Structuring Entry Into the Canadian Market: A Corporate Tax Primer

It is critical for non-residents to obtain proper Canadian legal advice respecting their long-term tax position before entering the Canadian market. The tax consequences of the various available structures vary significantly and opportunities for tax savings can be considerable.

The tax issues arising upon entering the Canadian market are best understood by recognizing that there are only three basic vehicles. A non-resident corporation may carry on business in Canada directly, through a Canadian corporation or through a partnership involving either or both of the foregoing. Once the consequences of each alternative are understood and compared, more complex, contextual, structures may be tailored from these basic building blocks.

Admittedly, this is a simplistic analysis since only the basic 'building blocks' are considered. Furthermore, this analysis is limited to the Canadian side of the equation. In respect of the first limitation, the essential point is that the tax issues remain the same for the most complex as for the most simple structures. The simpler the structure, the more readily understood are the tax issues. As to the second limitation, it is, of course, necessary to always consider the tax issues in the applicable foreign jurisdiction.

1. <u>Permanent Establishments</u>

Focusing, then, upon the Canadian side of the equation, the first scenario is one in which the non-resident corporation would carry on business in Canada directly. From a domestic perspective, subsection 2(3) of the Income Tax Act (Canada) (the **"Tax Act"**) would subject the non-resident to Canadian income tax on all Canadian-source business income. From a cross-border perspective, however, there may be an opportunity to avoid Canadian taxation by avoiding a Canadian permanent establishment. The first point to consider, then, is the threshold at which the Canada Revenue Agency (the **"CRA"**) would determine a permanent establishment to arise for the purposes of Canada's typical tax treaty.

It should be noted at the outset that treaty exemptions for non-residents carrying on business in Canada without a permanent establishment usually apply only to non-residents that are corporations. A similar exemption involving the identical concept of "fixed base" applies to individuals. That the concepts of "permanent establishment" and "fixed base" are identical has been recognized by the recent deletion of the latter concept from the Canada-U.S. Tax Convention (1980) (the **"Canada-U.S. Treaty"**) and the expansion of the former to benefit individuals. All comments on permanent establishments therefore apply equally to fixed bases.

(a) Permanent Establishment

The definition of a "permanent establishment" is set out with some particularity in the tax treaties. In essence, these definitions provide that a permanent establishment is predicated upon any of: (i) a place; (ii) a person; or, (iii) time allocation.

(i) *Places*

A permanent establishment as a place requires a "fixed place of business"; that is, a physical location controlled by, and identifiable by prospective clients with, the non-resident. Aside from the obvious examples of owning or leasing space, a non-resident may simply be permitted to use the office of a Canadian affiliate or client. In such circumstances, we would need to consider whether the non-resident has a key to those premises and access at any hour, whether it uses those premises to service other clients and whether it hangs its own shingle in the lobby or hands out business cards with that address or phone number. Relevant factors are as varied as the circumstances.

(ii) *Persons*

The second concept is that of a permanent establishment as a person. A person can be a permanent establishment if it has and habitually exercises in Canada the authority to contract on behalf of the non-resident. If circumstances permit, this situation can be avoided simply by denying any person in Canada the authority to execute contracts on the non-resident's behalf.

If, for example, a non-resident is to have only a sales force in Canada, a permanent establishment could be avoided by requiring head-office approval for all sales contracts. In this scenario, it should be noted that the typical treaty definition of "permanent establishment" specifically excludes the use of facilities for the purpose of storage, display or delivery of merchandise. A Canadian sales and distribution network could, therefore, be organized to avoid Canadian income tax entirely—subject to the new 183-day rule.

(iii) *Time Allocation: The New 183-Day Rule*

A third branch of the definition of permanent establishment, applicable as of January 1, 2010, applies in either of two sets of circumstances:

(A) services are provided in Canada by an individual who is present in Canada for an aggregate of 183 days or more in any 12-month period and more than 50% of the non-resident's gross active business revenues derives from those services; or

(B) services are provided in Canada by any number of persons, whether or not individuals, for an aggregate of 183 days or more in any 12-month period and those services are in respect of the same or a connected project—in this case, the customers may be either residents of Canada or merely have permanent establishments in

Canada, provided in the latter case that the services are provided in respect of those permanent establishments.

The first scenario, which contemplates only a single individual, applies to any number of projects whereas the second scenario, which contemplates any number of individuals, applies only to a single or a connected project. Further, whereas the first scenario applies a revenue test, the second does not.

When considering the use of local representatives, it should also be noted that the typical treaty specifically excludes from the definition of "permanent establishment" any agent of an independent status acting in the ordinary course of its business. Thus, distributors and other independent contractors would not usually constitute a permanent establishment.

(b) Pros and Cons

Assuming that the non-resident chooses to carry on business in Canada directly through a permanent establishment, what are the consequences? First, a non-resident that carries on business in Canada through a permanent establishment would be subject to Canadian income tax on all net Canadian-source income attributable to that permanent establishment. Although a foreign tax credit would presumably be claimed in the non-resident's home jurisdiction, the non-resident would remain liable to pay the higher of the two tax rates and would be required to file a Canadian income tax return. Second, liabilities incurred in Canada would be incurred by the non-resident—there would be no limitation of liability otherwise afforded by a subsidiary corporation. Third, customers of the permanent establishment would be required to withhold and remit income tax on all payments that they make to the permanent establishment, although non-resident corporations typically obtain waivers for this withholding and remittance requirement.

On the other hand, the principal benefit of carrying on business through a permanent establishment is that any losses incurred in Canada would generally be deductible by the non-resident in its home jurisdiction against its non-Canadian-source income. A permanent establishment may also be preferable if the extent or frequency of business activity in Canada does not warrant the incorporation of a separate company.

(c) Branch Tax

The last issue when considering whether to carry on business in Canada directly is "branch tax". Just as Part XIII of the Tax Act imposes a non-resident tax of 25% on dividends, so Part XIV imposes a branch tax of 25% on the after-tax profits of the branch that are not reinvested in the Canadian business. And, just as the tax on dividends is subject to reduction by treaty, so also is branch tax. This reflects the policy behind branch tax, which is to render the choice between a branch and a subsidiary tax neutral. Differences arise, however, in that the treaty-reduced rate applicable to dividends under most of Canada's tax treaties is variously 5% or 10%, as discussed in Part II(B), below, whereas the treaty-reduced rate applicable to branch tax is 5%.

Further differences between branch tax and non-resident tax are as follows. First, there is a timing difference since branch tax is payable annually whereas the non-resident tax applicable to dividends is payable at the time each dividend is paid or credited. Second, Canada's tax treaties typically exempt the first $500,000 of net income from branch tax. This is a one-time exemption. No such exemption applies to dividends, although an analogous result may be obtained for dividends through the use of an acquisition company, discussed in Part II(C), below.

2. Subsidiaries

Thus far, we have reviewed the possibility of avoiding Canadian income tax by avoiding a Canadian permanent establishment and the tax consequences of carrying on a business in Canada through a permanent establishment. The next likely vehicle through which to carry on business in Canada is a Canadian subsidiary.

(a) Pros and Cons

The pros and cons of a subsidiary are the converse to those of a permanent establishment. As a separate legal entity, any losses generated by a subsidiary cannot be deducted by the parent. On the other hand, the subsidiary's liabilities are its own and, as a Canadian corporation, its customers are not required to withhold and remit taxes. It should also be noted that a subsidiary's tax filing obligations are also its own, which is significant if the non-resident does not wish to disclose its financial information to the CRA.

Prior to recent amendments to the Canada-U.S. Treaty, unlimited liability companies (ULCs) were often incorporated under the laws of Nova Scotia, Alberta or British Columbia to provide U.S.-resident investors with the benefits of both a permanent establishment and a subsidiary. However, as a result of those amendments, all dividends, royalties and similar payments made to the U.S.-resident parent are now subject to non-resident tax, discussed below in Part II(B), at the full rate of 25% without the benefit of a treaty reduction or exemption. Nevertheless, ULCs continue to offer benefits for U.S. tax purposes, which must be weighed against the loss of treaty benefits.

Notwithstanding that a subsidiary is an independent legal entity, care must be taken to ensure that the subsidiary cannot be construed to be a mere agent of its non-resident parent. In such a case, the CRA might consider the subsidiary's premises to constitute a "fixed place of business" through which the non-resident parent carries on business in Canada, i.e., the subsidiary's premises could be construed to be a permanent establishment. This result may be avoided when drafting inter-corporate services agreements by making it clear that the subsidiary is engaged in its own business, that the relationship between the non-resident and its Canadian subsidiary is one of customer and independent contractor.

(b) Non-Resident Tax and Income Tax

(i) <u>Non-Resident Tax</u>

If we divide the non-resident and the Canadian operation into separate legal entities, we must then consider taxes on all payments flowing between them. Part XIII of the Tax Act imposes a non-resident tax on various passive forms of income, including dividends, interest, rents, royalties and so forth. This 25% rate rarely applies, however, since Canada's tax treaties generally reduce or eliminate this tax. Unlike the Tax Act, the tax treaties treat the various kinds of income differently such that each income source must be separately considered.

Looking at dividends, the treaty-reduced rate under the typical treaty is 5% if the beneficial owner of the dividends is a corporation that owns at least 10% of the voting stock. In all other cases, the treaty-reduced rate for dividends is 15%. Rents on real property situated in Canada enjoy no tax reduction. Any amounts that could be allocated to royalties for software licences would enjoy a complete tax exemption under the Canada-U.S. Treaty while certain other royalties would be taxable at 10%.

Interest payments between arm's-length parties are not taxable provided that the interest is not 'participating debt interest'. This concept refers to debt on which interest is contingent upon the use of, or production from, property in Canada or that is computed by reference to revenue, profit, cash flow, commodity price, etc. or by reference to dividends paid or payable on the shares of a corporation (not necessarily the debtor corporation). In other words, participating debt is debt the interest on which could be characterized as disguised dividends. Given this exemption from non-resident tax on arm's length interest payments, there is no tax disincentive to sourcing project financing abroad. When, however, debtor and creditor are not at arm's length, we must rely upon a tax treaty for a reduction or exemption of the non-resident tax which would otherwise apply at a rate of 25%. Pursuant to recent amendments to the Canada-U.S. Treaty, interest payments between the two countries are wholly exempt from taxation in the source country. Under Canada's other tax treaties, the typical rate is 10%.

(ii) <u>Income Tax</u>

Whereas Part XIII tax applies to passive forms of income earned in Canada by non-residents, income from carrying on business in Canada is subject to income tax under Part I of the Tax Act. It may be, for example, that the non-resident parent, or, perhaps, another member of the corporate group, will provide services to the Canadian subsidiary. In such a situation, income tax must be withheld by the Canadian subsidiary on all fees for such services at a rate of 15%. (For the application of sales tax to non-residents, see the article, "Canada's Federal Sales Tax—An Overview for Non-Resident Suppliers").

It should be noted that, whereas non-residents are not required to file Canadian tax returns in respect of non-resident tax, they are required to file Canadian tax returns in respect of income tax. As well, whereas a treaty reduction or exemption will reduce or avoid the amount of non-resident tax to be withheld, the same is not true of income tax. Income tax must be withheld at a rate of 15% regardless of the application of any tax treaty—subject only to the non-resident obtaining a waiver from the CRA. The treaty benefit is claimed, and the rebate obtained, when the tax return is filed.

(c) Acquisition Companies

The next point to consider in respect of the use of a subsidiary is the potential benefit of an acquisition company for the purchase of either Canadian assets or shares. In the absence of an acquisition company, the purchase price would simply be paid by the non-resident to the vendor and no tax benefit would be obtained by the purchaser (aside from a step-up in the cost base of the acquired shares or assets, as the case may be). If, however, the non-resident purchaser were to pay the amount of the purchase price to a Canadian subsidiary (which would then pay the vendor) paid-up capital would be created in the subsidiary (and the subsidiary would still obtain a step-up in the cost base of the acquired shares or assets). Thereafter, any distributions made by the subsidiary to the parent could, to the extent of the increased paid-up capital, be characterized as a tax-free distribution of capital rather than a taxable dividend or interest payment. Assuming the treaty-reduced rate under the Canada-U.S. Treaty of 5% on dividends, the tax savings to the non-resident on every $1 million of purchase price paid would be $50,000.

(d) Thin-Capitalization

Given the full tax exemption for interest payments under the Canada-U.S. Treaty, it is tempting to characterize all investment in a Canadian subsidiary by a U.S.-resident parent as debt. Unfortunately, there is already in place a "thin capitalization rule" which denies a deduction to the subsidiary for interest paid to the parent (or any other "specified non-resident") if the debt owed to the parent (or other "specified non-resident") exceeds twice its equity. Briefly, a "specified non-resident" is a non-resident that does not deal at arm's length with the subsidiary or that, either alone or together with other non-arm's-length persons, owns 25% or more of the subsidiary's votes or value. Given the ability of the Canadian subsidiary to deduct interest payments (and not dividends), it is difficult to envision a scenario in which a U.S.-resident parent would not wish to maintain the maximum 2:1 debt to equity ratio.

(e) Transfer Pricing

Finally, the last issue of which we need to be aware in respect of subsidiaries is the potential application of the transfer pricing rules. Since a subsidiary is not a permanent establishment, the non-resident would not be subject to Canadian income tax on fees for services performed in Canada (although withholding and filing obligations discussed above would still apply). Consequently, a non-resident parent could extract profits from a Canadian subsidiary on a tax-free basis by characterizing such amounts as fees for services. Such payments would then be deductible by the Canadian subsidiary. The same result could be obtained through the sale of goods to a subsidiary. In order to prevent such abuses, the CRA applies transfer pricing rules to amounts charged for goods or services passing between Canadian corporations and non-arm's-length non-residents. If the amounts charged differ from the amounts that would be charged between arm's-length parties, as determined by the CRA, subsection 247(2) of the Tax Act authorizes the CRA to adjust the taxable income of the subsidiary accordingly. While the application of these rules is beyond the scope of this paper, taxpayers should be aware that these rules exist and that taxpayers are required to maintain contemporaneous documentation to identify and support all amounts paid to or received from related non-residents as consideration for goods or services.

3. Limited Partnerships

The third and final vehicle to be discussed on the Canadian side of the border is the limited partnership. The fundamental point is that the taxation of partnerships reflects the fact that they are not legal entities. While tax practitioners often speak somewhat loosely of partnerships as though they were independent entities, it is important to remember that they exist only as contractual relationships among the partners. This is true of limited partnerships as well as general partnerships notwithstanding that limited partners enjoy limited liability. Broadly speaking, then, if a non-resident were to organize its Canadian operations as a partnership, we would need to look through the partnership and consider all of the above issues in respect of each partner, which will either be carrying on business through a permanent establishment or Canadian subsidiary. Since a Canadian subsidiary is a Canadian resident, the following references to non-resident partners refer only to those non-residents that hold their partnership interests directly.

For the purposes of calculating income and losses of the partners, income is determined and expenses deducted at the partnership level and the resulting taxable income or losses allocated among the partners in accordance with the terms of the partnership agreement. In most instances, the partnership is then required to file an information return which the CRA can then cross-reference with the income tax returns of each partner. This ability of limited partnerships to flow through losses to the partners while limiting liability is the reason such partnerships are often used as investment vehicles.

Partnerships with a non-resident partner are subject to specific rules relating to: (i) non-resident tax on payments to the partnership; and, (ii) income tax applicable to capital gains realized upon the disposition of taxable Canadian property held by the partnership.

(a) Non-Resident Tax

Paragraph 212(13.1)(b) of the Tax Act deems any amount paid or credited by a person resident in Canada to a partnership other than a "Canadian partnership" to be paid to a non-resident person. "Canadian Partnership" is defined in subsection 102(1) of the Tax Act to mean a partnership all of the members of which are resident in Canada. This relieves the CRA of the administrative burden of determining the residence status of each partner and the portion of each payment allocable to any non-resident partners. Instead, if even just one partner is a non-resident, Canadian resident payors must withhold non-resident tax on dividends, interest, rents, royalties, management fees, and so forth paid or credited to the partnership.

Left on its own, the effect of this rule would be draconian given that non-resident tax is not a withholding tax *per se* but is a tax in and of itself and is therefore non-refundable. We therefore have a further rule according to which a partnership is to be ignored for the purpose of applying the tax treaties. In conjunction with paragraph 212(13.1)(b), this shifts the burden of determining the residence of each partner and its share of partnership income from the CRA to the taxpayers. If tax treaty benefits are to be claimed, the residence of each partner must be separately determined as of the time of each payment and the tax reduction or exemption under the relevant tax treaty must be separately applied to each partner.

If a U.S.-resident corporation owns shares through a Canadian partnership then, for the purpose of determining whether the lower of two treaty-reduced rates referred to in Part (II) (B), above, is available in respect of dividends, the U.S.-resident partner will be considered to own shares in proportion to its partnership interest. Before recent amendments to the Tax Treaty, the lower rate was never available when a partnership was interposed.

(b) Income Tax

If Canadian operations are to be structured as a partnership, it is important to consider that the permanent establishment of one non-resident partner is considered to be the permanent establishment of every non-resident partner. This rule applies to both general and limited partners. Every non-resident partner will, therefore, be subject to Canadian income tax on its share of the partnership income as though that partner were carrying on business in Canada directly through a permanent establishment.

(c) Tax Clearance Certificates

For the purpose of determining whether a tax clearance certificate is required under section 116 of the Tax Act in respect of the disposition of taxable Canadian property, the partnership is generally ignored. Only non-resident partners are required to obtain tax clearance certificates while Canadian-resident partners may rely upon their own Canadian-resident status.

The difficulty arises in that a purchaser of taxable Canadian property is liable to pay tax in an amount equal to 25% of the purchase price unless either: (i) after "reasonable inquiry" it has “no reason to believe” that the vendor is a non-resident; or, (ii) a tax clearance certificate is obtained. When the vendor is a limited partnership, the obligation to conduct such due diligence would be problematic, to say the least. It is to be expected, then, that the agreement of purchase and sale would require the partnership—or, more properly, the general partner on behalf of the partnership—to represent and warrant that Canadian-resident partners are so resident and to provide tax clearance certificates for the rest.

The difficulty of obtaining tax clearance certificates from any number of non-resident investors is largely relieved by administrative concession. The CRA's position as stated in paragraph 10 of *Information Circular 72-17R5* is that a single application may be made on behalf of all non-resident partners provided that the application includes a complete listing of the non-resident partners together with their Canadian and foreign addresses, identification numbers, percentage ownership and their portion of the tax payment or security therefor. Separate tax clearance certificates are then issued for each partner and each partner must file its own Canadian income tax return to report the gain or loss.

Recent amendments to the Tax Act relieve the purchaser from the withholding and remittance obligation if: (i) the purchaser concludes after "reasonable inquiry" that the vendor is resident in a given treaty country; (ii) the sale proceeds would be exempt under the particular treaty; and, (iii) the purchaser provides the required notice to the Minister. Previously, then, a purchaser was relieved of its withholding and remittance obligations only if its reasonable inquiry disclosed that the vendor was a resident of Canada. Now, a purchaser is relieved of such obligations if its reasonable inquiry discloses that the vendor is a non-resident but is nevertheless entitled to a treaty exemption.

4. Conclusion

As stated at the outset, it is critical that non-residents obtain proper Canadian legal advice before entering the Canadian market. The long-term tax consequences of the various available structures vary significantly and opportunities for tax savings can be considerable.

Patrick Westaway is a Partner at Dale & Lessmann LLP, a Toronto, Ontario, Canada-based full service law firm specializing in Canadian taxation law. Patrick advises on a broad range of Canadian taxation issues such as corporate tax planning, structuring inbound investments, corporate reorganizations, cross-border financings, tax opinions for public disclosure documents, tax assessments, personal tax matters, wealth preservation, and on federal and provincial sales tax matters (HST/GST/PST). Patrick also practices corporate and commercial law with an emphasis on the implementation of matters related to his tax planning practice.