

# Net Worth

Publisher: Hartl Sala LLP, 390 Bay Street, Suite 705, Toronto, Ontario M5H 2Y2

## SHARING YOUR INVESTMENT RETURN WITH REVENUE CANADA?

### About Net Worth:

- Current tax and legal issues
- Emerging international trends
- Practical investment advice

Almost every article about investing advises us to *buy low, sell high* and states that the higher return we want the higher risk we have to take. Surprisingly, most of these articles are relatively quiet about the tax implications of our investment. But like it or not, we all have to share our investment income with tax authorities. Therefore, our investment planning should always consider the tax consequences of intended purchases and sales. Spending just a little time to reconsider portfolio allocation from the tax point of view will provide lower risk yet still grant a high income.

The government also wants us to save for our pension making all of our contributions to Registered Retirement Saving Plans (RRSPs) deductible for tax purposes. Income can then grow free of tax inside the plan and it is only taxable on withdrawal from the plan.

However, there are negative aspects to holding different kinds of investments in RRSPs. The investment in the RRSP loses its specific nature. On withdrawal from the RRSP all the cash is taxed as ordinary income and no tax advantages for dividends and capital gains are available.

One may ask why is all of this important? The fact is that we, along with a great number of other people, probably invest inside, as well as outside, our RRSP. In many cases we may be holding high growth / high risk stock inside our RRSP while holding other investments including GICs and other debt instruments personally. As a consequence, we might have mismanaged our portfolios from the tax point of view. In order to increase our after-tax investment return we can simply rearrange our portfolio by following this simple procedure:

1. Decide on the portfolio allocation including all the assets held inside and outside of the RRSP. Find out the percentage of interest bearing, dividend bearing and capital gains bearing securities which make you conformable with your portfolio.

2. Keep all the "tax disadvantaged" investment (such as interest bearing securities) inside the RRSP, thus protecting their return from high tax rates.

3. If the interest bearing securities still leave some room in the RRSP, add the dividend bearing securities.

4. Only if there is still some room in your RRSP should you add securities which are expected to appreciate, thus resulting in a capital gains.

Following this simple procedure consistently will help us share much less of our investment income with the tax department. Consequently, net worth will increase faster without unnecessarily high risk investments. *ph*

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To illustrate this point, let's assume that we make over \$74,000, live in Ontario and receive an investment income of \$100 before tax. Since not all investment income is created equal, should we receive interest income - we pay \$48 in tax. Yet, should we receive dividends, the amount of tax declines to \$32. Furthermore, should we have a capital gain on sale of the investment, our tax is only \$24. To put it differently, in order to make \$100 after tax, we would have to receive \$192 in interest, \$148 in dividends or \$131 in capital gain prior to tax.

## THE COMMERCIALISATION OF NAPSTER: EVEN IF YOU CAN BEAT 'EM, YOU MAY WANT TO JOIN 'EM



Reflections from the Ontario Hydro building  
(Image by www.toronto.com)

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*“On a daily basis the Napster.com website is accessed by over four million users which makes Napster the world’s leading file-sharing community...”*

In July of 1999, Shawn Fanning, an eighteen year-old freshman at Boston’s Northeastern University, created Napster, the free internet-based music-swapping service. After only seventeen months, with no money spent on advertising, Napster currently boasts a membership of over 38 million people who have downloaded the Napster software. On a daily basis the Napster.com website is accessed by over four million users which makes Napster the world’s leading file-sharing community, even more users than AOL. Napster’s software application “enables users to locate and share media files from one convenient, easy-to-use interface.” The users are able to download the music file onto their computer and then burn the song directly onto a C.D. or MP3.

During this expansion of the Napster empire, both record labels and musicians alike started realising that the continued growth of Napster could result in major profit losses. Thus, all good things must come to an end.

In December of 1999 the five major music labels, BMG., EMI, Sony, Universal, and Warner, along with a variety of smaller record labels, decided that enough was enough. These labels decided to bring an action to restrict Napster from allowing the distribution and sharing of music files since this was in violation of

copyright laws. The allegation was that Napster was abetting the free exchange of copyrighted songs. Napster argued in the U.S. District Court of California that their users can use the Napster service in a variety of ways that are “non-commercial” and constitute “fair use”. The record companies were successful. The District Court held that a user who makes a copy to avoid paying for a musical work is copying for a commercial use since the user does not have to actually purchase the music. The District Court also held that making a complete, potentially permanent copy of music is copyright infringement since only the owner of copyright is legally entitled to make such a copy. This decision was appealed by Napster and the case is currently before the U.S. Court of Appeal.

On the doorstep of what could easily be the death of Napster, Bertelsmann, the corporate owner of BMG, appears to have extended an olive branch to the enemy. On October 31, 2000, Bertelsmann agreed to loan Napster \$50 million provided Napster charges its users a monthly fee of approximately \$4.95 U.S. In addition to the user fee, Napster must use the loan to develop and implement technology which will monitor and track how many times a song is downloaded from the database onto a user’s computer. Once these steps have been implemented, Bertelsmann has agreed to with-

draw BMG from the copyright lawsuit. Of course, the \$50 million loan can also be used to defend the copyright lawsuit. The Bertelsmann-Napster partnership will attempt to develop “a secure, fee-based online service which would simultaneously respect copyright owners, and ensure payment of royalties.” The problem with this formula is that people who used the Napster service primarily did so because it was free. Also, if the other record companies do not get involved then Napster would have only BMG artists on their service. The other record companies will most likely follow suit since they will want a cut of the millions of dollars which user fees will generate.

BMG decided that rather than fighting against Napster, and losing Napster’s 38 million user base, they might as well join Napster, provided Napster plays by BMG’s rules. The question is: Will people continue to use the “new and improved” Napster which will be a pay-site with a potentially reduced musical base? Bertelsmann CEO Thomas Middelhoff has commented that he is confident that users will be willing to pay a small user fee for such an amazing service. In fact, Middelhoff has said that “one day we’ll have online divisions like Napster Music, Napster Books and Napster Films.” The smell of online money is clearly in the air.

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Yorkville: Bloor St. and Avenue Rd.  
(Image by www.toronto.com)

## E-COMMERCE: CHAOS IN THE TAX DEPARTMENT

According to recently released research from International Data Corp., the Canadian e-commerce spending will be growing at a compound annual rate of 75%, reaching approximately US \$100 billion by the year 2004. In the United States, the compound annual rate of growth will be about 68% and the e-commerce spending is expected to reach about US \$1 trillion by the year 2004. Given the magnitude of these numbers, one would expect that tax rules applicable to Internet transactions would be well established by now. Yet, nothing could be further from the truth.

The taxation of e-commerce brings about a number of significant issues. The Internet is not only a new medium that allows us to conduct our transactions more efficiently, but, in some cases, it fundamentally changes the nature of the transaction itself. For example, in order to use accounting software, I can use the traditional approach -- go to the store, buy the program, install it on my computer and use it. I can also use a modified traditional transaction -- download the program from the software company's web site and use it. As well, I can use a new approach by running the program located on the software company's server and uploading my data for

processing rather than downloading the program. Each one of these transactions might lead to a different amount of tax payable.

In general, the taxes are "national" taxes -- the residents or citizens of the nation are usually taxed on their worldwide income. As this approach could lead to double taxation when a resident of one country earns income in another country, the tax treaties between the countries attempt to prevent any such double taxation. The taxpayer earning profit in two countries which have a tax treaty is usually taxed only on the income that is attributable to each relevant country.

It was never easy to ascertain exactly how much profit was earned in which country, but the Internet made it even more complex. Let's consider my software transactions described above. If I buy the software from the store, the situation is easy. The store made the sale in Canada and it would pay its income taxes on the profit derived from the sale. It would also pay the GST applicable to this sale.

The second transaction is more complex. If I download the software from a site in the United States, where does the sale take place? In Canada or

in the United States? Does it matter if I download the software from a site located in Canada or from a site located in the United States? As we may see, the taxation depends on a number of facts and circumstances and the situation is rather complex for both income taxes and GST.

Now, let's consider the third transaction. When I upload my data on another company's server for processing, a number of questions arise. Where does the transaction take place? What do I pay for -- rental of the software or technical service provided? Where does the consumption take place? Since I could download the results of the processed transaction (e.g. financial statement) what do I pay for -- the processing or the specific results? What if the company has all its staff in Canada, but the processing is done automatically on the server located in the United States? The taxation of this transaction depends not only on relevant facts and circumstances, but also on the nature of the tax law in different countries.

To address these issues, the OECD, as well as most of the national governments, have established working groups on Internet taxation. These groups focus on two major issues - what is the character of income derived from different e-commerce transactions and where is this income earned. Although a consensus on some of the transactions is slowly emerging, a consistent cross-border approach to taxation of e-commerce has yet to be developed. As a consequence, these transactions can potentially result in double or multiple taxation with no offsetting tax relief. Let us hope that the time of tax uncertainty will not last for too long.

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Cumberland Avenue in Yorkville  
[Image by www.toronto.com]

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### About the authors

**Paul Hartl** is a partner with Hartl Sala LLP, Chartered Accountants. His work experience includes public accounting, controllership in a foreign-based distribution company and tax audit at Revenue Canada (CCRA). His areas of expertise include international taxation issues, transfer pricing and dispute resolutions before CCRA.

**Stephen Teixeira** is an articling student working for Jonathan C. Yen, a partner with Turner Michener LLP, Barristers and Solicitors. Stephen was the president of the Entertainment and Sports Law Association at Osgoode Hall Law School and has hosted a number of entertainment law conferences. He intends to specialize in intellectual property law.



Building detail at the corner of Bloor St. and Avenue Rd.  
[Image by www.toronto.com]

Graphic Design by Atlin

# Upcoming conferences

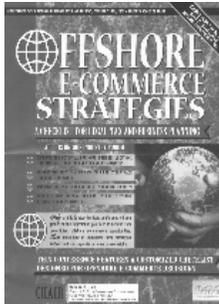


January 29, 30 and 31, 2001  
**6th Annual Transfer Pricing 2001**

Preparing For a Revenue Canada Audit  
Paul Hartl with Martin Przysuski and J.C. Chandani  
January 30, 2001 (3:00 p.m. - 4:30 p.m.)

Everything You Need to Know: Preparing For an International Audit  
Paul Hartl with Martin Przysuski and J.C. Chandani  
January 31, 2001 (9:00 a.m. - 12:30 p.m.)

Organized by INFONEX (1-800-474-4829)  
The Holiday Inn on King (Toronto)



February 19 and 20, 2001  
**Offshore E-Commerce Strategies**

Transfer Pricing for Cyberspace Transactions  
Paul Hartl with Martin Przysuski  
February 20, 2001 (9:15 a.m. - 10:00 a.m.)

Organized by STRATEGY INSTITUTE (416-944-8833)  
Toronto Board of Trade, 1 First Canadian Place

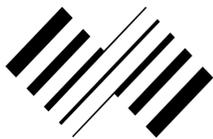


February 21, 22 and 23, 2001  
**E-Commerce Tax: Strategies for Canadian Business**

Advanced Transfer Pricing For E-Commerce Transactions  
Paul Hartl with Martin Przysuski and J.C. Chandani  
February 21, 2001 (1:30 p.m. - 4:30 p.m.)

Resolving E-Commerce Transfer Pricing Challenges  
Paul Hartl with Martin Przysuski and J.C. Chandani  
February 23, 2001 (11:00 a.m. - 11:45 a.m.)

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## HOW CAN WE HELP YOU?

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- **Time to concentrate on your business**  
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- **Understanding of issues**  
You can rest assured that every detail is being covered. We clearly explain the issues to you in a jargon-free manner.