CHAPTER 20

DOMESTIC AND INTERNATIONAL BUSINESS EXPANSION

Review Questions

1. Domestic and international expansion decisions, like any investment decisions, should attempt to use a structure that will minimize the start-up cash requirements and maximize the cash returns to the initiator. Briefly outline the fundamental tax considerations that are relevant to the expansion process.

2. What are the two basic organization structures that can be used for domestic expansion activities without the participation of new equity investors? What is the major difference between these structures regarding tax?

3. The rates of applicable provincial/territorial tax and tax on manufacturing profits may be different solely as a result of the expansion structure chosen for new activities. Explain why.

4. What basic organization structures can be used for domestic expansion activities requiring additional capital from new equity participants?

5. When new equity participants are required in order to complete an expansion, what decisions must be made before an analysis of the organizational structure is performed?

6. Is it possible to increase the after-tax rate of return by choosing to give up more equity, rather than less, when new equity participants are required for expansion? Explain.

7. What are the primary business structures used to conduct foreign expansion activities?

8. In most cases, what must be true before a Canadian entity will be subject to foreign taxes on foreign business activities?

9. When the tax rates in a foreign country are lower than Canadian tax rates, will the use of a foreign branch structure to conduct the Canadian entity's foreign activities be advantageous? Explain.

10. In what circumstances is a foreign branch structure preferable to a foreign corporation structure?

11. Assume that a Canadian individual owns a substantial portion of a foreign corporation's shares and receives a dividend from them. Would the tax treatment applied to that dividend be different if it were first paid to a Canadian corporation owned by that individual?

12. "If foreign tax rates are the same as Canadian tax rates, a Canadian corporation conducting profitable foreign activities will not care whether a foreign branch or a foreign corporation is used to house the foreign operations." Is this statement true? Explain.

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13. A Canadian business corporation may, in addition to providing equity capital, support its foreign operations by providing loan capital, management services, technology, and equipment. What general implications does the foreign organization structure (branch versus corporation) have on these additional support activities?

14. Why may a Canadian business entity attempt to underprice or overprice products sold to its foreign subsidiary corporation? How do Canadian tax laws treat such transactions?

15. What tax consequences may result when the business operations of a foreign branch are transferred to a newly created foreign subsidiary corporation? How does this compare with the tax treatment resulting from the transfer of a Canadian branch operation to a Canadian subsidiary corporation?

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Solutions to Review Questions

R20-1. When choosing an expansion structure, the decision-maker should consider the tax implications of future profits, the utilization of possible start-up losses, an expansion failure, and the repatriation of both the capital invested and accumulated profits.

R20-2. Domestic expansion without the participation of new equity investors can be structured as either a division of the existing corporation or as a separate subsidiary corporation. The major tax difference between these two structures relate to tax savings that occur from the utilization of losses, both in the start-up phase and those resulting from a complete failure. In the division structure, the losses are merged for tax purposes with the existing operations, creating immediate tax savings. Whereas, in the corporate structure, the losses must await the arrival of profits from the expansion activity.

Therefore, when start-up losses are expected, the divisional structure requires a reduced cash commitment. If the expansion fails completely, the losses that are locked into a separate corporation may be utilized by the parent entity if a wind-up or an amalgamation occurs but the tax savings are delayed until after that has occurred. Such a reorganization may not be available where the failed expansion corporation is permitted to become bankrupt to limit the losses.

R20-3. Under a divisional structure, the amount of income subject to tax in other provinces (which may apply different rates of tax) is determined by an arbitrary formula based on the ratio of sales and wages in the other province to the total sales and wages of the entire entity. Consequently, the amount of expansion income subject to tax in the new province may be different from the actual expansion profits. In contrast, expanding to another province by housing that expansion in a separate corporation results in the actual expansion profits being subject to tax in the new province.

Similar differences can occur for manufacturing activities because of the requirement to determine M&P profits eligible for the rate reduction (13%) by the arbitrary formula (based on the ratio of manufacturing capital and labor employed by the entire entity). By separating the expansion activity in a separate corporation, this ratio is affected.

R20-4. When the expansion project requires additional capital from outside investors, the primary available structures are:

- separate corporation
- standard partnership
- limited partnership

R20-5. Before choosing an expansion structure that involves outside equity participants, the project initiator must decide:

- Whether or not the new investors will participate only in the expansion project or in the existing operations as well.
- If the new participants will be active in management or passive investors.
- If funds should be sought from a large number of investors (each investing small amounts) or from a small number of investors (investing large amounts).
- Whether or not the project can be divided into separate parts attracting different participants for each.
- The amount of equity that will be given up to obtain the expansion funds.

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R20-6. In some circumstances, giving up additional equity may increase after-tax returns if it results in lower tax rates on the project profits. For example, retaining 50% equity in an expansion project organized as a Canadian-controlled private corporation may create the ability to obtain a new small business deduction limit on the new project profits, as it would not be associated with the initiator corporation. Consequently, a portion of the initiator's share of profits would be taxed at 13% (in some provinces) rather than at the higher corporate rate of approximately 27%. In comparison, if the initiator had retained 55% of the project's equity, all profits would be subject to the high tax rate. Therefore, although giving up additional equity results in a lower share of pre-tax profits, the after-tax profits may be higher.

R20-7. Foreign business expansion activities can be achieved through direct sales from the home based entity, or by establishing either a foreign branch location or a separate foreign corporation to house those activities.

R20-8. A Canadian entity will normally be subject to foreign tax on their foreign business activities if they carry on business in the foreign country from a permanent establishment located in that country. The term "permanent establishment" is usually defined in the tax treaty between Canada and the particular foreign country. In most treaties, the term means a fixed place of business from which foreign operations are conducted and includes a place of management, a branch, an office or factory (although a fixed place of business used primarily for storage or display of merchandise is usually excluded). Therefore, direct sales do not qualify as carrying on business in the foreign country and are not subject to the foreign tax.

R20-9. The profits of a foreign branch location will be subject to tax in the foreign country. However, because the foreign branch is formally a part of the Canadian entity (i.e., it is not a separate corporation) and the Canadian resident entity is taxable on its world income, the foreign branch profits are also taxable in Canada. The applicable Canadian tax can be reduced by the tax paid to the foreign country (foreign tax credit) thereby eliminating double taxation. Consequently, no advantage is gained under the branch structure when the foreign tax rate is lower than the Canadian tax rate because the higher Canadian rates prevail.

R20-10. Although the branch structure does not result in preferential tax rates on annual foreign profits, it has one major advantage over the corporate structure. If losses are incurred from the foreign branch operation, they can be used immediately to offset income from the home-based operations thereby creating cash flow from tax savings. This improved cash flow can be retained in Canada or reinvested in the foreign branch to enhance the opportunity for long-term success. In effect, it reduces the amount of funding required to service the foreign expansion.

R20-11. The receipt of a foreign dividend by a Canadian individual is included in his or her income as fully taxable property income without the benefit of the dividend tax credit that would apply to the receipt of Canadian dividends. For example, an individual in a 50% tax bracket would pay a tax equal to 50% of the actual dividend. While the foreign country would impose a withholding tax on the dividend, Canadian taxes are reduced by an equal amount from the application of the foreign tax credit.

In contrast, if the foreign dividend was first paid to a Canadian corporation and then passed on as a Canadian dividend to the individual shareholder, the result is quite different. The foreign corporation would qualify as a foreign affiliate of the Canadian corporation and, therefore, the foreign dividend is not subject to Canadian corporate tax. This means that the foreign withholding tax on the dividend becomes a cost because no foreign tax credit

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can be applied. However, when the foreign dividend income is passed on to the shareholder as a dividend from the Canadian corporation, it becomes eligible for the dividend tax credit. For example, if the foreign withholding tax rate is 10% and the individual tax rate is 35% on Canadian eligible dividends - after the dividend tax credit, the total tax paid is only 42% as follows:

	Income	Tax
Foreign dividend	$100	
Foreign withholding tax (10%)	10	$10
Net to Canadian corporation	90	
Tax on Canadian dividend (35%)	32	32
Net to individual	$ 58	$42

R20-12. The statement is not necessarily true. In a branch structure, if the foreign operation is subject to a 27% foreign tax rate which is the same as the Canadian tax rate, the total tax paid upon repatriation of the foreign profits is 27%. In other words, the foreign tax of 27% reduces the Canadian tax by an equivalent amount from the foreign tax credit mechanism and there is no further tax when those profits are transferred to Canada (this may not always be the case as some countries impose a special branch tax that is similar to a withholding tax).

In comparison, a foreign corporation would be subject to 27% tax on its profits but a further withholding tax would be paid on a dividend distribution of those profits to the Canadian corporate shareholder. Because the foreign dividend (received from a foreign affiliate) is not taxable to the Canadian corporation, a foreign tax credit for the withholding tax would not be available. Therefore, the foreign corporate structure tax cost is ultimately higher by an amount equal to the withholding tax rate.

R20-13. Providing support activities to a foreign branch operation (such as capital funds, equipment, technology and management services) does not alter the normal tax treatment of the foreign activities. Because the branch is a part of the Canadian entity, it simply requires a cost allocation to the foreign branch for the costs incurred on its behalf. However, when a foreign corporation is established, there is an actual separation of the foreign activities from the Canadian entity. As a result, providing the above mentioned support activities to the foreign corporation require compensation in the form of interest, rents, royalties and management fees.

These costs to the foreign corporation reduce the amount of foreign income that is subject to foreign corporate tax and increases the income of the Canadian entity. Most countries impose a withholding tax on the payment of interest, rents, royalties and management fees paid to Canada. However, because the receipt of these payments is taxable in Canada, the foreign tax credit will eliminate the impact of the imposed withholding tax.

R20-14. In some situations, the process of selling in a foreign market involves activities in both Canada and the foreign country. For example, a Canadian manufacturer may sell finished goods or component parts to its foreign corporation for completion, packaging, and selling. Therefore, an element of profit belongs to both countries. Where the tax rate in the foreign country is lower, there is a tendency to underprice the sale of product to the foreign corporation in order that they may earn a greater portion of the profit. Where the foreign country has a higher tax rate, the reverse is true.

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Canadian tax law deals with this by imposing a reasonableness test on the transfer prices of products and services to the foreign corporation. Therefore, regardless of the price established, the products and services sold to the foreign corporation are, for tax purposes, deemed to be sold at a price that would reasonably have been expected if the sale had been to an arm's length party.

R20-15. Properties of a foreign branch are owned by the Canadian corporation. Therefore, the incorporation of a foreign branch involves the sale of assets (inventory, equipment, goodwill and so on) from a Canadian corporation to a foreign corporation. The sale of assets at fair market value may, therefore, result in taxable gains. In comparison, the transfer of assets to a Canadian corporation can eliminate the creation of taxable income by electing to transfer the assets at tax values rather than at fair market values. Under Canadian tax law, this option applies only where the assets are transferred to another Canadian corporation. Therefore, in choosing an initial expansion structure, it is important to anticipate the potential tax implications if it should become necessary to alter the initial structure.

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