportionately large expenses in its early years, as the partnership structure would allow the individual co-

venturers to take advantage of the tax write-offs arising from these expenses. In the case of a limited partner, the amount of losses that may be available is limited by the amount that the limited partner is considered to have "at risk" in the partnership.

Practice Note

A franchisor and co-venturer may form either a general or limited partnership instead of a corporation, and may use a partnership agreement to establish their respective rights and obligations and their intended management and operation of the joint venture business.

(i) General Partnership

A general partnership is a relationship between two or more persons carrying on business in common with a view to profit. At its core, a general partnership creates an agency relationship, where each partner acts as an agent of the general partnership as well as the other partner(s). A general partnership is not a separate legal entity and, absent the desire to carry on business under a different name, there is no requirement to register a general partnership. However, non-registration is not sufficient to avoid being found to be operating as a partnership, as a partnership can be found to exist based solely on the conduct of the parties.

A general partnership is an appealing form of joint venture because it involves few formalities. It is simple and inexpensive to establish and dissolve. Moreover, a general partnership is not subject to the mandatory rules imposed on corporations, including any director residency requirements.

However, general partnerships expose their partners to significant commercial risk, as the partners are jointly and severally liable for the debts and obligations of the general partnership, and each partner has unlimited liability with respect to the full amount of the general partnership's liabilities. Further, circumstances affecting a partner, such as death, bankruptcy, withdrawal or retirement, may result in the automatic termination of the partnership. While general partnerships provide parties with significant flexibility, without the benefit of business corporations legislation providing a robust statutory framework, careful drafting of the partnership agreement is imperative to properly establish the significant rights and obligations of the partners.

Practice Note

In considering a general partnership structure, the parties should weigh the efficiency of the structure against the exposure to unlimited liability with respect to the general partnership's liabilities.

(ii) Limited Partnership

A limited partnership represents a middle ground between a corporation and a general partnership with respect to liability of shareholders or partners. A limited partnership consists of one or more general partners, whose liability is unlimited, and one or more limited partners, whose liability is limited to the amount of money or property they agree to contribute to the limited partnership. While a limited partnership is not a separate legal entity, it is still formed in compliance with specific legislation, such as the *Limited Partnerships Act* of Ontario. As with a general partnership, a limited partnership has no statutory requirements for directors. Nevertheless, any partner that is itself a corporation must comply with its own corporate compliance requirements.

Limited partners of a limited partnership will not be liable for more than the payment of their agreed capital contributions to the limited partnership, provided they refrain from participating in the management of the limited partnership. Instead, liability to third-party creditors will accrue to the general partner that manages the limited partnership business. A general partner may limit its liability significantly if it is incorporated by the limited partners for the sole purpose of managing the limited partnership, is given few assets to manage, and capitalization of the limited partnership is limited in amount.

The disadvantages of a limited partnership, as compared to a general partnership, include greater expense and formality in its creation, maintenance and dissolution. In particular, unlike a general partnership, a limited partnership must be registered with a governmental authority to be duly formed.

Practice Note

In considering a limited partnership structure, co-venturers should weigh the benefits of limited liability against the higher cost associated with its formation and the inability of any limited partner to participate in the management of the business (without risking the loss of its limited liability status).

(iii) Tax Considerations of a Partnership

A partnership is not a separate legal entity and, as such, is not a separate taxpayer. The partnership determines its profits or losses for any period and then allocates them to the partners in accordance with the terms of the partnership agreement, and each partner then pays income tax directly. Deductions and expenses (including discretionary deductions) are taken at the partnership level in determining profit or loss. Limited partners are subject to rules that generally impact the tax treatment of losses and partnership distributions allocated to them in excess of their investment.

The tax treatment of a partner that is a franchisor will depend on whether it participates in the partnership through a subsidiary or a branch, and is generally as described above in Part II (A) (and (B) for a ULC.

Practice Note

From the perspective of a person making payments to a partnership, the partnership is generally treated as a "see-through." This means that where a partnership has one or more non-resident partners, payments of fees to it may be subject to withholding tax, as well as withholding on payments for services it may perform in Canada.

(b) Corporation

(i) Limited Liability Corporation

To avoid the risk of being or being deemed to be a partnership, and thereby potentially attracting joint and several liability, joint venturers may decide to form a corporation rather than simply establishing an unincorporated joint venture or partnership. If they do form a corporation, the parties will define their respective rights and obligations through charter documents, such as articles of incorporation and bylaws and a shareholders' agreement. The charter documents and shareholders' agreement will establish a corporate name, share structure and share terms (including voting rights, rights to receive dividends, the right to receive property of the corporation on its dissolution, and the requirements for governance and management of the corporation (including the election of directors and approval requirements)). A corporation is a legal entity separate and apart from its shareholders. It has the rights, powers and privileges of a natural person. It can enter into contracts, sue and be sued in its own name, and is obligated to prepare annual financial statements and corporate tax returns.

If the joint venture sets itself up as a Canadian corporation, the tax consequences will be the same as those already described for a Canadian subsidiary.

A corporation is commonly used and well-understood as a joint venture vehicle. While the legal consequences of a joint venture may not always be clear, a joint venture established using a corporation provides certainty and clarity with regard to many legal issues involved. As a result, use of a corporation enhances acceptance of the venture and overall certainty in the marketplace.

Corporate joint ventures have several appealing traits. They are easily formed and can offer the parties flexibility in terms of financing through debt or equity. Once created, a corporation exists perpetually, which enhances market acceptance and certainty. Tax treatment of corporations may lead to advantages in-

cluding tax-deferred rollovers and tax-free flow of intercorporate dividends between Canadian corporations.

In a corporation, the shareholders have limited liability for the corporation's debts up to the amount of the price they have paid for their shares of the corporation. The personal assets of the shareholders are generally not at risk for satisfying corporate debts and liabilities. While the limited liability aspect of a corporation is attractive, it may be illusory, as lenders often require guarantees from shareholders as a condition of advancing funds. In addition, a significant range of matters attracting potential personal liability of directors under various pieces of legislation also renders the limited liability somewhat illusory, as corporations and shareholders will often indemnify directors and nominee directors of their subsidiaries.

Notwithstanding the numerous advantages offered by using a corporation as the vehicle for operating a joint venture, some disadvantages remain. Corporations must adhere to statutory compliance and regulations, which include mandatory annual filings and the requirement to hold meetings of directors and shareholders. This is in addition to other regulatory and disclosure obligations if the corporation offers its shares to the public, all of which will result in increased maintenance and compliance costs.

Moreover, corporations in some Canadian jurisdictions are subject to director residency requirements.

Québec's *Business Corporations Act* includes many modern, progressive and even innovative concepts, including the ability to have no directors at all if a corporation has only one shareholder.

Practice Note

Using a corporation as the vehicle for a joint venture offers the advantages of limited liability for shareholders, flexibility of financing, and market certainty, but corporations and their directors must comply with statutory requirements.

(ii) ULC

As described in greater detail above, as an alternative to a limited liability corporation, joint venturers may incorporate a ULC in Alberta, British Columbia or Nova Scotia for use as a joint venture vehicle. Similar to an ordinary limited liability corporation, a ULC is a separate legal entity from its shareholders and has perpetual existence. Of course, as described above, the critical difference between a ULC and the more conventional limited liability corporation is the unlimited joint and several liability of a ULC's shareholders for corporate debts

and liabilities. In some provinces, ULCs are more expensive to form and maintain than a conventional limited liability corporation. While there are no Canadian tax or corporate reasons to utilize a ULC as a joint venture vehicle, there are potential U.S. tax benefits that might warrant its use.

Practice Note

In evaluating the advisability of a ULC as a joint venture vehicle, the U.S. tax efficiencies must be weighed against the effects of the "anti-hybrid" rule in the Canada–U.S. Tax Treaty, which restricts the availability of treaty benefits on certain payments from a ULC to its U.S. shareholders.

2. Co-ownership

In a co-ownership situation, each owner holds an undivided interest in the assets of the joint venture. Co-ownership is a popular form for joint ventures involved in mining, oil and gas exploration, and major real estate developments (including shopping malls), but it is not commonly used in franchising.

Similar to contractual joint ventures, a co-ownership joint venture may have an uncertain legal status, create joint liability and be recharacterized as a general partnership if the parties act like partners with respect to joint venture activities. Though it may be a desirable form, a co-ownership may be complicated by the fact that the relationship must be addressed in its entirety in contractual documentation between the parties involved (as it does not benefit from a corporate statute governing its formation and operation).

When this form of venture is used, a tax advantage may derive from the fact that income or loss is calculated at the level of each joint venturer rather than in one common entity, such as a corporation, which may allow for flexible division of profits and losses. Each joint venturer may, within reason, claim differing levels of discretionary deductions, such as capital cost allowance (depreciation) on its interest in particular joint venture assets. Tax treatment for a franchisor will depend on whether its participation in the joint venture is through a subsidiary or a branch.

Practice Note

A co-ownership presents opportunities for profit and loss offsets, but must be carefully considered in light of the fact that the relationship must be entirely governed by a comprehensive contract.

3. Contractual Joint Venture

In a contractual joint venture, the co-venturers each agree to provide particular services or assets of their own for the joint benefit of all co-venturers. This form typically appeals to relationships involving long-term commitments such as outsourcing, licensing, distribution, and franchising arrangements (including master licence and area development arrangements).

A separate legal entity is not created by contract. This may provide for flexibility in the formation and operation of the joint venture and also be conducive to individual tax and succession planning by each party. The tax consequences of a contractual joint venture are generally the same as for a co-ownership that can be maintained as such (i.e., that will not be characterized as a partnership by tax authorities).

Notwithstanding the convenience and other advantages of a contractual joint venture, this type of arrangement also possesses unique challenges. The contract between joint venturers must be skillfully drafted to address the entirety of the relationship, as there is no robust statutory framework to fill in any gaps, as exists for corporations and, to a lesser extent, partnerships. Further, contractual joint ventures have uncertain legal status, and there is a risk that a joint venture of this type might be characterized as a general partnership, which could lead to unlimited liability for the parties involved and unintended tax treatment.

To help avoid the possible presumption that a partnership has been formed, the joint venture agreement should expressly declare that a partnership is not intended and that the venturers are independent contractors. The contract should also set out the scope of the venture and the methods of control and decision-making. It will need to stipulate the rights and obligations of the participants and provide mechanisms for settlement of disputes. Again, unlike a corporation, a joint venture is not a distinct legal entity. It cannot sue or be sued.

Master franchise agreements and area development agreements are examples of contractual joint ventures in which the franchisor licenses its franchise system, trademarks and branding to a Master Franchisee or Area Developer to develop and expand into their local market. The Master Franchisee or Area Developer, in turn, typically invests its own capital and resources in the establishment and development of the franchise system in a designated area (or all) of Canada and commits to developmental goals or quotas relating thereto.

Practice Note

A contractual joint venture can offer considerable flexibility; however, the uncertainty of its legal status can make contracting complex and create the risk of potential additional liability.

D. Master Franchise or Area Development

1. Master Franchise Agreement

A popular option available to a franchisor wishing to expand into Canada is the master franchise arrangement. It involves the granting of rights by the franchisor to one or more Master Franchisees (subfranchisors) to develop units in particular areas through subfranchisees. The rights granted to the Master Franchisee will normally be exclusive within a designated territory (which can be one or more provinces or even all of Canada) and will include the right to grant subfranchises to use the franchisor's trademarks and system within such territory. This differs from the standard franchise relationship in which a franchisor directly grants a franchisee the right to operate one branded business at a particular location.

In a master franchise structure, the franchisor relies on the experience and financial and human resources of the Master Franchisee to expand in the granted territory. It is vital that the franchisor choose a Master Franchisee that has experience in franchising, good character references, financial resources, well-trained staff, broad industry contacts, and working knowledge of the laws applicable to franchising and commercial practices of the territory. Also, good administrative skills are important. Sometimes the Master Franchisee will be required to open and operate one or more pilot locations itself or through a subsidiary in order to test and adapt the system to Canada. The Master Franchisee should bring valuable industry contacts, for example, in commercial leasing, banking and relevant types of suppliers. The franchisor must provide thorough training in the operation of its system to the Master Franchisee. The franchisor's training must enable the Master Franchisee in turn to provide training to new unit franchisees. In effect, the franchisor must "train the trainer."

The franchisor's revenue typically comes from three streams: (1) initial franchise, renewal and transfer fees; (2) periodic royalties typically based on a percentage of the franchisees' gross sales; and (3) in certain systems, sales of products and supplies to franchisees. In interposing a Master Franchisee to do most of the work, the franchisor must expect to share reasonable portions of these revenue streams with the Master Franchisee.

Most important, a formula for sharing initial franchise fees and ongoing royalties with the Master Franchisee must be established in the master franchise agreement. In the sharing formula, the franchisor must ensure that the Master Franchisee will receive enough income to support its provision of services to franchisees and to enable the Master Franchisee to continue to operate in Canada at a reasonable profit level.

In a master franchise arrangement, the franchisor must still supervise the Master Franchisee and, ideally, should make regular visits to some subfranchised lo-

cations, but much of the responsibility for running the system in the territory is transferred to the Master Franchisee. The saying is that "the Master Franchisee stands in the shoes of the franchisor" in the territory granted. This can result in substantial cost and time savings, although of course less revenue, to the franchisor. The franchisor must be prepared to place a great deal of faith in the Master Franchisee to properly maintain and develop the system in the territory granted, while at the same time protecting and enhancing the franchisor's brand there. A well-placed Master Franchisee can open doors in a market that is unfamiliar to the franchisor. However, choosing the wrong Master Franchisee can cause significant harm to the system very quickly, in terms of both operational efficiency and success and the reputation and value of the franchisor's brand. Also, while there is typically no privity of contract between the franchisor and the individual franchisees or their customers, the franchisor will often be viewed as having "deep pockets" that a plaintiff in either group may attempt to access if something goes wrong.

Practice Note

In a master franchise structure, the franchisor relies on the experience, contacts, financial and human resources of the Master Franchisee to expand in the granted territory. The Master Franchisee is said to "stand in the shoes" of the franchisor within the territory granted.

Other items to be covered in the master franchise agreement include the franchisor's ability to change its branding or franchise system to adapt to changing markets and technology, withholding tax on remittances to a non-Canadian resident franchisor, establishment of an advertising program, consequences of default of a unit franchise agreement, choice of law, and a dispute resolution mechanism. A master franchise agreement may also attach the form of subfranchisor "unit" agreement that the Master Franchisee must use and address the preparation and approval rights and requirements relating thereto. In doing so, the Master Franchisee must comply with the requirements of all applicable local laws, including provincial franchise legislation.

While the Master Franchisee will be required to comply with all applicable franchise legislation with respect to individual franchisees (since the Master Franchisee is the "franchisor" in that relationship for statutory compliance purposes), the franchisor itself will still be required to comply with applicable franchise legislation, including disclosure and good faith/fair dealing requirements, with regard to its relationship with the Master Franchisee.

In addition, the franchisor will want to ensure that the Master Franchisee discharges its obligations properly and that each franchise agreement is assignable to the franchisor upon the expiration or termination of the Master Franchise relationship.

Practice Note

There is often a strong business case for a franchisor to contract with a Master Franchisee in a foreign territory, as opposed to franchising individual units there directly. Interposing a Master Franchisee, however, is not inexpensive or without risk. As with any business relationship, finding the right Master Franchisee will be critical to the success of the master franchise relationship.

A variation on the master franchise relationship, sometimes called an "area representative" arrangement, involves finding a local candidate or entity that fulfills many of the functions of a Master Franchisee (e.g., franchisee recruitment, site selection, training and ongoing assistance). An area representative arrangement differs, however, in that the area representative does not have the right to sublicense to unit franchisees; the franchisor will directly franchise to them. Often, the franchisor pays the area representative a share of the fees the franchisor receives from unit franchisees. If appropriately structured, the area representative arrangement is not a franchise relationship at all, but rather an agency or marketing relationship.

2. Area Development Agreement

Establishing one or more area development agreements is another option for entry into Canada due to the large size of the country and prevalent regional differences. The franchisor will usually grant the area developer the right to develop the franchise system within an exclusive territory and, pursuant to such grant, to enter into unit franchise agreements with the franchisor. A Canadian Area Developer will need to possess the financial and human resources to establish an agreed number of franchise units in the exclusive territory granted. The Area Developer may be allowed to use its own subsidiaries as franchisees provided it maintains control of them through share-voting rights. The franchisor will want to receive and review charter documents and shareholders' agreements for such subsidiaries to confirm adequate control and governance by the Area Developer.

The area development agreement will typically have an initial fee for the right to open a specified number of units (possibly with an option for more units if the developer achieves its quota of openings over the initial term). The developer will sometimes be given a progressive partial discount against initial fees payable for its subsidiaries' units being opened. Some other provisions to be found in the area development agreement are: exclusivity of territory, the "shrinking" of territory (or, possibly, loss of exclusivity) if the developer fails to meet any quota, transfer rights, and a "cross-default" provision between the area development agreement and any franchise agreement held by the developer or its subsidiary.

Practice Note

Area development agreements with developers possessing "local knowledge" and other resources/attributes may be used to address regional differences in the Canadian market.

3. Tax Considerations

Generally, Canadian tax treatment of a non-resident franchisor will depend on whether it has established a Canadian subsidiary to contract with the Master Franchisee or Area Developer (in which case the tax consequences applicable to a Canadian subsidiary will apply) or the contract has been made directly by the non-resident franchisor (in which case the rules applicable to a branch operation will apply).

III. Goods and Services Tax (GST) and Harmonized Sales Tax (HST)

A. Overview

The Canadian government imposes a federal tax on goods and services supplied or imported into Canada. It is called the GST, which is similar to the value-added taxes (or VAT) that are imposed in Europe. The retail sales tax imposed by three Canadian provinces (see below) is in addition to the federal GST.

Generally speaking, GST is imposed on goods and services at all business levels: manufacturing, importing, wholesaling and retailing. The *Excise Tax Act,* which is the legislation that imposes GST, requires the supplier of goods and services in Canada to collect a tax equal to 5% of the value of the supply. The 5% tax is also applied on all goods imported into Canada (though there are exemptions for visitors' personal goods). However, if a party paying the tax is involved in commercial activity and is therefore charging GST on the goods and services that it provides to its customers, then such payor will be entitled to a refund (or credit) of all GST it has paid to provide such services or products. As a result, most manufacturers, wholesalers, retailers and importers obtain a full refund of the GST they have paid. The ultimate consumer absorbs the GST and is not entitled to a refund. In the end, the GST system is a multi-leveled structure for collecting a 5% tax on a value-added basis from the ultimate consumer.

Some types of businesses are not required to charge GST on their services but are still required to pay GST themselves. These businesses include banking, insurance and securities outlets, medical and dental services, and landlords of used residential accommodation (sales and rentals). The suppliers of these types

of services do not receive a refund of GST they pay. They are referred to as "exempt suppliers." An exempt supplier, therefore, is in the same GST position as a consumer.

There is another group of businesses that are not required to charge GST to their customers but are nonetheless entitled to a refund of the GST paid by them to provide their services. Such suppliers are referred to as "zero-rated suppliers." The principal zero-rated suppliers sell basic groceries, medical supplies, agricultural supplies and exports.

The Provinces of Nova Scotia, Prince Edward Island, Newfoundland, New Brunswick and Ontario, in cooperation with the federal government, have replaced their formerly existing single-stage, retail sales tax with a multi-stage sales tax which uses a broader base of goods and services and the same operating structure as the federal GST (i.e., persons involved in supplying taxable goods and services to others obtain a full refund of GST paid). In these cases, the tax rate is a combined rate of GST and provincial sales tax and is referred to as the HST. The rate in Ontario, New Brunswick and Newfoundland is 13%, consisting of the 5% federal GST component and an 8% provincial component. The rate in Nova Scotia is 15%, consisting of the 5% federal GST and a 10% provincial rate. The rate in Prince Edward Island is 14%, consisting of the 5% federal GST and a 9% provincial rate.

Practice Note

The Canadian government levies taxes on goods and services supplied or imported into Canada which are combined, or "harmonized," with retail sales taxes in some provinces.

B. Application of GST/HST to Franchises

The grant or supply of franchise rights is taxable, and a registrant franchisor must charge GST/HST on all types of fees it collects from a Canadian franchisee (including initial franchise fees, royalties, advertising contributions, any rents or other charges). GST or HST will apply depending on the application of place of supply rules to determine the province in which the supply is considered to have been made.

However, the grant or supply of franchise rights in Canada by a non-resident franchisor will be deemed to be made outside of Canada and therefore not subject to GST/HST, unless:

- the supply was made in the course of a business carried on by such franchisor in Canada; or
- the non-resident franchisor was registered with the Canada Revenue Agency for GST/HST purposes.

The Canadian franchisee would still need to consider whether GST/HST is required to be self-assessed on reporting forms by the franchisee as a recipient of an "imported taxable supply." This self-assessment obligation would be required only for franchisees that are not exclusively involved in GST commercial activity (i.e., are involved in making exempt supplies for GST/HST purposes and thus do not claim full input tax credits).

Practice Note

Canadian franchisees will generally be required to pay GST/HST on all fees (initial franchise fees, royalties and marketing fund contributions) charged by franchisors, other than to non-resident franchisors that have not registered in Canada for GST/HST purposes and are not carrying on business in Canada.

C. Registration Requirements

1. Branch Operation

(a) Mandatory registration

A non-resident franchisor that directly grants franchise rights for a particular geographic area in Canada but does not actively participate in soliciting franchisees or assisting in franchise operations in Canada will not be considered to be carrying on business in Canada. Accordingly, such a franchisor need not register for GST/HST purposes and need not report to the Canada Revenue Agency on GST/HST collection.

However, a reasonably high level of business activity in Canada, including actively soliciting franchisees, likely means that the non-resident franchisor is carrying on business in Canada. If a non-resident franchisor opens a business office in Canada, this will be a clear indication to the Canada Revenue Agency that the franchisor is carrying on business in Canada. Under these circumstances, the non-resident franchisor will be required to register for GST/HST purposes. If a non-resident franchisor has set up a subsidiary in Canada, and representatives of the non-resident franchisor visit Canada as part of its administration of the franchise system in Canada, this alone will not cause the non-resident to be "carrying on business" in Canada. However, if such representatives bill the subsidiary or subfranchisees for services provided during such visits, then the representatives will be carrying on business in Canada in respect of those activities, which will, in turn, require the franchisor to register for GST/HST purposes.

Practice Note

A non-resident franchisor will not be required to register for GST/HST purposes if it does not actively participate in soliciting Canadian franchisees or assist in the operations of the Canadian franchise system.

(b) Voluntary registration

A non-resident franchisor may wish to voluntarily register for GST/HST purposes even if it is not considered to be carrying on business in Canada. Such registration will generally require that it collect GST/HST from its franchisees. The Canadian franchisee will necessarily be a GST/HST registrant and will generally get a full refund of the GST/HST it pays in the course of operating its business, except to the extent that the franchise is an exempt supplier (e.g., an insurance broker). Registration will also mean that the non-resident franchisor will get a full refund of the GST/HST that it incurs in Canada. For example, representatives of a non-resident franchisor taking business travel in Canada often pay GST/HST for airfare, hotel rooms, meals and car rentals. GST/HST might also be paid on equipment and supplies that are brought into Canada in the course of franchise operations. This GST/HST paid will be refunded only if the franchisor has become a GST/HST registrant.

Compliance with the GST/HST system by a registrant is less complex and less costly than income tax compliance.

Practice Note

Voluntary registration for GST/HST purposes by a non-resident franchisor may be advantageous for a non-resident from a tax recovery perspective.

(c) Security

A limitation of GST/HST registration by a non-resident franchisor is that a non-resident must post security (whether registration is voluntary or mandatory) with the Canada Revenue Agency for one-half of its estimated net GST/HST remittances (i.e., GST/HST collected minus GST/HST paid) for the following year. Such security is reviewed from time to time by the Canada Revenue Agency to ensure that it continues to represent one-half of the net GST/HST in the preceding year. The security can be by way of an insurance bond; however, another common practice is to pledge a Government of Canada bond (the interest would be received by the non-resident franchisor). When the estimated net GST/HST liability of the non-resident is less than C$3,000 per year and the taxable supplies are less than C$100,000 per year, security will be waived.

Practice Note

Non-resident franchisors may be required to post security for GST/HST purposes with the Canada Revenue Agency.

2. Canadian Subsidiary

If a non-resident franchisor establishes a Canadian subsidiary (including a ULC) to own or manage its Canadian franchise operation, the subsidiary must become a GST/HST registrant and must collect GST/HST from Canadian franchisees on all types of fees paid. Unlike its parent, the Canadian incorporated subsidiary will automatically be considered a resident of Canada. Only the Canadian subsidiary (and not the parent franchisor) will be subject to GST/HST requirements. The initial fee for the grant (supply) of master franchise rights by the non-resident franchisor to a Canadian subsidiary pursuant to a master franchise agreement will not be subject to GST/HST unless the non-resident franchisor has elected to register for GST/HST purposes.

Note, however, that a Canadian subsidiary of a non-resident franchisor is not required to post security for GST/HST even though it may not have an office or other permanent establishment in Canada.

Practice Note

The Canadian subsidiary of a parent non-resident franchisor carrying on business in Canada must become a GST/HST registrant, but as the subsidiary is deemed a Canadian resident, it is not required to post security.

IV. Provincial Sales Tax

A. Overview

The province of Alberta and the three Canadian territories (Yukon, Northwest Territories, and Nunavut), being four out of the 13 Canadian provinces and territories, do not charge HST or impose a retail sales tax on the sale of goods and services.

B. Retail Sales Tax

Three provinces impose a single-stage sales tax similar to the retail sales tax in most U.S. states. The tax is payable by a buyer on retail sales in such provinces and by a person who imports goods into such provinces.

The rates of tax in the single-stage sales tax jurisdictions are:

Province	Rate
British Columbia	7%
Saskatchewan	5%
Manitoba	8%

Additionally, federal GST of 5% will be charged in these three provinces.

Higher sales tax rates apply to certain products in various jurisdictions. British Columbia, for example, charges 8% to 10% sales tax on luxury cars and 10% on liquor.

Sales tax was initially only levied on the purchase of tangible personal property but in more recent years has been expanded to include some intangibles (e.g., software) and some services (e.g., legal services in British Columbia).

Practice Note

In addition to federal GST, the provinces of British Columbia, Saskatchewan and Manitoba each apply sales tax to retail sales made in the province and imports into each province. Also, in British Columbia, certain services attract sales tax.

C. Québec Sales Tax (QST)

In 1992, the Province of Québec replaced its single-stage retail sales tax with a multi-stage tax. It initially was similar to the federal GST, though not identical. The Province of Québec has subsequently fully harmonized the QST with the federal GST but still separately administers the QST. As a result, the two taxes are assessed separately. Persons involved in the supply of taxable goods and services get a full refund of QST paid. As of January 1, 2014, the QST rate is 9.975% and is no longer calculated on a GST-included price. Consequently, the combined GST/QST rate in Québec is now 14.975% (5% GST plus 9.975% QST).

Practice Note

The Québec sales tax is harmonized with the federal GST, but is administered separately by the Province of Québec.