DOING BUSINESS IN CANADA - KEY CANADIAN TAX CONSIDERATIONS

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Foreign enterprises have long been attracted to investment opportunities in Canada. Canada has led the G7 in growth in total inbound investment over the past 15 years and Forbes and Bloomberg recently recognized Canada as having the most favourable commercial environment in the G20 in which to establish a business.[1]

However, the decision to commence commercial operations in Canada must be made with an understanding of the legal framework within which the enterprise will operate. An understanding of the Canadian taxation system is an integral component of the over-arching Canadian legal framework.

The Canadian Tax System

Canada has a unique system of taxation. The federal, provincial and municipal levels of government each impose taxes on businesses in Canada.

The federal *Income Tax Act* (the "**ITA**"), and the corresponding provincial statutes, impose tax on the world-wide income of Canadian residents.

By contrast, non-residents of Canada are only subject to tax on income derived from Canadian sources. In this regard, non-residents are typically only subject to tax in Canada if they carry on a business in Canada or dispose of "taxable Canadian property".

Canadian Business Operations

Non-residents planning to conduct business in Canada can do so either directly (through a Canadian branch) or indirectly (through a separate Canadian subsidiary corporation). Below we discuss certain of the principal tax considerations that must be taken into account when choosing how to conduct business in Canada.

Canadian Subsidiary

A subsidiary incorporated in Canada is deemed to be a Canadian resident for income tax purposes and is, therefore, subject to tax in Canada on its world-wide income.

Canadian Corporate Tax Rates

A Canadian resident corporation is generally liable for both federal income tax at a rate of 15%, and provincial income tax in those provinces in which it has a permanent establishment (as defined in the ITA and the applicable provincial tax statute). For example, a Canadian corporation that carries on business in the province of Ontario through a permanent establishment is generally liable for income tax at a combined rate of 26.5%, consisting of federal tax levied at a rate of 15% and Ontario tax levied at a rate of 11.5%. A lower rate applies in respect of certain manufacturing and processing income.

Each of Canada's other provinces similarly levy income tax on business income attributable to permanent establishments in the particular province. For example, the provincial income tax rates in the provinces of Quebec, Alberta and British Columbia are currently 11.9%, 12% and 11%, respectively.

Losses

In computing taxable income, a corporation may generally carry unused business losses back three years and forward twenty years and apply such losses to reduce taxable income earned in a particular taxation year in accordance with the detailed rules in the ITA.

Canada does not have a consolidated tax reporting system. As a result, losses incurred by a Canadian corporation cannot be applied to reduce the taxable income of affiliated Canadian corporations. Subject to certain restrictions, however, historical business losses may generally be assumed by a Canadian successor corporation following an amalgamation, or by a Canadian parent corporation after its wholly-owned subsidiary is wound-up.

Where control of a corporation has been acquired, use of business losses is restricted to prevent trading in losses.

Thin Capitalization Rules

If a Canadian subsidiary borrows from its non-resident parent corporation or from other specified non-residents, the ability of the subsidiary to deduct interest is subject to limitations imposed under the thin capitalization rules contained in the ITA. The thin capitalization rules provide that interest on indebtedness payable to specified non-residents is not deductible to the extent that the aggregate amount of such indebtedness exceeds 1.5 times the "equity amount" of the subsidiary.

Interest, in respect of which a deduction is disallowed under the thin capitalization rules, may be recharacterized as a dividend for the purposes of the ITA and subject to non-resident withholding tax (as described below).

Non-Resident Withholding Tax

Amounts paid or credited by a Canadian subsidiary to a non-resident parent on account of dividends, certain royalties, and certain interest payments are subject to Canadian withholding tax levied at a statutory rate of 25%.

However, the applicable rate of withholding tax may be reduced by treaty. For example, the *Canada-United States Income Tax Convention (1980),* as amended (the "**US Treaty**") reduces the applicable rate of withholding tax on dividends to 5% where the beneficial owner of the dividends (i) is a US resident corporation entitled to claim the benefit of the US Treaty (a "**US Resident Corporation**"), and (ii) owns at least 10% of the Canadian subsidiary's voting stock (otherwise, the applicable US Treaty reduced rate is 15%). The US Treaty also reduces the withholding tax rate in respect of royalties to 10%.

Conventional interest payments made to "arm's length" non-resident lenders are generally not subject to Canadian withholding tax. The US Treaty also generally eliminates Canadian withholding tax on conventional interest payments made to "non-arm's length" US resident lenders (assuming they are entitled to the benefits of the US Treaty).

Transfer Pricing

Transfers of goods or services between a Canadian corporation and a non-arm's length non-resident must be effected at an arm's length price and on arm's length terms and conditions. Where the terms and conditions of such transactions are not reflective of those that would be agreed to by parties dealing with one another at arm's length, the Canadian tax authorities may recharacterize the transaction as having been effected at an arm's length price pursuant to the Canadian transfer pricing rules, resulting in potentially adverse tax consequences for both the Canadian corporation and the non- resident.

In connection with such non-arm's length transactions, Canadian corporations should prepare contemporaneous documentation to document the basis for the terms and conditions of such transactions. The failure to do so may result in the imposition of penalties if such transactions are subsequently determined not to be consistent with the applicable arm's length standard.

Canadian Branch Operations

Under the ITA, a non-resident that carries on business in Canada through a Canadian branch is liable for tax on income attributable to any business that it carries on in Canada. However, non-residents that are entitled to claim the benefits afforded by one of Canada's tax treaties generally will only be taxed on income that is attributable to a "permanent establishment" of the non-resident situated in Canada.

Permanent Establishments

The concept of a "permanent establishment" is defined in each of Canada's bilateral tax treaties. For example, the US Treaty defines a "permanent establishment" of a US Resident Corporation as a fixed place of business through which the business of the corporation is wholly or partly carried on. Such fixed places of business include places of management, branches, offices, factories, workshops, sites of natural resource extraction, and building sites or construction or installation projects lasting more than twelve months. In certain circumstances, the US Treaty deems a person to have a permanent establishment. For example, a permanent establishment is deemed to exist where a dependent agent, acting on behalf of a US Resident Corporation, has authority to conclude contracts in the corporation's name and habitually exercises this power in Canada. Similarly, in contrast to most of Canada's other tax treaties, under the US Treaty, a US Resident Corporation that provides services in Canada may, in certain circumstances, be deemed to provide such services through a permanent establishment in Canada.

Canadian Corporate Tax Rates

A non-resident corporation that carries on business in Canada is generally subject to corporate income tax at the same rates as similarly situated Canadian resident corporations (as discussed above).

Branch Profits Tax

In addition to basic corporate income taxes, foreign corporations that conduct branch operations in Canada are generally liable to a 25% federal branch profits tax levied on the after-tax profits earned in Canada that are not invested in qualifying Canadian assets. The branch profits tax is designed to equal the non-resident withholding tax that would have been levied on dividends paid by a Canadian subsidiary to its foreign parent corporation had a Canadian subsidiary been utilized to carry on the subject business activities.

The applicable rate of branch profits tax is subject to reduction where the foreign corporation is entitled to claim the benefits afforded by a bilateral tax treaty. For example, a US Resident Corporation that carries on business in Canada through a permanent establishment, and is entitled to claim the benefits of the US Treaty, is generally liable to pay federal branch profits tax at the reduced rate of 5%. Further, under the US Treaty, the first CDN$500,000 of branch earnings will generally be exempt from branch profits tax.

Thin Capitalization Rules

In computing the taxable income of a non-resident corporation carrying on business in Canada through a branch, the amount of interest payable to certain non-resident lenders that may be deducted for Canadian tax purposes is limited by the thin capitalization rules contained in the ITA. The thin capitalization rules preclude a non-resident corporation from deducting interest on the portion of its interest-bearing loans from certain specified non-residents that exceed 60% of the aggregate cost of the property used by the non-resident corporation to carry on business in Canada (net of debts relating to the Canadian business owed to persons other than specified non-residents).

Regulation 105 Withholding

Section 105 of the regulations promulgated under the ITA imposes a 15% withholding requirement on fees, commissions or other amounts paid in respect of services rendered in Canada by non-residents. The Province of Quebec imposes a supplementary provincial withholding requirement of 9% in respect of services rendered in Quebec. The payor of such amounts is responsible for withholding and remitting the required tax, unless a waiver is obtained from the relevant tax authorities. In practice, this withholding obligation can be an impediment to a non-resident providing services in Canada through a branch.

Sales of "Taxable Canadian Property"

Non-residents are generally only subject to Canadian taxation in respect of the disposition of capital property that constitutes "taxable Canadian property" for the purposes of the ITA. "Taxable Canadian property" captures property with a strong connection to Canada, including real property situated in Canada, certain property used in carrying on business in Canada through a Canadian permanent establishment, and shares of a Canadian company whose value is derived principally from real property situated in Canada.

Non-residents are subject to Canadian income tax on capital gains realized on the disposition of taxable Canadian property. A capital gain is generally equal to the difference between the proceeds of disposition and the acquisition cost of a particular piece of property. In contrast to conventional business income, only one-half of a capital gain earned by a taxpayer is generally required to be included in the computation of taxable income for Canadian tax purposes.

A sale by a non-resident of taxable Canadian property triggers certain federal tax reporting and withholding obligations (so-called "Section 116" obligations) and, in respect of sales of similar property situated in Quebec, Quebec provincial tax reporting and withholding obligations.

Other Taxes

Value-Added Taxes

The federal government imposes a multi-stage value-added tax (referred to as the Goods and Services Tax or the "GST"), levied at a rate of 5%, which applies to domestic supplies of most types of property and services in Canada.

The provinces of Ontario, Nova Scotia, New Brunswick, Newfoundland & Labrador and Prince Edward Island have chosen to harmonize their sales taxes with the GST, resulting in a combined sales tax referred to as the harmonized sales tax (the "HST"). For example, the HST is levied on supplies made in the province of Ontario at a rate of 13%, consisting of an 8% Ontario component and a 5% federal component. HST is levied at different rates in the other HST provinces. Generally, persons making taxable supplies in the course of a business carried on in Canada must register for GST/HST and collect, remit and account for such GST/HST.

Provincial Sales Taxes

The provinces of British Columbia ("**BC**"), Saskatchewan and Manitoba currently impose a single stage, general retail sales tax ("**RST**") on the end-consumer or user of goods and certain services. RST is levied at a rate of 7% in BC, 5% in Saskatchewan and 8% in Manitoba. Persons making taxable retail sales, or leasing or licensing property in taxable transactions within an RST province in which they carry on business must generally obtain an RST licence or registration number in the province.

Quebec imposes a multi-stage, value added tax (the "QST") at a rate of 9.975%. The QST is substantially harmonized with the GST/HST, but is administered by the Quebec tax authorities and has its own registration and compliance regime.

Custom Duties

Canada levies customs duties on certain goods imported into Canada, and applies additional excise taxes on the importation of specific goods. The tariff classification and origin of imported goods determines the applicable rate of the customs duty. If goods satisfy specific rules-of-origin criteria, they may qualify for preferential duty rates. For example, US or Mexican goods that satisfy the NAFTA Rules of Origin are generally entitled to duty-free entry into Canada where the exporter provides the importer with a duly completed and signed NAFTA Certificate of Origin.

Provincial Land Transfer Taxes

In most Canadian provinces, a purchaser of real property situated in the province must pay a land transfer tax based on the value of the consideration paid for the property. The rate of land transfer tax varies by province. In Ontario, for example, transfers of commercial real property are generally subject to land transfer tax at a rate of up to 2% of the value of the consideration paid for the property.

Municipal Taxes

Local governments levy annual real estate taxes on real property owners. These taxes generally are based on the assessed value of the property. Municipalities also levy local business taxes and, in some cities, a land transfer tax is imposed on the sale of real property.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.