DOING BUSINESS IN CANADA

Tax Considerations for Non-resident Corporations

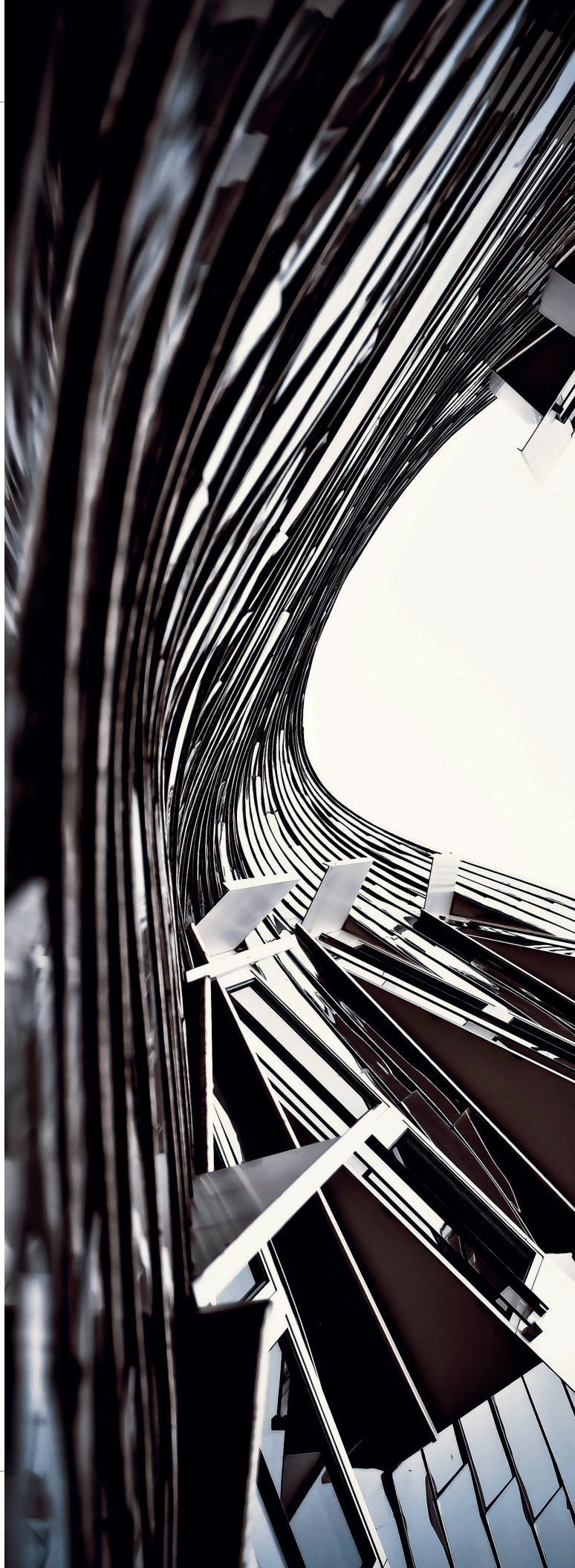
DLA PIPER

CANADA / TAXATION & ESTATES

Overview

This guide summarizes the key Canadian income tax, goods and services tax/ harmonized sales tax, and provincial sales tax considerations for non-resident corporations considering doing business in Canada.

In particular, this guide provides an overview of the Canadian income tax system, key methods of doing business in Canada (i.e. through an incorporated Canadian subsidiary or unincorporated Canadian branch), and associated Canadian income tax, goods and services tax/harmonized sales tax, and provincial sales tax considerations.



Income Tax

General

CANADA'S INCOME TAX SYSTEM

- Canada's income tax system is based on residence and source rules.
- A corporation is resident in Canada if it is incorporated in Canada or its "central management and control" is exercised in Canada.
- Residents are taxed on worldwide income.
- Subject to treaty relief, non-residents are taxed on Canadian-source income, including
  - income from carrying on business in Canada,
  - income from performing services in Canada (15% withholding tax on account of final Canadian tax liability, if any — otherwise it is refundable by filing a Canadian corporate income tax return),
  - capital gains from the disposition of "taxable Canadian property" ("**TCP**") — e.g. Canadian real, resource, or timber property, or certain interests in corporations, partnerships, or trusts that derive value from such property, and
  - certain passive income from Canadian sources — e.g. dividends, non-arm's length interest, rent, and royalties (25% withholding tax).

EFFECTIVE CORPORATE TAX RATES

- Business income — 23% - 31% combined federal/provincial rate, depending on the province.
- Capital gains — 11.5% - 15.5% combined federal/provincial rate, depending on the province.
- Withholding tax — 15% / 25%, unless reduced by treaty.
- Branch tax — 25%, unless reduced by treaty.

CANADA'S TAX TREATIES

- Canada has nearly 100 bilateral tax treaties, generally based on the OECD Model Convention, which provide relief from Canadian income tax on treaty country residents' Canadian-source income, including by
  - eliminating taxation of Canadian-source business profits unless attributable to a Canadian "permanent establishment" ("**Canadian PE**"), and
  - reducing the 25% withholding tax rate on Canadian-source passive income — e.g. the Canada-US Treaty reduces the dividend withholding tax rate to 5% / 15% (depending on the degree of share ownership) and exempts non-arm's length interest.
- Canada is a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

OTHER

- Canada has implemented the Common Reporting Standard and Country-by-Country Reporting.

Methods of Doing Business in Canada

- Non-residents can do business in Canada directly or indirectly through various legal entities — e.g. a corporation (limited or unlimited liability), partnership (general, limited, or limited liability), or trust.
- While non-residents often operate through a Canadian subsidiary corporation, it is common for non-residents who are resident in a country with which Canada has a tax treaty (such as the US) and do not have a Canadian PE to carry on business directly in Canada, since their Canadian-source business income is generally exempt from Canadian income tax.
- In certain provinces (British Columbia, Alberta, and Nova Scotia), it is possible to incorporate an unlimited liability corporation, which may be beneficial for US income tax purposes because it can be treated as a branch for US income tax purposes, but a subsidiary for Canadian income tax purposes.

Incorporated Canadian Subsidiary

- The subsidiary's (worldwide) income is taxed at a combined federal/provincial general corporate tax rate ranging from 23% - 31%, depending on the province.
- Capital gains are taxed at 11.5% - 15.5%, depending on the province.
- Canadian corporations do not pay branch tax, but dividends paid to a non-resident shareholder will be subject to 25% withholding tax, unless reduced by treaty (generally 5% or 15%).

LOSSES

- Non-capital losses incurred by the subsidiary may be deducted against its income from all sources in the year incurred, and any unused balance may be carried back 3 or forward 20 years. Capital losses are only deductible against capital gains; any unused balance may be carried back 3 years or forward indefinitely..

CAPITALIZATION

- Non-resident parents often capitalize a Canadian subsidiary with interest-bearing debt to reduce the subsidiary's Canadian income.
- Canadian thin capitalization rules limit the amount of deductible interest on non-arm's length cross-border debt to 60% of total capital. Interest on debt above the limit is not deductible and is deemed to be a dividend subject to Canadian withholding tax.
- As a further restriction on interest deductibility, consistent with the recommendations in the Action 4 Report of the BEPS Action Plan developed by the OECD and G20, the Canadian federal 2021 budget proposed a new "earnings stripping" rule that would generally limit the amount of "net interest expense" that is deductible to a fixed ratio (40% for one transition year and then phased down to 30%) of "tax EBITDA" for tax years beginning on or after January 1, 2023.
- Non-arm's length cross-border interest is subject to 25% withholding tax, unless reduced by treaty (generally 10% - 15%; 0% under the Canada-US Treaty).

REPATRIATION OF PROFITS

- A subsidiary's profits repatriated by
  - dividends are subject to 25% Canadian withholding tax when paid, unless reduced by treaty (generally 5% - 15%), and
  - returns of capital are not subject to Canadian withholding tax.

PAYROLL OBLIGATIONS

- On salary or other remuneration paid to its employees, the subsidiary must generally
  - withhold and remit income tax, Canada Pension Plan, and Employment Insurance, generally by the 15th day of the following month, and
  - report these amounts by issuing a T4 slip to the employee and filing all such slips and a T4 summary by the last day of February of the following year.
- Other provincial payroll-related taxes/levies may apply (e.g. employer health tax) in certain provinces.

TAX RETURN FILING OBLIGATION

- The subsidiary must file an annual corporate income tax return within six months of its taxation year-end.

Unincorporated Canadian Branch

- Subject to treaty relief, a non-resident corporation that carries on business in Canada directly and not through a Canadian subsidiary is treated as a Canadian branch and subject to
  - Canadian income tax on its income from that business at normal rates (i.e. 23% - 31%), and
  - Canadian branch profits tax on its branch profits from that business at the dividend withholding tax rate (25%, unless reduced by treaty to the equivalent dividend withholding tax rate — e.g. the Canada-US Treaty exempts the first CDN$500,000 of branch profits and reduces the rate to 5% on branch profits over that amount).
- The factual threshold for "carrying on business in Canada" is low and triggers the requirement to file a Canadian corporate income tax return within six months of the non-resident corporation's taxation year-end, even if the non-resident is exempt from Canadian income tax by treaty.

- Canada's treaties generally eliminate Canadian income tax on business income earned in Canada by a non-resident unless the non-resident carries on business through a Canadian PE.
- Canada's treaties generally define a Canadian PE to include, subject to certain exceptions, at least the following:
  - a fixed place of business; and
  - a dependent agent who has and exercises an authority in Canada to enter into agreements on behalf of the non-resident.
- Canadian business losses are deductible, but only against Canadian business income, and may be carried back 3 or forward 20 years.
- Capital losses from the disposition of TCP are deductible against capital gains from the disposition of TCP, and any net capital losses from the disposition of TCP may be carried back 3 years or forward indefinitely.
- A non-resident employer is generally subject to the same payroll obligations as a Canadian-resident employer on salary or other remuneration paid to employees resident or employed in Canada, subject to certain exemptions.

Subsidiary or Branch?

- A subsidiary is often used due to certain practical concerns associated with the use of a branch, unless the non-resident is resident in a country with which Canada has a tax treaty (such as the US) and does not carry on business through a Canadian PE, since the non-resident's Canadian-source business income will generally be exempt from Canadian income tax.

DISADVANTAGES OF BRANCH

The non-resident corporation will be

- required to prepare annual financial statements for the branch that are satisfactory to both countries,
- itself exposed to Canadian audit risk, and the Canada Revenue Agency ("**CRA**") will scrutinize its chosen method of allocating income and expenses to the branch,
- subject to 15% withholding tax on fees paid to it by Canadian customers for services rendered in Canada (on account of its final Canadian tax liability, if any — otherwise it is refundable by filing a Canadian corporate income tax return), and
- subject to branch profits tax on accrued income (vs. dividend withholding tax, which is payable only upon payment of a dividend).

ADVANTAGES OF BRANCH

Subject to the tax laws of its home jurisdiction, the non-resident may

- deduct losses from its Canadian branch against its non-Canadian income, and/or
- claim a foreign tax credit for Canadian income taxes paid.

Other Income Tax Considerations

- *Transfer pricing.* Domestic Canadian transfer pricing rules are based on OECD rules, and Canada follows the OECD Guidelines in interpreting and applying its domestic rules. Transactions between a resident and non-arm's length non-resident must be on arm's length terms and documented contemporaneously.
- *General anti-avoidance rule.* A transaction's tax consequences can be recharacterized if it results in a tax benefit, was not undertaken for primarily bona fide non-tax purposes, and is considered abusive.
- *Selected federal government tax incentives:*
  - Scientific Research and Experimental Development Program. Deduction and (15% / 35%) federal "investment tax credit" for qualifying expenditures.
  - Film or Video Production Services Tax Credit. 16% federal tax credit for qualifying Canadian labour expenditures on an accredited production.
  - Accelerated Investment Incentive. Immediate expensing for manufacturing and processing equipment and clean energy equipment and accelerated investment incentive for all businesses.

Goods And Services Tax/Harmonized Sales Tax ("GST/HST")

- GST/HST is a value added tax ("**VAT**") administered by the CRA.
- GST is 5% and applies throughout Canada. HST is a combination of 5% GST plus a provincial tax rate.
- HST applies only in Ontario (13%), Nova Scotia (15%), New Brunswick (15%), Newfoundland (15%), and Prince Edward Island (15%).
- GST/HST is a multi-stage European-style VAT, where all purchasers in a supply chain pay GST/HST and each of those purchasers (other than the end consumer) is generally entitled to recover (by way of "input tax credits" ("**ITCs**")) GST/HST paid in the course of its commercial activity.
- Every supplier of goods or services in Canada is required to register for and charge GST/HST on its taxable supplies.
- A non-resident that makes certain electronically supplied products or services to Canadian consumers (digital economy B2C transactions) is required to register for a simplified GST/HST account, and may possibly opt to register for a normal GST/HST account. Otherwise, a non-resident that does not "carry on business in Canada" for GST/HST purposes is not required to register for or collect GST/HST on goods and services it provides in Canada. The threshold for "carrying on business in Canada" for GST/HST is somewhat higher than for income tax purposes.
- A registrant must charge the correct amount of GST or HST on sales. The rate of tax depends on the place of supply. Certain goods and services are GST/HST exempt or zero-rated.
- A registrant with a normal GST/HST account files GST/HST returns reporting the amount of GST/HST collected and the amount of ITCs claimed for GST/HST recovery, and remits the net amount to the CRA. Where ITCs exceed GST/HST collected, the CRA will pay a refund to the registrant. A registrant with a simplified GST/HST account is generally not permitted to claim ITCs, except in very limited circumstances.

Provincial Sales Tax ("PST")

- PST applies to goods and certain services sold in British Columbia (7%), Saskatchewan (6%), and Manitoba (6%). PST is a single-stage US-state style sales tax, so only the end consumer is charged PST. Certain goods are subject to a special PST tax rate.
- These provinces may place certain requirements on non-resident businesses to register for and collect PST from customers in the province.

Québec Sales Tax ("QST")

- QST is a 9.975% tax that applies in Québec. QST is a VAT and generally applies in the same manner as GST/HST. QST is administered by Revenu Québec.

For more information

To learn more about our Canadian Tax practice, please visit www.dlapiper.com or contact any member of our Canadian Tax Group:

Kevin Fritz
Partner, Chair, Canadian Tax Group
Toronto, ON
T +1 416 941 5397
kevin.fritz@dlapiper.com

Mark A. Potechin TEP
Partner
Montréal, QC
T +1 514.392.8414
mark.potechin@dlapiper.com

Adrienne Woodyard
Partner
Toronto, ON
T +1 416 365 3414
awoodyard@dlapiper.com

Geneviève Lille
Counsel
Toronto, ON
T +1 416 862 3397
genevieve.lille@dlapiper.com