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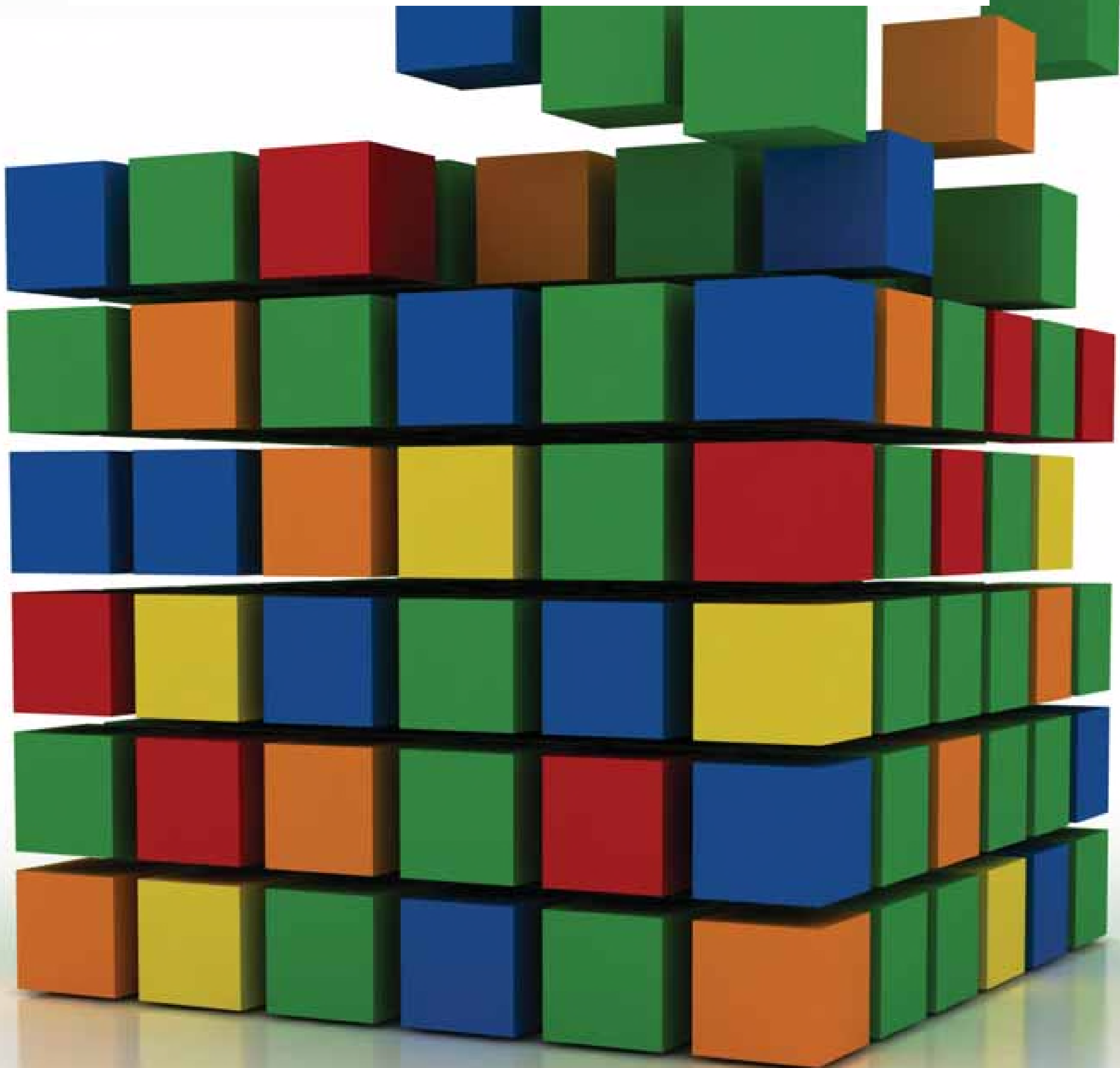
By Ron Mar



TAXATION

Income Tax

Income taxes are imposed at the federal level, as well as by the various provinces and territories. Federal income tax is levied on the worldwide income of every Canadian resident and, subject to the provisions of any applicable income tax convention, levied on the Canadian source income of every non-resident who is employed in Canada, who carries on business in Canada or who realizes a gain on the disposition of certain types of Canadian property. Generally, a province or territory will also impose an income tax on persons resident, or carrying on business, in the provincial or territorial jurisdiction. Certain provinces also tax non-residents on gains realized on the disposition of certain types of Canadian property situated in the province.

INCOME TAXES ARE IMPOSED AT THE FEDERAL LEVEL, AS WELL AS BY THE VARIOUS PROVINCES AND TERRITORIES.

The combined federal and provincial rate of income tax imposed on corporations varies widely depending on the nature and size of the business activity carried on, the location of the activity and other factors. In 2016, the highest combined rate of income tax applicable to non-Canadian-controlled private corporations was approximately 31%, while the lowest rate applicable to the ordinary business profits of such a corporation was approximately 25%. Tax credits and other incentives are also available in certain circumstances to reduce the effective tax rates.

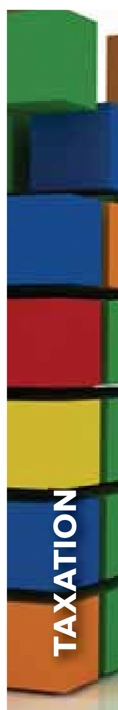
Individuals are subject to graduated rates. These rates depend on the type of income, the province of residence and other factors. In 2016, the highest marginal combined federal and provincial rate of tax on taxable income of an individual was approximately 54%, while the lowest top marginal combined federal and provincial rate was approximately 48%.

Canada also levies a 25% withholding tax on the gross amount of certain types of Canadian source income of non-residents.

Payments subject to withholding tax include dividends, certain types of interest, rents, royalties and certain management or administration fees. Withholding tax can also apply to payments made between non-residents if the payments relate to a Canadian business or to certain

types of Canadian property. Generally, there is no Canadian withholding tax on interest paid by a Canadian resident to arm's-length non-residents of Canada (other than interest that is contingent on the use of or production from property in Canada, or interest that is computed by reference to revenue, profit or cash flow). An applicable income tax convention may reduce or eliminate the relevant rate of withholding tax. While withholding taxes are imposed on the non-resident recipient, the payer is responsible for withholding the tax from amounts paid to the non-resident and for remitting the withheld amount to the government.

The following sections highlight some of the principal tax matters that should be considered in deciding whether to carry on business in Canada through a Canadian subsidiary or as a branch operation.



Carrying on Business Through a Canadian Subsidiary

A corporation incorporated in Canada will be resident in Canada and subject to Canadian federal income tax on its worldwide income. As noted above, income of the subsidiary may also be subject to provincial and/or territorial income tax.

A CORPORATION INCORPORATED IN CANADA WILL BE RESIDENT IN CANADA AND SUBJECT TO CANADIAN FEDERAL INCOME TAX ON ITS WORLDWIDE INCOME.

The combined federal and provincial/territorial income tax rate to which the subsidiary is subject will depend on the provinces and territories in which it conducts business, the nature of the business activity carried on and other factors.

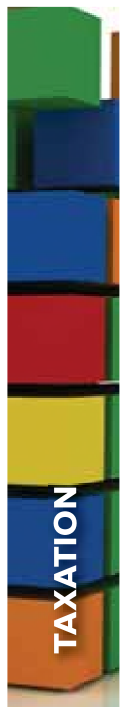
The calculation of the subsidiary's income will be subject to specific rules in the *Income Tax Act* (Canada) and any applicable provincial or territorial tax legislation. Income includes 50% of capital gains.

Expenses of carrying on business are deductible only to the extent they are reasonable. Neither federal nor provincial/territorial income tax is deductible in computing income subject to the other level of tax. Generally, dividends may be paid between related Canadian corporations on a tax-free basis. Groups of corporations may not, however, file consolidated income tax returns. Accordingly, business losses of the subsidiary will not be directly available, for Canadian tax purposes, to off-set income of an affiliated company. However, it may be possible to enter

into intra-group income balancing transactions in certain situations.

Transactions between the subsidiary and any person with whom it does not deal at arm's length, including its parent corporation, will generally need to be effected for tax purposes on a "fair-market-value" basis. Certain contemporaneous documentation may also be required under Canada's transfer pricing rules.

The debt/equity structure of the subsidiary will be subject to thin capitalization rules, which operate to deny the deduction of interest payable to specified non-residents by the subsidiary to the extent that the subsidiary is "thinly capitalized." The subsidiary is considered to be thinly capitalized where the amount of debt owed to the non-resident shareholder is more than 1.5 times the aggregate of the retained earnings of the corporation, the corporation's contributed surplus that was contributed by the non-resident shareholder and the paid-up capital of the shares owned by the non-resident shareholder. Interest that is not deductible because of the thin-capitalization rules is deemed to have been paid as a dividend and is subject to withholding tax as such.



In some cases, the subsidiary may be established as an unlimited liability company (ULC) under the laws of Alberta, British Columbia or Nova Scotia. This may be done to access the advantages of both a branch and a subsidiary operation for a U.S. parent corporation. The reason is that while a ULC is treated as a corporation for Canadian tax purposes, we understand that it may be treated as a branch for U.S. tax purposes. U.S. tax advice should be obtained on this point and certain provisions in the *Canada-United States Income Tax Convention (1980)* (U.S. Convention) should also be considered, as in certain cases they may eliminate the tax benefits associated with such hybrid entities or give rise to adverse tax consequences without proper tax planning.

The withholding tax regime, briefly described above, will apply to the subsidiary's payments to non-residents, including interest and dividends. In the case of payments by a subsidiary to a U.S.-resident parent, the U.S. Convention eliminates the withholding tax on interest (other than certain types of interest, such as interest determined with reference to profits or cash flow or to a change in the value of property). The benefits of the U.S. Convention are, subject to some exceptions, available only to certain "qualifying persons," as defined in the "Limitation on Benefits"

provisions of the U.S. Convention.

In October 2015, the Organization for Economic Co-operation and Development (OECD) released the package of final reports from its base erosion and profit shifting (BEPS) project. The 2016 Canadian federal budget reaffirmed Canada's commitment to move forward with a number of initiatives to address BEPS. These initiatives include the introduction of country-by-country reporting for large multi-national enterprises in taxation years beginning after 2015, the release of legislative proposals to implement the OECD common reporting standard in respect of financial accounts held by non-residents and Canada's ongoing participation in the development of a multilateral treaty to combat tax treaty abuse. Negotiations in respect of this multilateral treaty were concluded on November 24, 2016.

Carrying on Business in Canada Through a Branch Operation

Subject to the provisions of any applicable income tax convention, a non-resident corporation will be subject to Canadian income tax on business profits from carrying on business in Canada through a branch operation. A non-resident carrying on business in Canada must also pay a branch tax. The branch tax essentially takes the place of the withholding tax that would have been payable on dividends paid by a Canadian subsidiary carrying on the business. Because the withholding tax is imposed on dividends when they are paid and the branch tax is imposed when the profits are earned, it may be favourable in some circumstances to establish a subsidiary by the foreign business rather than a branch.

If the non-resident of Canada is: (i) a resident of a jurisdiction that has entered into an income tax convention with Canada; and (ii) entitled to the benefits of that convention, generally the non-resident will be taxable on its business profits earned in Canada only to the extent that such profits are attributable to a permanent establishment situated in Canada. Under certain of Canada's income tax conventions, a non-resident may have a significant business presence in Canada without being deemed to have a permanent establishment in Canada. As noted above, in the case of the U.S. Convention, treaty benefits are generally available only to U.S. residents who are qualifying persons. A thorough review of the applicable convention is crucial in determining the relative merits of establishing a branch or a subsidiary business in Canada.

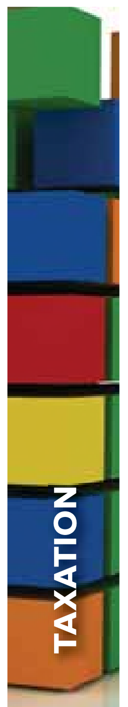
Generally, the income of the branch will be computed under the same rules that are applicable to the computation of the subsidiary's income, including the thin-capitalization rules.

If the Canadian operation will incur start-up losses, it may be possible for the non-resident to deduct these losses in computing its income for its domestic tax purposes if the Canadian business is carried on through a branch operation. When the Canadian business becomes profitable at a future time, it may be possible to transfer the branch operation to a newly incorporated Canadian subsidiary with no significant adverse Canadian income tax consequences.

Foreign Currency Controls and Repatriation of Income

There are no foreign exchange or currency controls in Canada, nor are there exchange restrictions on borrowing from abroad, on the repatriation of capital or on the ability to remit dividends, profits, interest, royalties and similar payments from Canada.

As noted above, there may be a withholding tax payable on the repatriation of certain types of income, including interest, dividends and royalties.



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