Tax Bulletin

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Tax-Efficient Investing in Canada: Dispelling the Myths

Historically high rates of income and withholding taxes have contributed to the enduring view of Canada as a country burdened by oppressive rates of taxation.

Fortunately, Canadian income tax rates have consistently been reduced over the past decade. In fact, many international studies now reveal that Canadian income taxes are lower than those found in most comparable western and European nations, including many areas of the United States of America.

In recent years, many innovative structures have been developed to further mitigate the impact of Canadian income and withholding taxes and the ongoing compliance costs borne by non-residents that wish to make equity investments in Canada.

This bulletin briefly outlines some of the strategies that non-resident investors can employ to reduce or eliminate the Canadian taxes imposed on income and capital gains derived from investments in Canada and the compliance obligations associated with such investments. While every factual circumstance is unique, the following techniques are frequently used to mitigate the effect of Canadian taxation on equity investments made by non-residents.

Strategies for Mitigating or Eliminating Canadian Withholding Tax

Use of Tax Efficient International Intermediaries

When structuring an investment in a Canadian entity, most non-residents are concerned about the imposition of significant Canadian withholding taxes.

However, Canada has entered into bilateral income tax treaties with over 80 countries around the world (including the United States of America). Canada's tax treaties serve to reduce the rate of withholding tax imposed on dividends paid to persons resident in treaty jurisdictions to as low as 5%. By effectively managing how investments in Canadian entities are made (e.g., by utilizing appropriate foreign intermediary holding corporations where necessary), non-resident investors can significantly reduce the amount of Canadian withholding tax levied on returns on their Canadian investments.

The use of international intermediaries is particularly relevant to non-resident investors that are limited liability companies, limited partnerships, or consortiums of offshore investors. Where investors are sensitive to Canadian tax compliance costs and/or reside in jurisdictions with which Canada has not entered into an income tax treaty, the use of international intermediaries can significantly reduce the Canadian tax costs associated with a particular Canadian investment opportunity.

Use of Cross-Border Management Fees

Non-resident investors frequently choose to provide foreign management and consulting services to entities in which they have made equity investments. Cross-border management fees are not subject to Canadian withholding tax and, thus, may generally be repatriated by non-resident investors on a tax-preferred basis. Consequently, the use of management service arrangements can reduce the level of Canadian tax imposed on the aggregate return on equity investments in Canada.

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The Use of Hybrid Canadian Holding Entities

Many non-resident investors, particularly those that reside in the United States of America, frequently wish to consolidate their foreign profits and losses with their domestic income when computing their domestic tax liabilities. Special hybrid holding entities can be formed in Canada, such as the popular Nova Scotia unlimited liability company (an "**NSULC**"), which are afforded "flow through" status for the purposes of the domestic tax rules in some nations. Most notably, NSULCs are treated as "check-the-box" entities for US tax purposes. The use of Canadian flow-through entities can allow non-resident investors to consolidate foreign and domestic profits and losses and thereby reduce the cumulative rate of tax imposed on the corporate group.

The Availability of Foreign Tax Credits

Domestic tax legislation in most foreign jurisdictions (including the United States of America) generally provides that recipients of dividends paid by a foreign corporation will be entitled to a foreign tax credit in respect of any withholding tax levied on their dividend receipts. Provided a non-resident recipient of a dividend is resident in a jurisdiction which permits taxpayers to fully claim foreign tax credits in respect of foreign withholding taxes, the non-resident will be eligible to reduce its domestic income tax liabilities by the amount of any withholding tax paid in Canada. Therefore, under many circumstances, the imposition of Canadian withholding tax will not ultimately increase a non-resident shareholder's aggregate income tax burden.

Investing in Canada: Opportunities Abound

The Canadian market stands as fertile ground for non-resident investors seeking new financial opportunities. With proper planning, non-resident investors can make equity investments in Canada on a highly tax-efficient basis.

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McMillan Binch LLP has extensive experience counselling non-residents on tax-effective means of structuring cross-border investments. We regularly work with both large financial institutions and boutique venture capital firms to enhance the after-tax return enjoyed by non-resident investors that wish to explore the Canadian market

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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