



Tax Issues – Canadian Operations

By

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July 11, 2002

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TAX ISSUES - CANADIAN OPERATIONS

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1. Introduction

This memorandum outlines some of the Canadian tax issues which may be relevant to you in connection with your Canadian operations. It also describes, in general terms, certain planning opportunities that may be available.

2. Branch versus Subsidiary

- Whether the Canadian operations are owned directly by you (i.e. a branch) or through a Canadian company (i.e. a subsidiary), the income from the Canadian operations will be subject to income tax under Part I of the *Income Tax Act* (the "ITA"). The Part I tax rate (approximately 40%) applicable to the Canadian operation's profits will be the same whether a branch or subsidiary is used.
- An additional tax known as the branch tax will be levied annually on these profits (unless they are reinvested in the business) if the business is carried on through a branch. Correspondingly, a dividend paid by a Canadian subsidiary to an American parent will be subject to withholding tax. Pursuant to the Canada-U.S. Income Tax Convention (the "Convention"), the rate of withholding tax on dividends is reduced to 5% (after 1996). Under the Convention, the branch tax rate is also reduced to 5%. There may be a timing advantage to using a subsidiary instead of a branch because a subsidiary may defer payment of the withholding tax (on amounts which are not otherwise directly reinvested in the business) by deferring payment of dividends.
- Under the Convention, the first \$500,000 of profit (in Canadian dollars) is exempt from branch tax. This would provide an aggregate tax savings of \$25,000 (\$500,000 x 5%). The \$500,000 branch tax exemptions as well as the opportunity to apply start-up losses against other income may be an incentive to operate initially as a branch rather than a subsidiary.
- Under the ITA, a tax-deferred transfer of the branch assets to a Canadian subsidiary may be affected after the Canadian operations have been established. However, a tax-deferred transfer is not available for real property held as a trading asset. A tax deferred transfer of the branch assets to a non-Canadian subsidiary is generally not available.

3. Capitalization Issues

- Generally, the U.S. tax rates are lower than the Canadian tax rates. This suggests that a Canadian subsidiary should be capitalized with debt instead of equity. This would permit the interest expense to be deductible at a higher rate in Canada than the corresponding inclusion rate in the U.S.

- Under the ITA, interest expense on money borrowed from significant non-resident shareholders is only deductible to the extent that the amount of such debt does not exceed two times the amount of equity attributable to such non-residents (equity includes retained earnings). The rules which limit the interest deduction are referred to as the "thin cap rules". A branch operation may be necessary to avoid the thin cap rules.
- Consideration should be given to the appropriate currency for investment and the possible need for a currency hedge.

4. **Entity Classification**

- The Canadian tax system does not have entity classification rules such as those contained in the Internal Revenue Code. In Canada, the legal form of the entity (i.e. corporation or partnership) will determine its status for tax purposes.
- With the exception of the Nova Scotia ULCs, Canadian hybrids do not exist. A Nova Scotia ULC is treated as a partnership for U.S. tax purposes unless it elects to be treated as a corporation under the U.S. "check the box" entity classification regulation.
- The Nova Scotia ULC as well as any U.S. LLC will be treated as a corporation for Canadian tax purposes.

5. **Canadian-Controlled Private Corporation**

- A Canadian-controlled private corporation ("CCPC") is a corporation incorporated in Canada and that is not controlled by any combination of non-residents or public companies. Control means voting control (more than 50% of the votes).
- The principal advantage of being a CCPC is that it receives a lower rate of tax (approximately 17%) on its first \$200,000 of annual income.
- It is unlikely that the Canadian operations will be able to take advantage of this low rate of tax unless a significant Canadian partner is included in the project.

6. **Transfer Pricing**

- On September 11, 1997, the Minister of Finance released draft legislation introducing transfer pricing rules for cross-border transaction between non-arm's length parties. The new rules include supporting documentation requirements and significant penalties for failure to respect the transfer pricing rules. At the same time, Revenue Canada released a draft Information Circular setting out its administrative practices relating to transfer pricing. The new rules will be effective for fiscal periods starting after 1997.
- The new transfer pricing rules provide a statutory basis for the application of the transaction method of applying the arm's length principles approved by the OECD. The draft Circular endorses the OECD transfer pricing guidelines which prefer the traditional transaction methods such as the comparable uncontrolled price method, the cost plus method, the resale price method and where any of these methods cannot be used then the profits split method or

the transactional margin method. Revenue Canada is empowered to adjust or to re-characterize the results of a transaction for Canadian tax purposes where any of the terms or the conditions of the transaction are different from those that would have been made between parties dealing at arm's length, or where the transaction would not have been entered into by arm's length parties.

- Both in the case of a Canadian branch or a Canadian subsidiary, there is an opportunity to reduce Canadian tax through the shifting of administrative costs from Canada to the U.S.

7. **Investment Repatriation**

- The Canadian tax and corporate rules permit a reduction of paid-up capital before the payment of any dividends (regardless of whether there are any "earnings and profits"). No withholding tax is imposed on a reduction of paid-up capital. Where a Canadian subsidiary has tax-sheltered income (eg. because of the application of prior year's losses) excess cash can be returned through a paid-up capital reduction. This repatriation of funds may not attract tax in the U.S. to the extent that the Canadian subsidiary does not yet have "earnings and profits".
- This type of strategy is more easily employed with a federally-incorporated company because of the relative ease with which a paid-up capital reduction may be affected through the *Canadian Business Corporations Act*.

8. **Consolidated Loss Rules**

- The ITA does not have consolidated loss rules similar to those contained in the Internal Revenue Code.
- However, there are significant planning opportunities to consolidate losses and profits within a corporate group and it is often possible to achieve a tax consolidation of a Canadian group of companies.
- The U.S. consolidated loss rules do not permit a consolidation with a Canadian company. Canadian losses will be consolidated if the Canadian operations are operated through a branch or a partnership (see entity classification, above). This tax advantage must be weighed against the loss of liability protection given by a Canadian company (including a Nova Scotia LLC).

9. **Capital Tax**

- The federal government imposes a capital tax known as the Large Corporation Tax ("LCT"). In effect the LCT acts as a minimum tax. It is levied at the rate of 0.225% of taxable capital employed in Canada. It acts as a minimum tax as corporations which pay Part I tax do not generally pay LCT. In addition, LCT paid in a particular year may be carried forward and applied against surtax applicable under Part I of the ITA in subsequent years.
- The province of British Columbia formerly levied a tax under the *Corporation Capital Tax Act*. It was recently repealed. Ontario and a few other provinces still levy a tax on capital employed in those jurisdictions. Capital is allocated among the Canadian jurisdictions based

equally on the jurisdiction in which revenues are sourced and the jurisdiction in which salary and wages are paid.

- Both the LCT and the provincial capital tax calculate the capital employed by reference to the right-hand side of a balance sheet prepared in accordance with GAAP. As a result, there are significant planning opportunities to minimize the capital tax through off-balance sheet financing. For example, leasing rather than owning property will reduce the capital employed in Canada and thus the amounts payable under both taxes.
- Another potential structure is to enter into a capital lease which may be recorded as a financing lease for capital tax purposes.

10. **Commodity Tax**

- The federal government imposes a value added commodity tax at the rate of 7%. This tax is known as the Goods and Services Tax ("GST").
- Businesses are entitled to full recovery of any GST paid in the form of an Input Tax Credit ("ITC"). To be eligible for ITCs, a business must obtain a GST number by registering with Revenue Canada.
- The province of British Columbia imposes a retail sales tax known as the Social Service Tax ("SST"). This tax generally applies to the purchase in the province or importation to the province of tangible personal property at the rate of 7.5%. It also applies to certain other sale services such as repairs. SST is not recoverable as is the GST. However, under a recently enacted exemption, most production equipment and machinery is now exempt from SST.

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