PRICEWATERHOUSECOOPERS

Tax Memo

Emerging Tax Topics for 1998 and Beyond

New tax topics are constantly emerging, often because of legislative developments in Canada and abroad, international treaties or landmark court decisions. Other new topics arise from changes in the business environment, such as the growth of electronic commerce. This publication highlights just a handful of tax topics having special currency in 1998.

Claude Lemelin and Michael C. Durst, of the Canadian and US transfer pricing groups, consider Advance Pricing Agreements (APAs). They note that Canadian companies doing business abroad may be able to save money - and possibly aggravation - by negotiating APAs with Revenue Canada on methodologies for calculating transfer prices on goods and services sold within a corporate group. International tax partners Paul Glover and Nick Pantaleo comment on the relevant findings of last spring's Mintz report (formally, the Technical Committee on Business Taxation). The Mintz report's recommendations create serious concerns for the resource industry, as Rich Carson and John Gravelle of the mining tax group explain.

Electronic commerce gets a lot of coverage in business press. Partners Chris Potter and Pierre Bourgeois explore some of the tax implications of this fascinating and rapidly evolving field. In sharp contrast to the novelty of electronic commerce is the venerable institution of the family business. Developments in this area need constant monitoring, and two of our partners working in the area, Don Wray and Virginia McKenna, focus much-needed attention on succession issues that can make the difference between business failure and survival.

As for the title of this publication, the choice of the word "emerging" has nothing directly to do with the merger that created PricewaterhouseCoopers LLP this year. Still, we are proud to have emerged as a pre-eminent business advisor. In tax alone we have over 600 partners and staff in Canada and 16,400 around the world, all keen to provide their top-notch advice.

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Advance Pricing Agreements

Transfer pricing has become one of the most talked-about topics in international tax, for several reasons. Perhaps the most important is the fact that the world economy has become increasingly global. Markets not long ago considered separate and distinct are now seen as one. With many Canadian corporations (and not just multinationals) conducting more business abroad, issues involving intercompany transactions are surfacing.

Transfer pricing

A transfer price is the amount a corporate entity charges to, or is charged by, related entities in another country for goods or services. That price is used in calculating the taxable income of the related entities, both in Canada and in the foreign country.

Revenue Canada and its foreign tax counterparts fear that related corporations can fix prices for their transactions with the goal of minimizing taxes globally. Many countries, including Canada and the United States, have developed transfer pricing rules to counteract these strategies. Two key elements are strict requirements for contemporaneous documentation and penalties for understatement or overstatement of transfer prices between related corporations.

Transfer prices have a direct effect on the amount of income taxes paid by a corporation, or related corporations, in more than one country, so any problems can put corporations at risk in several jurisdictions. They may face the possibility of double taxation.

In response to these transfer pricing issues, advance pricing agreements (APAs) are rapidly becoming an integral part of international tax. An APA is a binding agreement between a taxpayer (or several related taxpayers) and the taxation authorities of one or more countries that determines a transfer pricing methodology (or methodologies) to be used in pricing the goods and services of future transactions between those related taxpayers. The APA covers the transfer of goods and the various forms of transfer of services, including management services, research and development, cost sharing arrangements and the use of intangibles. An APA can also be seen as a process for resolving potential transfer pricing disputes before they actually arise.

APAs are gaining acceptance worldwide, although countries are at different stages in their implementation. Canada, the United States, Australia and Mexico, among others, already have systems to provide APAs on transfer prices between related corporations. Many other countries are refining their process. APAs are increasingly seen as the potential answer to the transfer pricing concerns of many multinationals.

A method, not a price

An APA determines a method to fix transfer prices, not the appropriate price for specific goods or services. The APA incorporates a set of criteria and critical assumptions under which the proposed transfer pricing method would operate on future transactions.

With an APA request, a taxpayer has to provide explanations and analyses of the proposed transfer pricing method. These must comply with the requirements of the *Income Tax Act* and, therefore, must be consistent with the "arm's length principle." Under this principle, transactions between parties not dealing at arm's length should be executed on terms and at a price that one could reasonably expect in similar circumstances (i.e., similar product or service, credit terms, reliability of supply) had the parties been dealing at arm's length.

The following brief extract from an actual APA with the Internal Revenue Service demonstrates this attention to method:

> *Taxpayer agrees to comply with the terms and conditions of this APA, including the transfer pricing methodology ("TPM") that is described in Appendix A. If Taxpayer complies with the terms and conditions of this APA, then the Service will not contest the application of the TPM to the Covered Transactions and will not make or propose any reallocation or adjustment under section 482 of the Code with respect to Taxpayer concerning the Transfer Prices in Covered Transactions for the years covered by this APA (the "APA Years").*

The APA process

One or more pre-filing meetings may take place between the taxpayer, the taxpayer's representatives and Revenue Canada. These meetings are an opportunity to meet Revenue Canada's APA officials and discuss their willingness to issue an APA in the particular circumstances of the taxpayer. Most importantly, parties can explore some of the issues involved, including the kind of information that will be required to be disclosed and the timing of the process.

After the pre-filing meeting, the taxpayer will formally request an APA from Revenue Canada, which (if it

agrees) will send an acceptance letter. This letter constitutes the formal acceptance by both parties of the essence of the agreement. Several other meetings and negotiations with the tax authorities will occur over a period. During the rounds of negotiations, and prior to the conclusion of the APA, the taxpayer will be required to disclose a great deal to the tax authorities, including information:

- On existing transactions of goods and services between the taxpayer and related entities;
- About the detailed organizational structure of the operations of the taxpayer;
- Regarding the taxpayer's competitors and comparable businesses; and
- That was used to determine the proposed transfer pricing method, including a functional analysis, economic studies and profitability calculations.

In most cases, the factual information disclosed to the tax authorities as part of the APA process is confidential and will be treated like any other information gathered by Revenue Canada during an audit. As such, it can be used by the tax authorities in the administration of the *Income Tax Act.* Taxpayers should take this into consideration in deciding whether to go forward with an APA request.

The APA process takes from 18 months to three years, according to recent experience. The meetings usually require that additional information be submitted to tax authorities and can be very demanding on the taxpayer.

The fees charged by Revenue Canada are "out-of-pocket" costs incurred in completing the APA. They vary from $5,000 to $40,000, but generally are in the vicinity of $20,000 (compared to approximately US$25,000 in the United States). Barring significant changes in the operations covered in the APA, the agreement can be renewed at the request of a taxpayer. The initial costs associated with the conclusion of the APA can accordingly be amortized over a number of years.

Prior years

The APA is a prospective process that does not address prior years. However, if the methodology in the APA differs from that used in the prior years, it will likely affect those prior years. This point is one of the most important to consider in deciding to apply for an APA. In practice, Revenue Canada auditors will delay concluding their audits of open years until the APA is finalized.

Unilateral/bilateral/multilateral

An APA can be unilateral, bilateral or multilateral. Negotiations with other countries are conducted under the Competent Authority procedure of a relevant tax treaty. When an agreement is reached between Canada and a foreign country, a taxpayer has the assurance that both tax authorities will accept the transfer pricing methodology used in determining the transfer prices for the transactions covered by the APA. The risk of potential double taxation on transfer pricing issues is thereby reduced.

Advantages of an APA

An APA offers numerous advantages. For example, it assures a taxpayer and related taxpayers that no transfer pricing adjustments will be made over the period covered by the agreement if the terms and conditions set in the agreement are respected. Also, it significantly reduces the taxpayer's costs associated with transfer pricing audits by the tax authorities, and will allow a taxpayer to be protected from penalties and interest for understatement or overstatement of income due to transfer prices. More importantly, it protects a taxpayer from any possibility of double taxation.

APAs are not for everyone. Some (typically smaller) companies, which are not regularly subject to tax examination, might feel that APAs bring them into more frequent contact with tax authorities than might otherwise occur. In many instances, however, companies can expect to be examined regularly, so an APA could accelerate and simplify resolution of potentially difficult issues that the company otherwise would need to deal with in the more adversarial environment of examinations. Indeed, bilateral APAs have become a standard tool for large companies doing business in both Canada and the United States. In other circumstances, even for smaller companies, APAs can provide needed certainty, or can be used as vehicles to resolve pending examinations. All told, APAs can be a valuable tool in dealing with today's stricter environment of transfer pricing enforcement.

♦ Claude Lemelin; Michael C. Durst

Cybertax: Carving taxes out of the information superhighway

Cybertax, information highway, electronic commerce, new millennium, global economy – what does all this mean to your business? What will be the tax cost of the

new way you are conducting business? What are the risks and opportunities?

Electronic commerce is changing the way the world is conducting business. Tax administrations around the world and the Organisation for Economic Co-operation and Development (OECD) have embarked upon a review of their fiscal policies and collection procedures in contemplation of the likely effect of these changes. On the US legislative front, the *Internet Tax Freedom Act* was signed as part of the October 21, 1998 omnibus appropriations bill. The legislation imposes a three-year moratorium on state and local taxes on Internet access fees charges by Internet service providers and on "multiple" or "discriminatory" taxes on electronic commerce. The legislation also grants states that currently have taxes on Internet access that are generally imposed and actually enforced as of October 1, 1998, the right to continue to levy these taxes.

Until recently, electronic commerce referred primarily to electronic data interchange (EDI) offerings and electronic messaging technologies that facilitated the exchange of information between businesses and organizations. During the past two years, the term electronic commerce has broadened to encompass business-to-business and business-to-consumer transactions conducted over the Internet and the World Wide Web. The Internet and Web browsers have created an easy-to-use, standardized infrastructure for conducting business and have made new products and ways of conducting business possible. The use of electronic commerce for business transactions is expected to grow dramatically over the next several years, fuelled by the availability of sophisticated Internet and Web technology and tighter security mechanisms.

The repercussions are significant. According to Marc Milgrom, the Canadian tax leader of Pricewaterhouse-Coopers LLP's Technology Industry Group: "The adequacy of tax systems is being brought into question. Existing legislation must be interpreted in today's electronic age in a consistent and predictable manner. Concerns arise because tax legislation and tax treaties were drafted when the presence of bricks and mortar were necessary to conduct business. New technologies significantly reduce the need for a physical presence in a jurisdiction, and reduce the number of intermediaries needed to complete a transaction. The pace of change will only heighten, creating further issues, risks and opportunities."

In a global economy, the issues are complex, spanning a multitude of taxing regimes, philosophies and cultures. Nevertheless, a consensus is starting to emerge on some broad principles:

- *Tax neutrality*: Any changes should provide for different taxpayers to be taxed in the same manner when entering into similar transactions in similar situations.
- *Retention of existing principles*: For the moment, suggestions that a unique basis of taxation be developed to tax electronic commerce have been rejected. For example, a "bit tax" on the number of bits transmitted and the use of formulae to allocate income among jurisdictions have been advanced. To varying degrees, most countries that have taken a position want existing tax principles to be retained and adapted, if necessary, to deal with electronic commerce.
- *Cooperation and consensus are essential*: Given the global reach of electronic business, countries recognize that a particular jurisdiction cannot make unilateral changes without hurting their residents and their tax bases. A consensus is being sought on how to adapt existing principles.

The effect of electronic commerce

A number of characteristics of electronic commerce affect how business is conducted and the interpretation of existing tax principles. For example:

- Electronic commerce facilitates international trade and cross-border cooperation within an organization, as well as joint ventures between businesses. Consider, for example, the collaborative development of software by a team of engineers located in Canada and other countries. Barriers of entry are significantly reduced, resulting in an increase in the number of international transactions, most notably among small- and medium-sized businesses with lower-value transactions.
- Products that have been sold in physical form can now be sold in digital form from computer to computer. These include software, music, videos, books and other written material. The transformation of physical goods to digital versions raises issues with respect to the characterization of income and the appropriate tax treatment for domestic, international and sales and customs purposes. Compliance and documentation issues also arise.
- Access to new technologies may also reduce the number of intermediaries in a given transaction, an effect known as "disintermediation." For example, shrink-wrapped software sold through traditional distribution channels (developer→manufacturer→

wholesaler→retailer→consumer) may now be sold directly from the developer to the consumer via the Internet.

Disintermediation raises important concerns, because intermediaries have traditionally acted as tax collectors and provided tax authorities with an audit trail. In addition, the lack of intermediaries may erode a local tax base, especially for a jurisdiction that is a net importer of goods and services transacted electronically. On the other hand, the tax base of a country that is a net exporter likely would not suffer, and may even expand. Clearly, there are competing interests among governments.

- There is no necessary relationship between an Internet address or a Web site, the residence of a party or its physical location. Such anonymity may make it difficult to determine which tax treaty applies to a given transaction and has governments concerned about intentional non-reporting of transactions.

International income tax issues

Just as electronic commerce is clearly a global issue, so are the tax issues raised by conducting business electronically. Until an international consensus emerges, there will be a risk of incompatible treatment of revenue derived from electronic commerce when more than one jurisdiction is involved.

Underlying all the issues that are discussed below is one of today's greatest concerns for governments: transfer pricing. Although transfer pricing issues that must be considered in the context of electronic commerce are not new, they are particularly complex. For example, the creation, ownership, valuation and transfer pricing methods relating to intangibles raise difficult issues for businesses transacting globally. The use of a branch or a subsidiary can have vastly different results when intangibles are involved.

Canadians taxpayers transacting electronically with non-residents

Canadian taxpayers that transact electronically across borders face these issues:

- With the emergence of a computer server and Web site as vehicles for conducting business, the level of activity necessary to constitute a permanent establishment, and thus be subject to income tax, is uncertain. Various US states, in particular, have taken a rather aggressive stance in this regard.
- When income derived from electronic commerce is considered business income by Canada, but subject to withholding taxes in a foreign jurisdiction, the current foreign tax credit mechanism fails to provide adequate relief.

Canadian withholding obligations also need to be considered, as Canadians increasingly make payments to non-residents with respect to electronic commerce. These withholding requirements apply to payments to non-residents for services rendered in Canada (raising issues such as where a service is performed and whether a Canadian recipient will even know the residency of a service provider over the Internet) and for information, licences and sales of digitized products.

One way to view business conducted electronically is that only the ***method*** of delivery is changing, not the purchaser's underlying rights. The delivery of a product by land, sea or air does not affect its taxation; why should the purchase of a digital product be taxed differently from the purchase of a physical newspaper or CD-ROM, if in both cases the purchaser effectively obtains the same bundle of rights?

Canadians that conduct business through controlled foreign affiliates must be alert to the possibility that income earned by those affiliates may be considered foreign accrual property income (FAPI). FAPI is generally passive income from property, as opposed to income from an active business. FAPI is subject to immediate taxation in Canada, with compensation for foreign tax paid by the controlled foreign affiliate. Issues include:

- To the extent that processes become more and more automated, activities that once were considered the carrying on of business now might be considered to give rise to FAPI.
- Many companies within an international organization will likely be earning royalty and similar income. These types of income are generally considered passive, and are subject to the FAPI rules unless earned by the originator of the intellectual property.
- The FAPI rules also have a number of provisions that deem active business income to be FAPI. Depending on how these provisions are interpreted, electronic business has the potential of changing the nature and character of income generated by controlled foreign affiliates. Given that the FAPI regime was developed in a pre-electronic era of physical goods and traditional services, previous interpretations may no longer be appropriate.

Non-residents transacting electronically with Canadians

Non-residents transacting electronically with Canadians will have to consider whether their activities constitute carrying on a business in Canada which, subject to treaty protection, would make the non-resident taxable in Canada. Issues include:

- Could viewing a non-resident's Web page from a computer located in Canada constitute carrying on business? Although it is generally agreed that such activity alone should not constitute carrying on business, the degree of activity that will constitute carrying on business in the electronic age is less than clear.
- Where is a contract concluded when entered into by a Canadian with a non-resident via a Web page? Offer and acceptance rules will need to be examined carefully, as the place of contract is one of the factors in the determination of whether business is being carried on in Canada.
- Would a computer consultant performing diagnostic analysis on computer code stored on a Canadian-based computer be considered to have improved something in Canada? Such an improvement is considered to result in the carrying on of a business under domestic tax legislation.
- Can a Canadian Internet Service Provider (ISP) be considered to be acting as an agent for a non-resident when it hosts a non-resident's Web page? Current views suggest that the ISP may, at most, be an independent agent; however, a number of factors must be considered in such a determination.
- Is the storing by a non-resident of digital product on a computer situated in Canada tantamount to maintaining a stock of merchandise in Canada ? This is another factor in the determination of the carrying on of a business. Given the ease with which such inventory can be moved to any jurisdiction, is this criterion even relevant for electronic commerce?

The same issues must also be kept in mind regarding foreign jurisdictions when Canadians are transacting abroad.

Application of traditional interpretations will lead to unsatisfactory results in many cases. To avoid an onslaught of new legislation that is unlikely to keep up with the pace of technological change, governments will have to interpret existing legislation in a fair and pragmatic manner, keeping in mind their underlying policy objectives.

Tax treaties

The traditional method of avoiding double taxation, tax treaties between nations, will also require new interpretations to implement the underlying principles upon which they were drafted.

Issues that arise in a treaty context are similar to those raised domestically: the characterization of income; the existence of a permanent establishment; residency of a corporation and the location of "mind and management"; and, more fundamentally, the determination of which countries are even involved in a particular electronic transaction.

Sales tax and customs issues

Many issues that arise with respect to sales tax are similar to those raised above for income tax. For example, the "carrying on business in Canada" and "place of supply" rules are critical for application of the goods and services tax to both Canadian residents and non-residents. Businesses also need to be aware of registration, collection and filing requirements. Similar concerns arise with respect to provincial sales taxes, state sales and use taxes and European value-added taxes.

At a recent Ottawa OECD conference there was agreement that consumption taxes should be levied in the country where consumption takes place, and that for the purpose of these taxes, the supply of digitized products should be treated as a supply of goods.

Customs duties are levied on tangible goods. Electronic commerce may transform some tangible goods into electronic products, eroding duties and taxes.

Depending on the reaction of governments to the income tax issues, sales and consumption taxes may become increasingly important sources of revenue.

What's next?

Until some consensus is reached between taxing jurisdictions, it will be essential for companies to monitor the tax implications of how they conduct business. Businesses that are able to minimize major problem areas and, indeed, maximize planning opportunities, are the ones that will have a competitive advantage in the digital age.

While many questions with respect to the taxation of electronic commerce remain unanswered, opportunities

exist for taxpayers to optimize their tax structures by reviewing existing and proposed transactions, as well as approaches to such key areas as income classification, source of income, permanent establishment and transfer pricing. PricewaterhouseCoopers LLP has assembled a team of tax practitioners who can help you minimize the risks and optimize the benefits for your electronic business.

♦ Pierre Bourgeois; Chris Potter

Report of the Technical Committee on Business Taxation (Mintz Committee)

On April 6, 1998, the Technical Committee on Business Taxation, chaired by Professor Jack Mintz of the University of Toronto, released its long-awaited report. The report discussed various aspects of Canada's system of business income taxation, and made numerous recommendations. Brief comments on the committee's recommendations on the resource industry and international taxation follow.

Resource sector

The main findings of the committee with respect to the resource sector (mining, oil and gas) can be summarized as follows:

- Resource companies pay federal income and capital tax at an average effective tax rate of 6% of financial profits, the lowest of all industry groups;
- Existing legislation provides significant "incentive" deductions, such as the 25% resource allowance, 100% write-off for exploration and development costs, the opportunity to "flow-through" tax deductions to shareholders, and accelerated tax depreciation of equipment;
- Canada's resource tax regime compares favourably to those of other countries with resource-based economies; and
- Resource exploration, development and production is a high-risk endeavour, but one that can produce "higher than normal profits...from the use of provincial resources."

From these findings, many of which were derived from other recent government studies by the Department of Finance and the Ministry of Energy, Mines and Resources, the committee concluded that the industry as a whole is effectively undertaxed, relative to the service industry and the high-technology industry, for example. Accordingly, the committee made the following recommendations for changes to the tax system affecting the resource sector:

- Limits on the declining-balance deduction per annum, as follows:

	Maximum recommended declining-balance deduction per annum
Resource property acquisition costs	10%
Tax depreciation for all extraction-related equipment	25%
Canadian development expenses	

- The 25% resource allowance should be retained, but applied to income net of all deductions, following consultations with the provinces; and
- The general 5% corporate tax rate reduction recommended for other businesses should not apply to the resource sector until after consultations with the provinces on the proper integration of lower overall tax rates and a revised resource allowance.

Each of these warrants a brief explanation.

Limits on the declining-balance deduction per annum

Resource property acquisition costs limited to 10%

Currently, the cost of acquiring a Canadian mineral property is deductible at 30% per annum on a declining-balance basis, whereas the cost of acquiring a Canadian oil and gas property is only deductible at 10% per annum. The committee recommended that this distinction be eliminated, and that all resource properties be limited to the 10% per annum deduction.

In general, the committee found that several tax rules favoured the mining industry over the oil and gas industry. For example, oil and gas equipment costs are either depreciable at 25% (tangible equipping costs) or deductible at 30% (intangible drilling and equipping costs). By comparison, tangible mining equipment is eligible for an accelerated deduction up to 100% and intangible mine development costs are fully deductible as "Canadian exploration expense" as incurred (or deferred until required, with no pre-established time limit before expiry). Although certain special rules can mitigate these distinctions in practice, the committee urged the government to review them.

Tax depreciation limited to 25%

The current tax depreciation rules for mining equipment allow 100% of the cost of equipment acquired prior to

the commencement of commercial production to be deducted in the year of acquisition, to the extent that there is income from the mine. That is, income can be reduced to nil by tax depreciation, but a loss cannot be created. Equipment acquired after the commencement of commercial production is restricted to a 25% declining-balance deduction per annum. The committee recommended that this distinction be eliminated, and that all equipment be restricted to the 25% annual deduction.

Canadian development expense limited to 25%

Currently, the deduction for Canadian development expense is 30%, and generally is available for costs incurred to expand a mine after commencement of commercial production, as well as intangible drilling, equipping and other development costs of oil and gas wells (as noted above). The reduction is designed to reduce the distinction between these costs and tangible costs.

Resource allowance computed net of all deductions

The resource allowance is a deduction in computing federal income for tax purposes designed to compensate resource companies for the non-deductibility of provincial royalties. Currently, the allowance is computed as 25% of "resource profits," determined prior to any claims for interest expense, exploration and development costs, but after claims for tax depreciation. As a result, tax depreciation reduces resource profits, and hence reduces the benefit of the resource allowance, while interest, exploration and development expenses do not. Consequently, the tax system provides greater tax relief for these expenditures than for capital costs. Although recognizing that this area has already been the subject of recent revisions, and that consultation with the provinces is essential, the committee recommended this distinction be removed.

Defer implementation of general corporate tax rate reduction

The committee made a general recommendation that corporate tax rates be no higher than 33% (20% federal tax plus 13% provincial tax). However, in light of the recommendation above to change the resource allowance, it recommended that the current statutory rate be preserved for the resource sector pending the outcome of consultations with the provinces, and the completion of a review of the inter-relation between its base broadening and rate reduction proposals as applied to the resource industry.

Conclusion

The resource sector is clearly one of the "losers" in the Committee Report. The Mintz report recommends adjustments to the income tax structure for the industry that will result in an increase in its tax burden. Given the depressed nature of the industry today, these tax increases are unlikely to achieve the announced objective of enhanced prospects for economic growth and job creation. The inherent risks in the industry and the burden of substantial provincial levies that have led to the current tax system for the industry seem to have been discounted or ignored. The recommended further studies and the phased implementation may give the industry an opportunity to demonstrate that it is already bearing its fair share of the cost of public service and that these tax increases are unwarranted.

♦ Rich Carson, John Gravelle

International taxation

The committee made a number of recommendations in the area of international tax. These deal with both foreign investment by Canadian taxpayers ("outbound taxation") and investment in Canada by foreign taxpayers ("inbound taxation").

Outbound taxation

The committee thoroughly evaluated the merits of the current system of taxing foreign income earned by Canadian taxpayers. Their conclusion: the Canadian foreign affiliate system is "fundamentally sound" but that "certain elements...weaken its integrity." The committee identified weaknesses that needed to be addressed and made the following recommendations:

- Narrow the definition of *foreign affiliate,* so that only foreign companies in which Canadian corporations have a "significant equity interest" would be considered foreign affiliates. The committee recommended no change to the definition of *controlled foreign affiliate.*
- Disallow interest expense of Canadian taxpayers on indebtedness incurred to invest in foreign affiliates ($10 million of accumulated indebtedness related to investments in foreign investments by small businesses would be exempt). The committee recommended that the tracing method be used for purposes of identifying the amount of indebtedness allocable to investments in foreign affiliates.

Disallowed interest expense would be deductible to the extent dividends are paid from taxable surplus of the affiliate. Otherwise, the disallowed interest would be added to the cost base of the shares of the relevant foreign affiliate. Indebtedness incurred or committed under existing rules should be exempted from disallowance, or would be eligible for a generous transition period.

- Maintain the FAPI exemption for interaffiliate transactions, but include payments in respect of those transactions in taxable surplus if the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under the tax treaty between Canada and that jurisdiction. The government should actively renegotiate existing tax treaties to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions.
- The FAPI exemption should not be available in respect of payments received by a foreign affiliate of a taxpayer resident in Canada from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer, if related party status arises solely as a result of share ownership by foreign parent companies located outside Canada.
- Revenue Canada should challenge certain foreign trust structures in the courts when the trust income may be subject to the FAPI rules. If those challenges fail, appropriate amendments should be made to the tax law.

Inbound taxation

The committee also made recommendations that would affect the income of non-resident investors in Canada:

- Extend the withholding tax exemption for interest paid to arm's length non-resident lenders to all indebtedness, regardless of its term. The exemption should be disallowed in circumstances involving back-to-back transactions and similar financial support arrangements.
- In respect of the thin-capitalization rules, change the existing debt/equity ratio of 3-to-1 to 2-to-1. Further, the rules should apply to Canadian branches of foreign corporations, and to partnerships and trusts. The existing provisions with respect to back-to-back arrangements using third-party intermediaries should be strengthened to include all indebtedness between a specified non-resident and a third party if all or part of the amount may reasonably be considered to have been lent or transferred, directly or indirectly, by the third party to a Canadian business.
- Repeal the provisions regarding Non-resident Owned Investment Corporations.

Commentary

These recommendations, particularly those relating to outbound taxation, are among the most controversial made by the committee.

The recommendation to eliminate the deduction of interest on funds borrowed to invest in foreign affiliates would have a significant effect on the way operations carried on by foreign affiliates are financed and their cost. This recommendation would force many foreign affiliates to borrow directly from third-party lenders outside Canada. However, it would likely be difficult for foreign affiliates to establish third-party financing arrangements comparable to those in place in their Canadian parent companies. As a result, this recommendation would increase the cost of financing foreign affiliates and would hurt the earnings of many Canadian companies.

The deductibility of interest on funds borrowed to invest in foreign affiliates has contributed significantly to the growth of many Canadian companies abroad. Eliminating the deductibility of interest would undermine the ability of Canadian companies to continue to expand and to compete effectively in other countries. This could force many companies, in particular, newly established ones, to reconsider whether Canada is an appropriate location for head office activities, especially if there is no significant decrease in corporate income tax rates. The committee did indicate, however, that the recommendation to disallow a deduction for interest should not be implemented unless there is a significant reduction in corporate income tax rates.

If interest expense is restricted in respect of Canadian borrowings invested in foreign affiliates, a major issue will be the method for attributing expense to the foreign investment. The committee decided that the so-called *tracing* method, rather than one of the more arbitrary allocation methods, should be used. A broadly drafted tax provision to implement the tracing method might well encompass borrowings reasonably considered to have been used to assist (directly or indirectly) another person to make the foreign direct investment. A similar type of provision is found in subsection 18(3.1) of the *Income Tax Act.* Anti-avoidance provisions would have to be introduced to deal with planning techniques, such as cash damming, that would circumvent this rule. Drafting the tracing rules, including related anti-

avoidance and grandfathering provisions, would be controversial and immensely complex.

The committee strongly endorsed the FAPI exemption for interaffiliate transactions in recommending that it be maintained.

The exemption from FAPI for interaffiliate payments has attracted considerable attention, especially in recent years. Some commentators have argued that the exemption should be repealed because it encourages tax-planning arrangements that erode the Canadian tax base. However, the committee correctly pointed out that the interaffiliate exemption ensures that the active business of one foreign affiliate is not, as a result of deductible payments such as interest, royalties and rents, characterized as FAPI in the hands of the recipient affiliate. It concluded that the combined effect of eliminating the interaffiliate exemption, along with certain other recommendations in the report (denying interest deductions on borrowings to invest in foreign affiliates and exempt surplus status to interaffiliate payments earned by entities denied treaty benefits), could significantly impair the international competitiveness of Canadian businesses.

The proposal to tighten the thin capitalization rules seems to be an attempt to raise additional revenues to offset the effect of the committee's proposal to reduce corporate tax rates. The current required debt-to-equity ratio appears reasonable and comparable to those of other jurisdictions, given Canada's relatively high withholding tax rate on interest payments to non-arm's length lenders. (The withholding tax rate imposed under section 212 of the Act is 25%. This rate is reduced under tax treaties to no less than 10%.)

The committee concluded that there is no compelling rationale for the existing limitation to the withholding tax exemption on borrowings by Canadian corporations from arm's length non-resident lenders. (The exemption currently applies if the Canadian borrower is not obliged to pay more than 25% of the principal within five years from the date of issue of the indebtedness.) The recommendation to eliminate Canadian withholding tax in these circumstances would provide Canadian businesses increased access to global financial markets. Unfortunately, combined with the recommendation to eliminate a deduction in respect of interest paid on borrowings to invest in foreign affiliates, it would adversely affect the ability of Canadian lenders to make loans to Canadian businesses.

Summary

The Department of Finance has already started reviewing the issues raised by the committee, in particular, the issues of interest deductibility on funds borrowed to invest in foreign affiliates and whether the FAPI exemption should be maintained. Changes to the foreign affiliate rules are likely in the near future, although it is expected that the department will be consulting the public before any proposed changes are finalized.

In the meantime, Canadian companies should begin to consider how the committee's proposals, if implemented, may affect the way their foreign affiliates are financed and structured.

♦ Nick Pantaleo; Paul Glover

The family business and succession

Succession planning is a process, not an event. Traditionally, this process has been tax-driven. While tax is critical to any estate and succession plan, it should not drive the process. Rather, the objectives of the family in business should predominate.

Empirical research shows that what is best for one family business is not necessarily best for another. Practitioners at PricewaterhouseCoopers LLP's Family Business Centre take a systematic approach to succession planning that is specifically tailored to each business.

Luanna McGowan, of PricewaterhouseCoopers LLP's Family Business Centre, states: "Family businesses must deal with family issues in addition to all the challenges that every business faces. This can make the family business strong and unique, but also more complex."

Approximately 80 to 90% of businesses in Canada are family-owned. Statistics reveal that even though owners want to pass their businesses to the next generation, only *three out of ten* survive to the second generation and only *one out of ten* survives to the third generation.

There are several reasons for these staggering statistics:
- The founder did not have an adequate succession plan in place;
- The chosen successor was not properly prepared to take over the business;
- The founder did not have an adequate estate plan in place; and/or
- There were conflicts with family members both within and out of the business.

Failure of a family business is primarily due to a lack of planning. Plans need to be devised and policies put in place to reflect the objectives of the family business.

What are typical objectives?

Objectives of the family in business must be identified at the outset. Typical objectives of the owner include:

- Ensuring:
  - economic independence and financial security;
  - long term and short term success of the business;
  - smooth management succession;
- Providing family ownership succession;
- Maintaining harmony; and
- Minimizing taxes.

Families in business must deal with difficult questions. Succession planning provides a systematic way of addressing critical issues that affect the business and family.

Some questions that family businesses face are:

- How does the family business owner choose among several potential successors?
- When should the family business owner retire?
- How can the family business owner keep active after retirement?
- How can a successor be trained through formal education and in practice?
- How can key employees be motivated and stay committed?
- What is a fair arrangement for those family members involved in the business and those not involved in the business?
- Who would constitute the best management team?
- Who should sit on an advisory board?

Understanding different perspectives

When devising a succession plan, it is critical to understand the different perspectives of families in business. Only with full information can the family business owner make decisions to ensure management succession, to provide for the transfer of ownership, and to provide for family members. Once everyone's needs are identified, a plan can be devised to satisfy their objectives.

McGowan challenges you to consider the perspectives of family members in the following cases:

Case 1: The window manufacturer

John has built a successful window manufacturing company. He has three children. Two (Tom and Kate) are involved in the operations of the business. The third (Brenda) is a dental hygienist and not active in the business.

John's perspective

John wants to reorganize the business to take advantage of some tax opportunities. He claims to have a succession plan in place, under which Tom and Kate would manage the business under a co-leadership model. All three children will receive equal shares of the business.

John advises that there is good communication among family members. All are aware of the plan. Apparently John makes business decisions in collaboration with Tom and Kate.

John is proud to leave his empire to his children. In the event of sudden death, John has asked a close advisor to assist Tom and Kate in the transition.

Tom and Kate's perspectives

Neither Tom nor Kate want to be in the business, but both are reluctant to tell their father because they do not want to disappoint him. According to Tom and Kate, John has control over everything and all decisions are made by John, without consultation with either Tom or Kate.

Tom and Kate feel that they are neither adequately trained nor prepared to take over the business. Because of John's controlling nature, they do not see the opportunity of ever being groomed to run the business. They wonder if selling the business is an option but worry about where they would work if there were no business.

Tom and Kate feel that John is leaving them a mess. They have no idea what will happen in the event of John's untimely death.

Case 2: The auto dealer

Alex and Karen successfully run their third generation auto dealership. They have two children, Gerry and Frank. Gerry, the oldest, is involved in the business. His education, training, outside work experience, and desire to position the company for growth, have made him the undisputed heir apparent. Frank has never

expressed an interest to be involved in the business. He is a freelance writer and enjoys his work.

Alex and Karen's perspectives

Alex and Karen wish to treat their children fairly. They want to ensure that Frank does not feel "left out" because he has chosen not to enter into the family business. They want to give him every opportunity possible to pursue his chosen career path.

Alex and Karen want to retire. They believe Gerry should manage and lead the company. They want to divide the company between the children, but allow Gerry to buy Frank out over time so that Gerry is free to run the company as he sees fit.

Karen is especially protective of Frank, since she believes that Gerry has often "pulled rank" and made Frank feel less important than his brother.

Gerry's perspective

Gerry has positioned himself to take over the company. He wants to build the company and receive the growth in the company.

Frank's perspective

Frank feels attached to the company. He has a sense of heritage in the business and does not want to lose that tie to the family business.

Frank believes that Gerry can grow the business and he wants to benefit from that growth. Rather than allowing Gerry to buy his interest out, Frank wants to own stock in the company.

While Frank has no present desire to enter the business, he worries that his writing career may not provide him with an adequate lifestyle. Frank wonders if he will ever be able to join the family business. He also wonders if there will be an opportunity for his children to enter the business, especially if he has no financial interest in the company.

Case 3: Sporting goods retailer

James and Donna own and manage two sporting goods stores. One store carries specialty lines of clothing and equipment; the other store caters to the everyday sports consumer. Their two sons, Brian and Adam, are both involved in the business. Brian is responsible for the speciality line store and Adam is responsible for the other store.

James and Donna's perspective

James and Donna want to retire. They worry how their sons will deal with each other if James is not around to referee their disagreements. They worry about the business, especially since their retirement funding likely will be dependent on Brian and Adam getting along and making sound business decisions – together.

Brian and Adam's perspective

Brian wants to grow and build specialty sports stores across the country. Adam is content with his store and does not have the same vision as his brother. Both recognize the benefits of working together in some capacity, but worry how they will deal with their disagreements.

The answer

These cases raise issues about competing interests and how to deal with them. Understanding different perspectives is a first step in realizing a succession plan. A family business advisor, experienced in facilitating discussions among family members, ensures that different perspectives are identified. With this information, families in business can explore options available to them to develop a plan that reflects their unique objectives.

Tax advice is critical to any succession planning process. As tax advisors, PricewaterhouseCoopers LLP can help develop tax-effective strategies for succession plans.

A family business advisor leads a family in business through a systematic succession planning process. This advisor provides an outside objective perspective and can co-ordinate the team of professional advisors. However, it is the objectives of the family in business that should be driving the process.

Family business owners with a succession plan in place should revisit it annually to ensure that it continues to meet its objectives. In particular, new issues and

opportunities may arise as a result of any of the following events:

- Commencement or restructuring of the business;
- Birth of children or grandchildren;
- Death (of spouse, beneficiary, key employee; potential successor);
- Marriage or divorce (of a child or shareholder);
- Major change in circumstances (e.g., illness or disability);
- Tax or other relevant legislative changes;
- Retirement;
- Sale of all or a portion of the business; and
- Employment of family members in the business.

Effective succession planning is essential to the success of the family business. The ultimate plan may include hiring outside professionals to run the business, or positioning the business for sale, or providing a grooming strategy to prepare the next generation to assume leadership. Whatever the outcome, as tax advisors, PricewaterhouseCoopers LLP will help implement the plan in the most tax-effective manner.

♦ Donald G. Wray; Virginia McKenna

Contributors

Pierre Bourgeois B. Comm., GDPA, C.A.
Pierre Bourgeois is a partner in Pricewaterhouse-Cooper's International Tax Services Group of the Montreal Office. Pierre has extensive experience in corporate reorganizations and structuring investments into the United States, Europe and Asia. Pierre has written extensively on the topic of electronic commerce, notably a two-part article in the *Canadian Tax Journal* of the Canadian Tax Foundation, and was a speaker at a conference on the international tax aspects of electronic commerce.

Richard Carson FCA, B.A.
Rich Carson is a partner in the Vancouver office of PricewaterhouseCoopers LLP and is a member of the firm's mining tax consulting group. During his career, Rich has been directly involved in developing, coordinating and delivering tax services to major multinational corporations in connection with their Canadian and international operations. The range of services has included income tax advice in connection with new ventures or acquisitions, and restructuring and operations, as well as cross-border charges and transfer pricing.

Michael C. Durst M.S., J.D., LL.M.
Michael Durst is an International Tax partner in the National Tax Services Office in Washington D.C. of PricewaterhouseCoopers LLP. With over 15 years in the field, he is recognized as a worldwide expert in international transfer pricing. Previously, he was the Director of the Advance Pricing Agreement Program with the Office of Associate Chief Counsel (International) of the Internal Revenue Service.

Paul B. Glover C.A.
Paul Glover is a tax partner with PricewaterhouseCoopers LLP in Mississauga, and has experience in Canadian and international taxation matters, particularly, taxation matters relating to inbound investment into Canada. Paul has authored and co-authored several books and articles on various taxation matters and has spoken at international tax conferences on such topics as structuring investments in Canada, transfer price planning and tax minimization strategies.

John Gravelle B. Comm., C.A.
John Gravelle is a tax partner who deals with mining and multinational taxation. In the resource field he has dealt extensively with base metal miners and industrial mineral companies. John also has experience in the areas of acquisitions and divestitures, corporate finance and reorganizations.

Claude Lemelin B.A., MscCom., C.A.
Claude Lemelin is an integral part of the Transfer Pricing Group in Canada. Previously he spent over 20 years with Revenue Canada, his most recent position being that of Chief, Transfer Pricing & Competent Authority. In that capacity, he was responsible for the Transfer Pricing program, for the negotiation of double taxation cases with Canada's treaty partners, and for the Advance Pricing Agreement program.

Luanna M. McGowan B.A., LL.B., LL.M.
Luanna McGowan is with the Family Business Centre at PricewaterhouseCoopers LLP. Luanna is dedicated to working exclusively with family businesses in the areas of contingency and continuity planning, and she provides private training in alternative dispute resolution. She is president of the Ontario Association for Mediation and a member of the Board of Directors for Family Mediation Canada.

Virginia A. McKenna B.A. (Hons), LL.B.
Virginia McKenna is a tax partner working in the areas of trust and estate planning, charitable giving and income tax matters relating to estate and family litigation in the Hamilton and Mississauga offices of PricewaterhouseCoopers LLP. She is a regular speaker on taxation matters at the Hamilton Law Association, Canadian Bar Association (Ontario), Law Society of Upper Canada and the Federation of Law Societies' Family Law Conference.

Marc Milgrom LL.B.
Marc Milgrom is a tax partner and the Canadian tax leader of PricewaterhouseCoopers LLP's Technology Industry Group. Marc's clients include companies involved in the high tech, and entertainment, media and communications industries, as well as sophisticated private investors. Marc is a member of the International Fiscal Association, the Canadian Tax Foundation, the Law Society of Upper Canada, and the Canadian Bar Association.

Nick Pantaleo B. Comm., C.A.
Nick Pantaleo is an international tax services partner in the Toronto office of PricewaterhouseCoopers LLP and is a member of the PricewaterhouseCoopers LLP's International Tax Services Group. He is involved primarily in providing tax planning advice to Canadian national and multinational corporations in the area of international taxation, including cross-border transactions, profit repatriation and structuring investments abroad.

Christopher J. Potter B.A., C.A.
Chris Potter is a partner in the North York tax practice who provides tax and related services to clients in the hi-tech and other industries. He advises software and other hi-tech companies in structuring their business affairs, and leads the research and development tax incentive area. In addition, Chris has extensive experience in structuring and restructuring limited partnership syndications and tax-assisted financing arrangements, international licensing structures, corporate group reorganizations and tax planning. Chris has also spoken and written articles addressing intellectual property and research and development tax issues.

Donald G. Wray FCA, LL.B.
Don Wray is a partner in the Hamilton office of the firm and has considerable experience advising clients in estate and succession planning matters. He has participated in the in-house training of firm professionals in estate and succession planning and related matters. He is a past-president of the Estate Planners' Council of Hamilton, and is the 1998-1999 president of the Institute of Chartered Accountants of Ontario.