Branch of a foreign corporation vs. Canadian subsidiary

Things to know

One of the most important considerations for a non-resident is whether to incorporate a Canadian subsidiary or to establish a branch operation.

A Canadian subsidiary of a non-resident corporation will be considered a resident of Canada for the purposes of the *Income Tax Act* and will be subject to Canadian income tax on its worldwide income. Under Canada’s domestic rules, there is no withholding tax on non-participating interest paid to arm’s length persons, and under the Canada-U.S. Income Tax Convention, withholding tax on arm’s length or non-arm’s length on-participating interest paid to U.S. persons is generally nil.

Since a Canadian subsidiary is a Canadian corporation, it is not subject to branch profits tax; however, upon the repatriation of funds by the Canadian subsidiary to the non-resident corporation by way of dividend, a 25% withholding tax is payable, subject to reduction by an applicable tax treaty.

The thin-capitalization rules can disallow a deduction for interest payable by a Canadian subsidiary on debts owing to “specified non-resident persons” when such debts exceed the subsidiary’s equity by a ratio of 1.5:1.

Subject to treaty relief, a Canadian subsidiary must withhold tax on several types of payments to non-residents, including dividends, interest paid to non-arm’s length parties, participating interest, certain management or administration fees and rentals, royalties and similar payments.

A non-resident corporation carrying on business in Canada through a Canadian branch is liable for income tax on its Canadian-source business income at the same rates that apply to Canadian residents.

In addition to federal and provincial income taxes, a non-resident corporation (NRC) carrying on business in Canada will be subject to the so-called “branch profits tax” which is intended to approximate the withholding tax that would have been paid on taxable dividends from a Canadian resident subsidiary if the non-resident corporation had incorporated a Canadian subsidiary to carry on business in Canada, rather than using a branch. Under the *Income Tax Act*, the branch profits tax is generally levied at a rate of 25% (which may be reduced under certain tax treaties) on the profits of the branch, after Canadian taxes and an allowance for investment in Canada.
Branch of a foreign corporation vs. Canadian subsidiary

The *Income Tax Act* requires a non-resident taxpayer that carries on business in Canada to calculate income or loss from its Canadian business. Expenses incurred exclusively and directly for the Canadian branch should be deductible in computing the income of the branch.

The “thin-capitalization” rules have been extended to apply to non-resident corporations carrying on business in Canada.

Canadian non-resident withholding tax generally only applies to payments made by residents of Canada to non-residents of Canada. However, a non-resident of Canada who carries on a business though a branch in Canada may be deemed, for purposes of the withholding tax rules, to be resident in Canada; this means that certain payments made by the non-resident to another non-resident may be subject to Canadian withholding tax, unless such tax is reduced by an applicable tax treaty.

Under the ITA, a branch generally may be incorporated without incurring immediate significant income tax or branch tax liability.

**RELATED DBIC TOPICS**
- Initial structuring and income tax considerations
- Canada’s tax system
- Forming a Canadian subsidiary

**Need more info?**
Contact us at counsel@osler.com