An Introduction to Canada’s Tax System

Several federal and provincial tax considerations are relevant to non-residents seeking to do business in Canada. While Canadian residents are subject to tax on worldwide income, non-residents of Canada are generally subject to tax on their Canadian source income only. You are considered a non-resident for tax purposes if you:

- customarily live in another country and are not considered a resident of Canada; or
- do not have significant residential ties in Canada;
  - and you live outside Canada throughout the tax year; or
  - stay in Canada for less than 183 days in the tax year.

General Tax Considerations

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. More general considerations include capital taxes, the taxation of individuals, tax matters for partnerships and joint ventures and sales and commodity taxes.

ORDINARY INCOME TAX

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. The following is a list of key definitions (and their implications) for considerations.

RESIDENCE

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 was 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. 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. An 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 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.
Methods of Carrying on Business in Canada

One of the most important considerations for a non-resident is whether to incorporate a Canadian subsidiary or to establish a branch operation. (There is a third option which involves the non-resident corporation carrying on the business in Canada but restricting its Canadian presence such that it does not have a permanent establishment in Canada (assuming that the non-resident corporation is resident in a country with which Canada has an international tax treaty)).

Whether a non-resident chooses to carry on business in Canada through a Canadian subsidiary or a Canadian branch, in both cases, the profits of the Canadian operation will be subject to Canadian income tax.

**USE OF A CANADIAN SUBSIDIARY**

A Canadian subsidiary of a non-resident corporation will be considered a resident of Canada for the purposes of the ITA 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 non-participating interest paid to U.S. persons is generally nil.

**RE Pattiation 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 1.5:1.

**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.

**Use of a Canadian Branch**

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.

**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 a result of recent amendments, the “thin-capitalization” has been extended to apply to NRCs carrying on business 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 through 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.

**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 AND HARMONIZED SALES TAX**
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 Ontario, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland and Labrador.

**GST/HST – NON-RESIDENTS**

Non-residents must register under the GST/HST legislation and charge and collect GST/HST if they are carrying on a business in Canada that involves making taxable supplies therein. A foreign firm with a permanent establishment in Canada is deemed to be a resident of Canada, for GST/HST purposes, with respect to activities carried on through that establishment in Canada and may be required to register for GST/HST 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.

**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 British Columbia 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.

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