An Introduction to Canada's Tax System

by SEAN AYLWARD & JACK SILVERSON

Several federal and provincial tax considerations are relevant to non-residents seeking to do business in Canada. One of the most important considerations is whether to establish a branch operation or to incorporate a Canadian subsidiary.

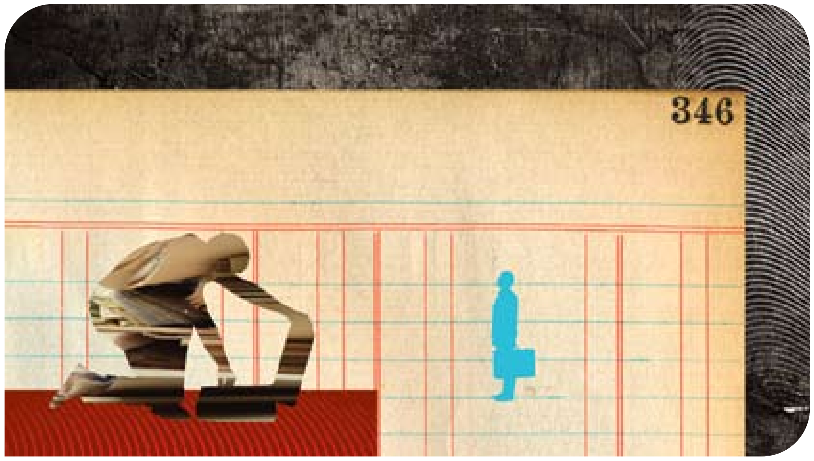
Canada's tax regime for businesses (and individuals) is largely governed by the federal *Income Tax Act* (ITA) and its regulations, as well as by the sales tax, corporate tax and other laws of the provinces and territories. When establishing a business in Canada, a non-resident will have to decide whether to conduct its business in Canada through a branch operation or a Canadian subsidiary. More general considerations include capital taxes, the taxation of individuals, tax matters for partnerships and joint ventures and sales and commodity taxes.

In addition to filing annual income tax returns, corporations are subject to various reporting requirements under the ITA. Severe penalties can be levied for failing to file an information return, or for providing incorrect or incomplete information on a return.

General Tax Considerations

Ordinary Income Tax

The ITA levies income tax for each taxation year on the taxable worldwide income of every "person" (which includes a corporation) resident in Canada in that taxation year. Likewise, a non-resident who, in a particular taxation year, was employed in Canada or carried on a business in Canada is liable to pay income tax on the non-resident's taxable income earned in Canada. Also, the disposition of "taxable Canadian property" (defined in the ITA) may result in a non-resident being subject to tax in Canada. Provincial taxes are also payable by a non-resident on taxable income earned in a province where the non-resident carries on business through a permanent establishment located in that province.



Residence

At common law, a corporation will generally be resident in Canada if its "central management and control" is located in Canada (e.g., if the corporation's board of directors meets in Canada). In addition, generally a corporation that is incorporated in Canada after April 26, 1965 is deemed by the ITA to be resident in Canada for the purposes of the ITA.

An individual will generally be resident in Canada if the centre of his or her vital interests (i.e., family, home, personal property, etc.) is in Canada. Further, an individual who is present in Canada for one or more periods that, in total, amount to 183 days or more in a taxation year will be deemed to have been resident in Canada throughout that year.

Canadian Withholding Tax

Income earned by a non-resident that is not subject to ordinary income tax may still be subject to a withholding tax at a rate of 25% (unless reduced or eliminated by an applicable tax treaty) on certain Canadian source income. This includes management fees, interest, dividends, rent royalties and some distributions from trusts. A recent amendment to the ITA eliminates withholding tax on most interest payments paid to persons dealing at arm's length with the payer.

Tax Treaties

Canada has entered into over 85 income tax treaties with other jurisdictions. These tax treaties generally provide that the business profits of a non-resident of Canada that is a resident of the other jurisdiction are not subject to tax under the ITA, except to the extent that such profits are attributable to a permanent establishment (i.e., a fixed place of business) of the non-resident in Canada. These tax treaties also usually reduce both the withholding tax rate imposed under the ITA and the branch-profits tax rate.

Amendments to the Canada-U.S. Tax Convention (Convention) eliminate withholding tax on almost all interest, including interest paid between related persons. In addition, these amendments address "treaty shopping" by ensuring that treaty benefits are only available to residents of Canada or the U.S. that satisfy certain tests. The provinces generally adhere to (although they are not bound by) the provisions of the treaties.

Transfer Pricing in Non-Arm's Length Transactions

The ITA deems related persons to not deal with each other at arm's length; whether unrelated persons deal with each other at arm's length is a question of fact. Under the transfer pricing rules, a Canadian taxpayer and a non-arm's length non-resident must conduct their transactions in a manner similar to that which would have applied had the parties been dealing at arm's length. If the terms and conditions of the non-arm's length transaction differ from those that would have prevailed between arm's length persons, the rules provide that the terms and conditions may be adjusted to reflect those that would have existed had the parties been dealing at arm's length.

General Anti-Avoidance Rule

The ITA's general anti-avoidance rule allows the re-characterization of transactions and amounts in certain circumstances where taxpayers have entered into tax-motivated transactions that result in a misuse or abuse of the provisions of the ITA.

Income Tax – Corporations

How Profit Is Determined

The ITA provides that a taxpayer's income from a business for a year is the taxpayer's business profits for the taxation year, which are generally computed on an accrual basis in accordance with ordinary commercial principles. Deductions from income are generally only permitted for expenses or outlays that are made or incurred for the purpose of earning income from the business, are not on account of capital (except as expressly permitted), and are in an amount that is reasonable in the circumstances.

Subject to the thin-capitalization rules (as discussed below), interest expense is generally deductible from a taxpayer's income if it is reasonable in amount, incurred pursuant to a legal obligation to pay interest on borrowed money or on an amount payable for property, and used for the purpose of earning income from a business or property. In lieu of book depreciation, the ITA sets out a capital cost allowance (CCA) system that provides taxpayers with discretionary deductions for depreciable property. Depreciable assets are segregated into "classes" and a maximum annual allowance applies for each class.

Capital Gains and Losses

Generally speaking, one half of capital gains (i.e., taxable capital gains) in excess of one half of capital losses (i.e., allowable capital losses) are included in income and are subject to ordinary income tax at regular rates under the ITA.

Determining Taxable Income

Taxable income is generally calculated on the basis of income for the taxation year. That income is then modified by the specific provisions of the ITA by subtracting certain permitted deductions, including losses carried forward or back from other taxation years. Generally losses can be carried back for three taxation years or forward for 20 taxation years to reduce taxable income in those years. Net allowable capital losses for a taxation year may generally be carried back three taxation years and forward indefinitely, but may not be claimed against any income other than taxable capital gains.

No Consolidation

Related corporations may not file consolidated returns and the losses incurred by one corporation may not be used to offset, on a current basis, the income of another corporation. However, certain permissible corporate reorganizations may achieve loss consolidation between related corporations.

Use of a Corporate Branch

Branch Profits Tax

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 NRC had incorporated a Canadian subsidiary to carry on business in Canada, rather than using a branch. Under the ITA, 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 Accounting

The ITA 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.

Financing the Branch

As the "thin-capitalization" rules (as discussed below) do not apply to NRCs carrying on business in Canada, these rules do not limit the deduction of interest payable by an NRC on money borrowed for the purpose of financing the branch in Canada.

Withholding Tax

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; so, 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.

Converting a Branch to a Subsidiary

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

Use of a Canadian Subsidiary

Repatriation of Funds

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 NRC by way of dividend, a 25% withholding tax is payable, subject to reduction by an applicable tax treaty.

Thin-capitalization Rules

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 2:1.

Withholding Tax

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.

Capital Tax – Corporations

Provincial Capital Taxes

Most provinces, including Ontario and Québec, have announced that they will reduce and ultimately eliminate their capital taxes. Federal capital tax, known as "Large Corporations Tax," was eliminated as of January 1, 2006.

Corporate Minimum Tax

Ontario levies a Corporate Minimum Tax (CMT) on all corporations subject to Ontario tax (other than those that are eligible for the CMT small business exemption) on adjusted book income allocated to Ontario. A corporation generally is required to pay CMT only to the extent that it exceeds corporate income tax payable.

Income Tax – Individuals

The federal tax brackets for individual taxpayers for ordinary income tax are adjusted each year against the Consumer Price Index. Provincial income tax for individuals is calculated as a percentage of federal tax in all provinces (except Québec, which levies its own income tax).

Income Tax – Partnerships and Joint Ventures

A partnership is generally considered to be the relationship that exists between two or more persons carrying on business in common with a view to profit; therefore, a partnership is not considered to be a separate legal entity. Although the income of a partnership (including a claim for CCA) is generally calculated as if the partnership were a separate taxpayer, it is allocated among the partners according to the terms of the partnership agreement and is taxed in the hands of the partners. Special rules apply in determining the adjusted cost base of a partnership interest. A non-resident partner in a partnership that carries on business in Canada will generally be considered to carry on business in Canada for the purposes of the ITA. If the partnership has a permanent establishment in Canada for purposes of a tax treaty, each partner is deemed to carry on business through the permanent establishment.

The ITA limits certain deductions that may be claimed against a limited partner's "at-risk" amount for the partnership. In certain cases, a partner that is a general partner for non-tax purposes may be deemed to be a limited partner for tax purposes.

In a joint venture, the profit of each joint venturer is determined and taxed separately in the hands of each joint venturer (i.e., each joint venturer makes a separate CCA claim).

Sales, Excise and Other Commodity Taxes

The federal government imposes a sales tax, in some cases at a combined federal-provincial rate, in all provinces. Some provinces also impose a separate provincial sales tax.

Federal Goods and Services Tax (GST) and Harmonized Sales Tax (HST)

Subject to certain exemptions, the federal Goods and Services Tax (GST) is imposed at each stage of distribution. A vendor (registrant) must maintain books and records sufficient to determine its GST liabilities and collect GST from the purchaser at the rate of 5% of the amount payable for taxable supplies made in Canada. An importer is required to account directly for tax at the rate of 5% on taxable imported goods or services. A business may deduct the GST payable on its purchases as an "input tax credit" against the GST collectible on its sales and may claim a refund of input tax credits in excess of tax collectible on sales during the relevant reporting period.

The federal sales tax is referred to as the "Harmonized Sales Tax" (HST) in those provinces that have repealed their former separate provincial retail sales taxes in favour of receiving a share of the federal sales tax. The HST is essentially the GST levied at a higher rate that includes a federal (5%) component and a provincial component that varies by each HST-participating province. The HST generally has the same basic rules of operation as the GST described above. The current HST-participating provinces are British Columbia, Ontario, New Brunswick, Nova Scotia and Newfoundland and Labrador.

GST/HST – Non-residents

Non-residents must register under the GST legislation and charge and collect GST if they are carrying on a business that involves making taxable supplies. A foreign firm with a permanent establishment in Canada is deemed to be a resident of Canada, for GST purposes, with respect to activities carried on through that establishment in Canada. A business with a Canadian branch may be required to register for GST and collect tax on supplies made through the permanent establishment. Non-resident registrants without a permanent establishment in Canada are required to post security with the Canada Revenue Agency for collection and remittance obligations.

GST/HST – Partnerships and Joint Ventures

For GST/HST purposes, a partnership is considered to be a separate legal entity. Accordingly, a commercial activity carried on in a partnership is deemed to be an activity of the partnership, and not of the partners. As such, partnerships must be registered for GST/HST purposes if the business of the partnership involves making taxable supplies. The GST/HST collectible, and any input tax credits, must be reported/claimed in GST/HST returns filed at the partnership level.

Joint ventures that do not constitute partnerships are not treated as separate persons. Therefore, each joint venturer generally is responsible for GST/HST registration, reporting and remittance obligations in respect of its own share of the joint venture sales. Some special rules apply, however, in the cases of oil and gas, real estate and other specified types of joint ventures.

Excise Taxes

Federal excise taxes, which may be a fixed monetary amount or based on a percentage of value, are levied on certain specified goods such as tobacco and gasoline. The excise tax rate varies with the class of goods taxed and is in addition to any other taxes or duties payable.

Provincial Sales Taxes

Single-stage provincial retail sales taxes are imposed by Saskatchewan, Manitoba and Prince Edward Island at rates that vary with each of those provinces. These retail sales taxes are generally applicable to all goods and, to a limited extent, services purchased by consumers and other end users. Québec imposes a multi-staged sales tax, the Québec Sales Tax (QST), which is substantially consistent with the GST/HST. The Québec Revenue Ministry administers both the GST and the QST for businesses operating in Québec.

CONTACT

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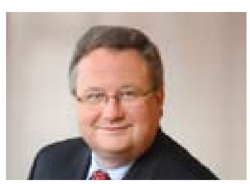

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