

# Mergers And Acquisitions In Canada

**Section 2:** Tax Considerations: General Overview  
of Canadian Income Tax Principles



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# Tax Considerations – General Overview of Canadian Income Tax Principles

## Introduction

Tax considerations are always critical in any acquisition transaction. This discussion provides an overview of the relevant Canadian tax considerations (including federal and provincial income, commodity and payroll taxes) which must be reviewed by a non-Canadian resident considering the acquisition of a Canadian business. Although the comments in this section focus on an acquisition by a U.S. resident, they are generally applicable to all non-Canadian residents.

## Federal Income Taxes

Canada imposes tax on residents of Canada on their worldwide income determined under its *Income Tax Act*<sup>38</sup> (the “Act”). Taxable income includes employment income, business profits, and investment income such as dividends, interest and capital gains (net of capital losses) from the disposition of capital property.

In contrast, non-residents are only subject to income tax on taxable income earned in Canada in respect of employment income earned in Canada, income from a business carried on in Canada and gains from the disposition of “taxable Canadian property.” The definition in the Act of “carrying on business” in Canada is very broad and includes soliciting orders or offering anything for sale in Canada through an agent or servant, whether the contract or transaction is completed inside or outside Canada. “Taxable Canadian property” includes: (a) real property situated in Canada; (b) property held or used in carrying on a business in Canada; (c) shares and interests in corporations, trusts and partnerships (whether Canadian or non-Canadian) which are not publically listed, if at any time in the 60 months before the disposition, more than 50% of the fair market value of the shares or interests was derived from Canadian real estate, Canadian resource properties, Canadian timber resource properties and options in such properties; and (d) in the case of certain publically listed shares and interests, in addition to meeting the 50% test set out in (e), at any time in the 60 months before the disposition, the owner of the shares or interests along with non-arm’s length persons must have owned more than 25% of a class of shares of the corporation or interests in trusts or partnerships. Canada also imposes a non-resident withholding tax on certain dividends, royalties, management and administration fees, rent, interest and certain other payments paid or credited by a Canadian resident (and certain non-residents subject to Canadian tax) to a non-resident (please see “Withholding Taxes” below). As discussed below, the tax imposed on non-residents may be reduced or eliminated under an applicable tax treaty.

## Provincial Income Taxes

Each of the Canadian provinces and territories also imposes income tax on residents of that province or territory that are individuals, estates or trusts. The income tax is typically a percentage of the federal tax payable. However, Quebec uses its own formula which closely follows the federal one.

A provincial or territorial tax is also imposed on both corporations incorporated in Canada and non-resident corporations that carry on business through an establishment in a province or territory. The computation of

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38 (1985, c.1 (5th Supp.)).

taxable income of the corporation is determined in a manner similar to the federal rules. The allocation of income among most of the provinces and territories is based on rules contained in the *Income Tax Regulations*.<sup>39</sup> However, Quebec and Alberta allocate income based on their own provincial rules.

## Commodity Taxes and Payroll Taxes

In addition to income taxes and capital taxes, both goods and services are taxed in Canada. For the most part, a consumption tax is levied at both the federal and provincial levels, although some provinces levy this tax through a harmonized structure. The federal sales tax is presently 5% and is called the goods and services tax (the "GST"). Ontario's and British Columbia's sales taxes, 8% and 7% respectively, are "harmonized" with the GST (the "HST") although it should be noted that BC taxpayers have recently voted to rescind the BC HST and return to a provincial sales tax (the "PST") system. Quebec levies a sales tax of 8.5% (the "QST") which is very similar to the GST. It should be noted that the GST, the Ontario and British Columbia HST, and the QST, are "value added taxes" and are generally refunded to most commercial operations. In addition, most goods exported from Canada are not subject to the GST, HST or QST.

Commercial entities that are involved in making taxable supplies in Canada, including non-residents of Canada who are making supplies in the course of a business carried on in Canada, are required to register for and charge, collect, and remit GST, HST and QST, where applicable, on such supplies.

Currently, the provinces of Saskatchewan, Manitoba and Prince Edward Island impose a PST which is a single incidence sales tax imposed on end-users of tangible personal property as well as certain services in the province. The PST varies from 5% in Saskatchewan to 7% in Manitoba and 10% in Prince Edward Island. The province of Alberta does not impose a separate sales tax.

Most provinces also levy a tax when land is transferred. In addition there are several payroll taxes imposed by the federal and provincial governments including employment insurance, Canada Pension Plan (which in Quebec is replaced by the Quebec Pension Plan) and provincial health taxes.

Accordingly, in connection with any transaction, income, commodity and payroll tax advice should be obtained.

## Federal and Provincial Income Tax Rates

This discussion focuses on resident and non-resident Canadian corporations. The 2011 combined federal and provincial corporate income tax rates on taxable business income allocable to a permanent establishment in a province generally range between 26.5% to 32.5% (a lower rate of tax is available on a portion of the taxable active business income earned by Canadian-controlled private corporations). Based on the present provisions of the Act, the tax rate will be reduced by 1% in 2012.

It should be noted that Canada does not permit corporations to use consolidation in determining their taxable income. In other words, each entity must determine its own taxable income (or losses) and is subject to tax on this basis. Therefore, losses of one corporation cannot offset the profit of a related corporation. However, in the 2010 federal budget, the government announced that it was seriously considering a change to the Canadian tax system which would permit consolidation.

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39 (C.R.C., c.945).

## Withholding Taxes

Canada imposes a withholding tax at a rate of 25% on non-residents who receive from Canadian residents and certain non-Canadian residents, various types of income from property including certain dividends, royalties, management and administration fees, rent and interest payments. However, in respect of interest, the Act provides that interest (which is not participating interest) paid to an arm's length creditor is not subject to withholding tax. The rate of withholding tax may be reduced by a tax treaty entered into by Canada and the country in which the recipient is resident, if the recipient is entitled to the benefits of the treaty. For example, the rate of withholding tax is reduced to 15% (or 5% in certain circumstances) with respect to dividends under the *Canada-United States Income Tax Convention* (the "Treaty") for U.S. residents who can benefit from the Treaty.

In addition, the Treaty stipulates that there is no withholding tax payable in respect of all interest payments (including non-arm's length interest payments) which are not participating interest payments, as defined in the Treaty.

The Canadian resident payor of any amount subject to withholding tax is liable for withholding and remitting this tax on behalf of the non-resident recipient. In addition, certain payments to a non-resident person by another non-resident person whose business is carried on in Canada may be subject to Canadian withholding taxes to the extent that the payments are deductible in computing the payor's taxable income earned in Canada.

Payments made by a Canadian subsidiary for products purchased from its non-resident parent company will generally not be subject to Canadian withholding tax, provided that the products are purchased under terms and conditions that are comparable to arm's length transactions. If the inter-company prices diverge from arm's length prices, any discrepancies could be subject to Canadian withholding taxes and may also give rise to other Canadian income tax consequences (please see "Transfer Pricing Rules" below).

## Branch Taxes

In addition to the tax payable in respect of income from a business carried on in Canada, a non-resident corporation which carries on business in Canada directly (as contrasted to carrying on business through a Canadian subsidiary) is subject to a tax in respect of after-tax branch profits of the corporation which are remitted outside of Canada. This tax is commonly referred to as a "branch tax" and is a rough equivalent to the withholding tax which would be payable on any dividends paid by a Canadian subsidiary to its foreign parent corporation.

Branch tax is payable at a rate of 25% on the after-tax profits of the branch operation in excess of the corporation's investment allowance, but is reduced to the treaty rate on dividends paid by a corporation resident in Canada to a non-resident corporation that owns all the shares of the Canadian corporation. For example, under the Treaty, the rate of branch tax is reduced to 5% for U.S. residents who can benefit from the Treaty. In addition, the Treaty eliminates the branch tax on the first \$500,000 of income subject to branch tax.

The "investment allowance" represents the accumulated after-tax profits that the corporation has re-invested in its Canadian branch operations. It is calculated based on the assets and liabilities of the branch. Debt will reduce the corporation's investment allowance for branch tax purposes if the interest on such debt is deductible by the corporation in computing branch profits, or would be deductible but for certain interest

deductibility restrictions. The investment allowance is re-calculated at the end of each year. The amount deducted in computing branch profits for a particular year is added back into the branch tax base in the immediately following year. This method of calculating the branch tax base ensures that the tax is payable on after-tax profits of the branch that are not re-invested into the Canadian branch operations.

## Capital Taxes

The federal government phased out the “large corporation tax” effective for the 2006 and later taxation years. This was essentially a tax that was imposed on the capital employed in Canada by a corporation. All provinces have announced the elimination of their capital taxes on most corporations other than financial institutions. Some provinces, including Ontario, Alberta and British Columbia, do not currently impose a capital tax on most corporations. It should be noted that financial institutions are subject to specific rules relating to federal and provincial capital taxes.

## Transfer Pricing Rules

Transfer pricing refers to the prices charged for goods and services and the use of property (including intangible property) to or by a non-resident related party. Canada’s transfer pricing rules are found in section 247 of the Act. Many other countries, including the U.S., have similar transfer pricing rules in their domestic tax law.

The transfer pricing rules embody the arm’s length principle, which is endorsed by the Organization for Economic Co-operation and Development (“OECD”). This principle requires taxpayers to determine their income tax consequences in respect of virtually all transactions with non-arm’s length parties based on arm’s length terms and conditions. The rules are intended to prevent multinational corporations from shifting profits out of Canada by charging prices for intra-group transfers of property, or use of property and provision of services that deviate from arm’s length prices.

The transfer pricing rules apply where a taxpayer (or a partnership) and a non-resident person with whom the taxpayer (or partnership, or a member of the partnership) does not deal at arm’s length, are participants in a transaction or a series of transactions, and:

1. the terms and conditions made or imposed in respect of the transaction or series between any of the participants in the transaction or series, differ from those that would have been made between persons dealing at arm’s length; or
2. the transaction or series would not have been entered into between persons dealing at arm’s length, and can reasonably be considered not to have been entered into primarily for bona fide purposes, other than to obtain a tax benefit.

If the transfer rules apply, the Act provides a recharacterization so that:

- a. in the case of the first condition, the transaction or series is deemed to occur under terms and conditions that would have been entered into between arm’s length parties; and
- b. in the case of the second condition, the transaction or series is deemed to be a transaction or series that would have been entered into between arm’s length parties.

In addition to the adjustments to arm's length prices, a taxpayer will be subject to a penalty under subsection 247(3) of the Act where the deviation from arm's length amounts is greater than CDN\$5M, or 10% of the taxpayer's gross revenue for the year, whichever is less. The penalty is essentially equal to 10% of the adjustment to the arm's length amounts.

Generally, a taxpayer will avoid the penalty where the taxpayer, or the partnership of which the taxpayer is a member, makes a reasonable effort to determine and use arm's length prices or allocations. The taxpayer or the partnership is deemed not to have made a reasonable effort to determine and use arm's length transfer prices or allocations in respect of a transaction or series, unless the taxpayer or the partnership complies with certain requirements to maintain contemporaneous transfer pricing reports to support the determination of arm's length prices and allocations.

A large part of determining the appropriate arm's length prices and preparing contemporaneous documentation is identifying comparable arm's length transactions and obtaining relevant information about such transactions. The OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "OECD Guidelines") outline a number of factors which may influence the degree of comparability of the transactions in question. These factors include:

1. the characteristics of the property or service being purchased or sold;
2. the functions performed by the parties to the transactions;
3. the terms and conditions of the contract;
4. the economic circumstances of the parties; and
5. the business strategies pursued by the parties.

Over the years, various methods have been accepted by tax authorities in determining whether the prices or other amounts used by the taxpayer are arm's length amounts. The methods are divided into two groups: the traditional transaction method and the transactional profit method. The traditional transaction method includes the comparable uncontrolled price ("CUP") method, the resale price method and the cost-plus method. The transactional profit method includes the profit-split method and the transactional net-margin method ("TNMM"). According to the Canada Revenue Agency (the "CRA"), the federal agency that administers the income tax law for the Government of Canada and most provinces and territories, "traditional transaction methods are the most reliable means of establishing arm's length prices or allocations." (See *Information Circular*, IC 87-2R, entitled "International Transfer Pricing," dated September 27, 1999 (<http://www.cra-arc.gc.ca/menu/ICSC-e.html>), in which the CRA provides its views on the topic of transfer pricing).

It should be noted that a transfer pricing dispute involving a corporation which is resident in a country with which Canada has entered into a tax treaty, and which is entitled to the benefits of such treaty, may be settled by the Competent Authority of Canada and the treaty jurisdiction, as set out in the mutual agreement procedure provision of the relevant tax treaty. Alternatively, a taxpayer can appeal a CRA transfer pricing determination to the Tax Court of Canada (the "TCC") and if unsuccessful at the TCC to the Federal Court of Appeal, and then with leave to the Supreme Court of Canada.

## Canada-U.S. Tax Treaty<sup>40</sup>

The application of Canadian income tax in accordance with the Act is subject to the provisions of any tax treaty entered into between Canada and another country or jurisdiction. Canada has entered into many tax treaties and a complete list of the tax treaties in force is available on the Department of Finance Canada website (see [http://www.fin.gc.ca/treaties-conventions/treatystatus\\_-eng.asp](http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp)).

The purpose of the Treaty (and all other tax treaties) is to prevent the double taxation of income which arises because each country asserts its authority to tax its residents, as well as any income derived by non-residents, from sources within the country. Like other tax treaties, the Treaty generally recognizes a country's prerogative to tax its own residents and minimizes the incidence of double taxation by limiting the source country's jurisdiction to tax the residents of the other country.

### Treaty Relief

The Treaty contains relief provisions for income tax, withholding tax, branch tax on business profits, as well as various types of investment income. However, as noted below under the section "Limitation on Benefits Provision," it contains a limitation on benefits provision which may restrict the ability of certain U.S. resident entities from benefiting from its provisions.

### Business Profits

Article VII of the Treaty limits Canada's jurisdiction to tax the business profits of a U.S. corporation that are attributable to a permanent establishment (as defined in the Treaty) situated in Canada. Accordingly, business profits that are not attributable to a permanent establishment situated in Canada are not subject to Canadian income taxes. In this regard, business profits include income from a business, as well as other types of income that do not fall within other categories of income recognized by the Treaty. For instance, as noted above under the section "Withholding Taxes," the payment of certain management and administration fees is subject to withholding tax at the domestic withholding tax rate of 25%. However, Article VII of the Treaty will normally permit a full exemption for such fees paid to a resident of the U.S. who can benefit from the Treaty, provided that the fees are not business profits attributable to a permanent establishment situated in Canada and that the fees are reasonable.

The definition of "permanent establishment" under Article V of the Treaty includes branches, offices, agencies and other fixed places of business of a U.S. corporation. However, a place of business used solely for the purpose of storage, display or delivery of goods belonging to the U.S. resident, or used solely for the purchase of goods, the collection of certain information and advertising, is excluded from the definition of "permanent establishment."

A "permanent establishment" of a U.S. resident also includes an agent (other than an agent of an independent status), if such person has, and habitually exercises in Canada, an authority to conclude contracts in the name of the U.S. resident. A U.S. resident will not be deemed to have a permanent establishment in Canada merely because such resident has a broker, general commission agent or any other agent of an independent status in Canada.

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40 This discussion focuses on the Treaty. However, many comments with respect to the Treaty are applicable to tax treaties between Canada and other countries.

In addition, a permanent establishment will be deemed to exist in Canada for: (a) an individual who performs services in Canada, is present for more than 182 days in Canada in any 12-month period, and more than 50% of the gross active business revenue of the enterprise consists of income derived from the services performed in Canada by the individual; and (b) any person providing services, if the services are provided in Canada for an aggregate of more than 182 days in any 12-month period with respect to the same or a connected project for customers who are either residents of Canada or who maintain a permanent establishment in Canada, and whose services are provided in respect of that permanent establishment.

### **Dividends**

Article X of the Treaty limits the rate of withholding tax that can be imposed on payments of dividends to a resident of the U.S. which qualifies for Treaty benefits to 15%. In addition, paragraph 2 of this Article provides that if a U.S. corporation beneficially owns at least 10% of the voting stock of a Canadian corporation, dividends paid by the Canadian corporation to the U.S. corporation will be subject to a 5% withholding tax rate.

### **Interest**

The rate of withholding tax that can be imposed on payments of interest to a resident of the U.S. is governed by Article XI of the Treaty. However, as noted above, effective January 1, 2008, the Act was amended to eliminate withholding tax on interest paid by a Canadian resident to an arm's length person resident in any country, so long as such interest is not "participating debt interest." In addition, the Treaty eliminates withholding tax on most interest paid to non-related U.S. residents, including interest paid to a non-arm's length U.S. person) so long as such interest is not a form of participating interest, as defined in the Treaty. It should be noted that the definition of "participating interest" in the Act is different than that found in the Treaty. Interestingly, no other Canadian tax treaty has a similar provision relating to non-arm's length interest payments.

### **Branch Tax Relief**

The Treaty also reduces the rate of branch tax on non-resident corporations carrying on business in Canada to 5%, (which is comparable with the rate reduction that would apply to dividend payments by a Canadian corporation to its U.S. parent). It also provides for an exemption from branch tax in respect of the first CDN\$500,000 of branch profits, net of prior years' losses, which must be shared among related or non-arm's length corporations. This "lifetime" exemption can result in tax savings of up to CDN\$25,000 (i.e. \$500,000 x 5%) and the repatriation of such exempt branch profits will not be subject to Canadian withholding taxes.

### **Capital Gains**

Article XIII of the Treaty limits Canada's jurisdiction to tax gains from the disposition of property by a U.S. resident. Paragraphs 1 and 2 of this Article provide that Canada may impose income tax on gains of a U.S. resident from the disposition of real property situated in Canada, and personal property forming part of the business property of a permanent establishment in Canada. For the purpose of this Article, real property situated in Canada includes a share of the capital stock of a company that is resident in Canada, if the value of the shares is derived principally from real property situated in Canada, and an interest in a partnership, trust or estate, the value of which is derived principally from real property situated in Canada. Real property is defined in Article VI of the Treaty to include rights to explore for or to exploit mineral deposits, sources and other natural resources such as oil and gas as well as rights to amounts computed by reference to the

amount or value of production from such resources. Interestingly, under the Treaty, shares of non-Canadian resident corporations cannot be “real property situated in Canada,” even if such corporation’s value is derived from Canadian real estate. Paragraph 4 of Article XIII provides that gains of a U.S. resident from the disposition of any property that is not specifically subject to Canadian tax under the Treaty is taxable only in the U.S. Accordingly, a U.S. resident’s gain from the disposition of shares of a corporation resident in Canada will generally be exempt from Canadian income tax if the value of the shares is not derived principally from real property situated in Canada at the time of the disposition of the shares, even if the shares are taxable Canadian property, as discussed above under the heading “Federal Income Taxes.”

Similar provisions, as the ones discussed above, are found in most of Canada’s tax treaties. However, several treaties including those entered into with Japan and Australia, do not exclude Canadian tax on capital gains in respect of taxable Canadian property by non-residents.

## Treaty Entitlement

The Treaty provides relief from Canadian income taxes only to residents of the U.S., as defined in Article IV of the Treaty. A “resident of a Contracting State” means “any person that, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature.”

In *The Queen v. Crown Forest Industries Limited*,<sup>41</sup> the Supreme Court of Canada established that the concept of residence for the purpose of the Treaty entails “being subject to as comprehensive a tax liability as is imposed by a state,” and that such comprehensive taxation is taxation on worldwide income. Accordingly, the CRA has applied these indicia in determining whether certain special types of non-resident entities are residents of the U.S., and thus eligible for Treaty benefits.

### “S” Corporation

A corporation that files an election under Subchapter S of the *Internal Revenue Code*<sup>42</sup> is commonly referred to as an “S” Corporation. This type of corporation may be treated as a flow-through entity for U.S. federal income tax purposes. However, administratively, the CRA considers an “S” Corporation to be a resident of the U.S. for the purposes of the Treaty.

### U.S. Limited Liability Company

A U.S. limited liability company (“LLC”) that is treated as a flow-through entity for U.S. income tax purposes will not generally be subject to U.S. income tax on its worldwide income. The CRA took the position that an LLC was not liable to tax and was thus not a resident of the U.S. for purposes of the Treaty, and would not qualify for the benefits offered by the Treaty. Without the relief granted by the Treaty, dividends payable by a Canadian corporation to the U.S. LLC would be subject to withholding tax at a rate of 25%. The relief for capital gains, the rules governing the allocation of business profits, and the reduction in the Canadian branch tax under the Treaty, would also not be available. It should be noted that the CRA’s position may be incorrect (see *TD Securities (USA) LLC*, a decision of the Tax Court of Canada in April 2010).<sup>43</sup>

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41 95 D.T.C. 5389 at 5395.

42 Title 26 of the United States Code (26 U.S.C.).

43 2010 D.T.C. 1137. This case held that an LLC was liable to tax in the U.S. and therefore a resident in the U.S. under the Treaty. Although the CRA did not appeal this decision it has publically stated that it disagrees with the decision.

However, the Treaty was amended effective January 1, 2009 and it now enables Canada to “look-through” U.S. entities that are fiscally transparent to determine their entitlement to Treaty benefits. Although an LLC itself is not entitled to Treaty benefits, under the Treaty after January 1, 2009, an LLC can claim the benefits that are available to its U.S. resident members as a result of the look-through provisions.

### **Limitation on Benefits Provision**

The Treaty has been recently amended to include a limitation of benefits (“LOB”) provision which deals with entities that are not ultimately owned by U.S. entities or by public corporations, the principal class of shares of which are primarily and regularly traded on recognized U.S. or Canadian stock exchanges. The LOB rules are aimed at countering “treaty shopping” by non-residents. This is the first LOB provision utilized by Canada and, accordingly, there is only limited guidance in Canada on such rules. In general terms, the rules operate to deny Treaty benefits to any U.S. entity which otherwise meets the requirements under the Treaty, unless certain tests are met.

Generally, a U.S. or Canadian public company whose shares regularly trade on a recognized Canadian or U.S. stock exchange can benefit from the Treaty. A U.S. company controlled by five or less U.S. individuals who own at least 50% of the votes and value of the company can also benefit from the Treaty. In addition, U.S. residents may qualify for Treaty benefits under the LOB provision if the income in question is earned in Canada in connection with, or incidental to, a trade or business carried on in the U.S., and the trade or business in the U.S. is substantial in relation to the activity carried on in Canada. In certain situations, the U.S. resident may qualify for certain Treaty benefits if the ultimate owner of the U.S. resident is a resident of a country with which Canada has entered into a comprehensive tax convention, which provides similar treaty benefits as those set out in the Treaty, and certain other tests are satisfied. Alternatively, a U.S. resident may apply to the Canadian Competent Authority for a determination of the applicability of Treaty benefits on the basis of all relevant factors. In this regard, it will be necessary to show that the principle purpose of the creation and existence of the U.S. resident was not to obtain benefits under the Treaty that would otherwise not be available, and that it would be appropriate, having regard to the purposes of the LOB rules, to not deny Treaty benefits. If the CRA determines that either test applies, the U.S. resident will be granted the benefits of the Treaty.

It should be noted that at present, the Treaty is the only one which includes a LOB provision which is applicable to Canadian taxes.

## **Structuring Considerations**

This section outlines some of the Canadian income tax implications of carrying on business in Canada through a branch or a subsidiary, including the use of an unlimited liability company (“ULC”).

### **Canadian Subsidiary**

A subsidiary incorporated in Canada is generally considered to be a Canadian resident for income tax purposes. It is subject to Canadian income tax on its income earned anywhere in the world from any source and a credit for foreign taxes paid on non-Canadian income.

The income of the Canadian subsidiary that is subject to Canadian income tax is generally calculated in accordance with generally accepted accounting principles. However, there are numerous inclusions and deductions which are specifically required or not permitted under the Act.

The Canadian tax rules treat capital gains more favourably than ordinary business or trading income. Generally, only one-half of realized capital gains, net of capital losses, are included in income.

In general terms, the Act permits a corporation to carry back for three years and carry forward for twenty years, non-capital losses (also referred to as net operating losses or "NOLs"). Such losses can generally be applied by the corporation against any form of income. Capital losses can be carried back three years and carried forward indefinitely but can only be used to offset capital gains. The direct or indirect acquisition of control of a corporation may limit the carry back and carry forward of both types of losses as well as certain other tax attributes of a corporation.

An efficient means of reducing the Canadian tax liability of the Canadian subsidiary involves having the U.S. parent corporation charge reasonable expenses to the subsidiary that are deductible in computing income of the subsidiary for Canadian income tax purposes. For instance, the U.S. parent corporation might charge the Canadian subsidiary a reasonable management or administration fee.

The parent corporation may also lend funds to the Canadian subsidiary and charge a reasonable rate of interest. Subject to the thin capitalization rules discussed below, the Canadian subsidiary will be able to deduct the interest paid to its parent. However, withholding tax may apply on the interest payment made by the Canadian subsidiary to its parent. As noted above, for U.S. parent corporations which can benefit from the Treaty, recent amendments to the Treaty have eliminated the withholding tax on interest paid to U.S. related parties which is not "participating interest," as defined in the Treaty.

## **Branch**

A foreign company that is not resident in Canada is subject to Canadian income tax on income earned from any business carried on in Canada. If a business is carried on in Canada through a branch operation, the income attributable to that branch will be subject to income tax in much the same way, as if it had been earned by a subsidiary. However, the majority of Canada's tax treaties generally provide that the business profits of a foreign enterprise derived from carrying on business in Canada will only be taxable in Canada if they are attributable to a permanent establishment situated in Canada (see the discussion on "Business Profits" above).

A non-Canadian corporation carrying on its business as a branch will be subject to income tax as discussed above, on the income attributable to its Canadian branch. The determination of such net-taxable income will involve determining the gross profit on a reasonable allocation basis from its activities in Canada (this normally involves complex accounting allocations, keeping separate books and records, or segregating the Canadian operations in the corporation's books). In theory, a certain portion of the gross profit could be allocated to the head office to reflect its contribution to the branch in the form of management and administration services.

A foreign corporation carrying on business in Canada will also be subject to Canadian branch tax as discussed above. For U.S. corporations which benefit from the Treaty, the rate is 5%. However, the first CDN\$500,000 of the corporation's earnings will be exempt from such taxes under the Treaty, and as such, the repatriation of such exempt profits to the head office will not be subject to withholding taxes.

The exemption can result in tax savings of up to CDN\$25,000 (i.e. \$500,000 x 5%). Therefore, in certain situations, for U.S. companies, it may be efficient to carry on the Canadian operations initially through a branch and then to transfer the Canadian business to a Canadian corporation after the earnings of the branch exceed the CDN\$500,000 exemption threshold.

### **Using an Unlimited Liability Company (“ULC”)**

The “check-the-box” rules under the U.S. *Treasury Regulations*<sup>44</sup> permit a Canadian corporate entity to elect to be treated as a flow-through entity for U.S. income tax purposes, if the corporate entity does not provide limited liability protection to its shareholders. Nova Scotia, Alberta and British Columbia are the only Canadian provinces that offer the flexibility of creating a ULC under their provincial statutes.

It is important to understand that a ULC is treated as a corporation for Canadian income tax purposes and is subject to the same Canadian income tax consequences as any Canadian corporation. Accordingly, it is liable to pay Canadian income taxes on its worldwide income.

However, amendments to the Treaty which came into effect January 1, 2010, contain a rule that denies certain benefits of the Treaty to U.S. residents that have an interest in a ULC, where the ULC is a disregarded entity for U.S. tax purposes. An amount of income, profit or gain paid by a ULC (including interest or dividends) to a U.S. resident, no longer qualifies for a reduced rate of withholding tax under the Treaty. Rather, the statutory withholding rate of 25% under the Act applies to such amounts. However, the CRA has issued several technical interpretations and advance income tax rulings which permit a ULC to benefit from the withholding tax rate set out in the Treaty on interest and dividends, so long as such interest and dividend payments are structured in the manner set out in such interpretations and rulings. Therefore, existing structures using a ULC should be reviewed.

### **Choosing Between a Subsidiary and a Branch Operation**

If business is carried on in Canada through a branch operation having a permanent establishment, it is subject to income tax in much the same way as if it had been earned by a subsidiary. However, it is important to note that in the case of a U.S. resident who benefits from the Treaty, that person may generally carry on business in Canada without attracting Canadian income tax, provided that no permanent establishment, as defined in the Treaty, is maintained in Canada. In addition, when a non-resident decides to carry on business in Canada (whether or not subject to tax), appropriate federal, as well as provincial or territorial income tax returns, will need to be filed.

On a long-term basis, the use of a subsidiary is often found to be preferable since the existence of a separate legal entity in Canada encourages and facilitates the separate accounting necessary for Canadian purposes and the determination of acceptable cross-border transfer pricing. On the other hand, the ability of the non-resident to use Canadian source start-up losses may encourage the use of a branch operation until the Canadian business becomes profitable. Subsequently, branch assets can generally be transferred to a Canadian subsidiary on a tax-free basis for Canadian purposes, provided that the appropriate tax elections are made. Before a foreign corporation transfers assets to a Canadian subsidiary, caution should be taken since it could trigger taxes in the foreign corporation’s country of residence, and in certain situations, Canadian tax.

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44 (26 C.F.R.).

Whether a business comes to Canada as a branch or subsidiary can impact the valuation of imported goods. For customs purposes, it is generally the transaction value (the value at which goods are sold to the Canadian importer) that forms the value for duty (i.e. the base upon which customs duties are calculated). However, where goods are transferred to a Canadian branch, a sale may not take place. Consequently, the transfer price may not form the value for duty and another value, such as the selling price in Canada less certain adjustments, may become the value for duty.

Whether a business operates in Canada as a branch or subsidiary can affect whether the provisions of section 105 of the *Income Tax Regulations* apply. This provision applies to fees paid to a non-resident for services provided in Canada (other than remuneration for employment services) and requires the payor to deduct and withhold 15% of such payment. If the services are rendered in Quebec, a further 9% must be withheld and remitted to Revenue Quebec. This withholding tax is on account of any Canadian or Quebec taxes owed by the non-resident. If the non-resident is not subject to Canadian or Quebec tax (e.g. because it does not have a permanent establishment in Canada and can benefit from the Treaty provisions applicable to business profits), it can apply for a refund of the withholding tax. A waiver of this withholding may be obtained from the CRA and Revenue Quebec in certain circumstances. In contrast, payments received by a Canadian subsidiary in respect of services provided in Canada will not be subject to this provision.

## Financing Considerations

### Thin Capitalization Rules

Under the “thin capitalization rules,” a portion of any interest that a corporation resident in Canada pays to a specified non-resident shareholder (or a person with whom the shareholder does not deal at arm’s length) on amounts owing by it to such persons, may not be deductible in computing the Canadian corporation’s income. A “specified non-resident shareholder” is generally defined to include a non-resident person along with certain non-arm’s length parties who own shares of the corporation having 25% or more of the votes or value of all of the issued shares of the corporation.

Generally, if the ratio of debt (owing to the specified shareholder or the shareholder’s non-arm’s length parties) to equity (paid-up capital, surplus and retained earnings) of the Canadian corporation does not exceed two-to-one, no amount of interest expense will be disallowed. If the debt-to-equity ratio exceeds two-to-one, the interest on the excess debt will not be deductible. The calculation of the debt-to-equity ratio uses monthly debt and equity values.

The thin capitalization rules are relevant for determining taxable income only for corporations resident in Canada and thus do not apply to non-resident corporations which operate in Canada through a branch. However, the determination of Canadian branch profits of a non-resident corporation requires a reasonable allocation of expenses between the Canadian branch and other sources of income. Consequently, even if the use of borrowed funds by a non-resident corporation can be traced entirely to a Canadian branch, the deductible amount of interest might be limited to a reasonable allocation of such interest to the Canadian branch. In addition, interest-bearing indebtedness used to finance a Canadian branch operation of a non-resident corporation will generally reduce the corporation’s investment allowance for the purposes of calculating Canadian branch taxes (please see “Branch Taxes” above).

Where the Canadian operation is capitalized by debt financing, gross revenue will be subject to less Canadian tax, by virtue of the interest deduction, than if the parent corporation had financed the Canadian operation with equity. Although interest payments made to related non-resident parties generally are subject to a greater withholding tax rate than dividend payments, for U.S. corporations which benefit from the Treaty, withholding tax on most related party interest payments has been eliminated under the Treaty, as discussed above.

Where a foreign corporation (e.g. a parent corporation) guarantees the debt of the Canadian payor, the Canadian payor can avoid the thin capitalization rules by borrowing from a third party lender rather than its U.S. parent. Thus, determining whether it is preferable to finance with debt or equity requires a consideration of both Canadian and foreign income tax consequences, since the interest income received by the foreign corporation will usually be taxable in the foreign jurisdiction.

Where a non-resident guarantees the debt of the Canadian payor and the Canadian payor pays a guarantee fee, the amount of such fee is deemed to be interest for purposes of the Act. If such deemed interest is paid to an arm's length party, the deemed amount will not be subject to withholding tax under the Act. In addition, the Treaty provides that there will be no withholding tax on such payments if the recipient is a U.S. resident entitled to Treaty benefits. For all other non-arm's length party guarantee fees paid to non-U.S. non-residents, withholding taxes may apply. It should be noted that there may be transfer pricing issues related to the value of the guarantee payment, as well as foreign tax issues. (please see "Transfer Pricing Rules" above).

## **Paid-up Capital**

"Paid-up capital" in respect of a class of shares of a corporation, is an income tax term that is defined under the Act. However, Canadian corporate statutes do not use the term "paid-up capital," per se, but refer to the equivalent corporate concept as "stated capital." Accordingly, the starting point for the computation of paid-up capital of a class of shares of capital stock of a corporation, for income tax purposes, is the stated capital of that class, as determined under the applicable corporate statute. The Act provides many adjustments to paid-up capital which can apply in many situations.

Canadian corporate laws require a corporation to maintain a stated capital account and, except in specific circumstances, to add the full amount of any consideration that the corporation receives for any shares which the corporation issues for the public Canadian corporation. Generally, for non-public Canadian corporations, paid-up capital can be returned to a non-resident parent by a Canadian subsidiary without any Canadian withholding tax.

Unlike many jurisdictions including the U.S., there is no Canadian income tax requirement that a corporation pay out its profits before returning capital and, therefore, the foreign parent of a Canadian non-public subsidiary should consider a return of capital as a method to extract after-tax profits from the subsidiary on a tax effective basis. In addition, if a foreign corporation initially uses equity to capitalize its Canadian non-public subsidiary, it will generally be able to reduce the equity and increase the amount of debt financing without giving rise to any adverse Canadian income tax consequences, assuming that such actions do not give rise to interest deduction limitations under the thin capitalization rules discussed above.

## Tax-Deferred Sale of Shares and Amalgamations

Sections 85 and 85.1 of the Act provide for the tax-deferred transfer of property to a corporation. Section 87 of the Act relates to tax-deferred amalgamations.

### Section 85 Election

Section 85 of the Act permits the transfer of property to a corporation on a tax-deferred basis by electing the amount at which the transfer takes place for tax purposes. The transferor (seller) may be any “taxpayer,” including a non-resident person. However, the transferee (purchasing corporation) must be a “taxable Canadian corporation.” The seller must receive at least one share of capital stock of the purchasing corporation. The seller may also receive non-share consideration, which may include cash, promissory notes, the assumption of debt or any other property. Certain types of property may not be “rolled over” into a corporation under section 85, including real property or an interest in real property owned by a non-resident that is not used in a business carried on in Canada by such non-resident. To affect the rollover under section 85, the seller and the purchasing corporation must jointly execute a prescribed election form and file it with the CRA in the prescribed time. The elected amount cannot be less than the tax cost to the taxpayer of the property and it cannot be more than the fair market value of the property. In addition, the elected amount cannot be less than the fair market value of any non-share consideration received by the transferor.

### Section 85.1 – Share-for-Share Exchanges

Section 85.1 allows a taxpayer (seller) to transfer shares of a corporation on a tax-deferred basis to another corporation for treasury shares of the transferee (purchaser) corporation. The following conditions must be satisfied for section 85.1 to apply:

1. the purchaser of the “old shares” must be a Canadian corporation;
2. the “old shares” that are being disposed of by the seller must be shares of a taxable Canadian corporation and must be held as capital property;
3. the purchaser corporation must issue its own shares (i.e. treasury) to the seller in exchange for the “old shares” owned by the seller of any particular class of another corporation that is a taxable Canadian corporation; and
4. the only consideration the seller receives for the “old shares” is shares of one particular class of the purchaser corporation.

Once these conditions are met, the provision applies automatically and no election is required for the tax-deferred rollover to the seller. The tax cost of the transferred shares to the purchaser corporation is the lesser of the fair market value of the shares and the paid up capital of the shares, immediately before the exchange. However, the seller can opt out of the “automatic” rollover.

The rollover under section 85.1 does not apply in the following circumstances:

1. the seller and purchaser were, immediately before the exchange, not dealing with each other at arm’s length;
2. immediately after the exchange, the seller or persons not at arm’s length with the seller, alone or together, controlled the purchaser or beneficially owned more than 50% of the value of all outstanding shares of the purchaser;

3. a section 85 election was filed in respect of the transaction to which the particular taxpayer is a party; or
4. non-share consideration was received by the seller for the transferred shares.

It should be noted that a section 85 election may provide the purchaser with a higher tax cost if the vendor's tax cost of the transferred shares is greater than the paid-up capital of the transferred shares.

### **Tax Deferral for Target Shareholders**

The availability of the tax-deferral benefits under sections 85 and 85.1 of the Act can often facilitate transactions since a buyer could purchase a target corporation without causing immediate tax consequences to the target shareholders. In an all-cash deal, the selling shareholders will realize a capital gain to the extent that the proceeds of disposition of their shares exceed their tax cost and reasonable costs of disposition. However, where the buyer has the ability to issue shares or cause shares to be issued to the target shareholders as consideration, the provisions of sections 85 and 85.1 could be used to provide such shareholders with the opportunity to defer all or a portion of their gain.

Although no similar rule permits a tax-deferred transfer of property to a non-resident corporation, it is possible for a non-resident corporation to offer a tax-deferral to the shareholders of the target corporation by offering exchangeable shares. Under a typical exchangeable share transaction, a Canadian acquisition company acquires the shares of the target corporation and issues to the sellers its shares that are exchangeable into shares of the non-resident parent corporation. The terms and conditions of the exchangeable shares may be designed to place the holders of such shares in the same economic position as if the holders owned the shares of the non-resident corporation (see the discussion on Exchangeable Shares under the section "Overview of Canadian Securities Legislation – Plan of Arrangement," in Chapter 1 of this guide).

### **Amalgamations**

A tax deferral can also be offered to shareholders of a target company through an acquisition strategy that involves an amalgamation. Section 87 of the Act provides for the merger of two or more taxable Canadian corporations (the "predecessor corporations") into a new corporate entity (the "amalgamated corporation"). For tax purposes, the amalgamated corporation is treated as a continuation of the predecessor corporations, standing in their place with respect to various assets, liabilities, surpluses and other tax-oriented accounts.

This tax-deferred merger under section 87 is available under the following conditions:

- a. the merger must involve two or more corporations, each of which was immediately before the merger, a "taxable Canadian corporation";
- b. all of the property of the predecessor corporations immediately before the merger, except amounts receivable from any predecessor corporation or shares of the capital stock of any predecessor corporation, must become the property of the amalgamated corporation;
- c. all of the liabilities of the predecessor corporations immediately before the merger, except amounts payable to any predecessor corporation, must become liabilities of the amalgamated corporation;
- d. all of the shareholders of the predecessor corporations immediately before the merger, except any shareholder that is a predecessor corporation, must receive shares of the capital stock of the amalgamated corporation; and

- e. none of the foregoing requirements has been accomplished as a result of the acquisition of property of one corporation by another corporation, pursuant to the purchase of that property by the other corporation or as a result of the distribution of that property to the other corporation on the winding-up of the corporation.

Section 87 applies automatically without the need for an election to be filed.

The shareholders of each predecessor corporation (other than shareholders who are other predecessor corporations) will be deemed to have disposed of their shares in the predecessor corporations (the “old shares”) for proceeds equal to the adjusted cost base of such shares. The shareholders will then be deemed to have acquired shares of the amalgamated corporation at the price equal to the adjusted cost base of the old shares.

### **Triangular Amalgamations**

The Act also permits the tax-deferred amalgamation of two or more taxable Canadian corporations where the Canadian parent corporation of the amalgamated entity issues shares to the shareholders of the predecessor corporations. This type of amalgamation is commonly referred to as a “triangular amalgamation.”

A triangular amalgamation can also be conducted on a tax-deferred basis under the rules in section 87 of the Act, even though the shareholders of the predecessor corporation are not shareholders of the new corporation. In this case, the amalgamation will not give rise to a taxable event resulting in a corporate level of taxes. Similarly, the shareholders of the predecessor corporation will dispose of their shares on a tax-free basis when they become shareholders of the new corporation’s parent.

## **Other Considerations**

### **Assets vs. Shares**

The decision to acquire the assets of the Canadian business or the shares of the operating company will affect the manner in which the acquisition is completed.

From a commercial perspective, a purchaser would generally prefer to acquire the assets of a business to limit its exposure to the “hidden” liabilities of the target company. It also provides the purchaser with the ability to choose the assets that the purchaser wants in order to carry on the Canadian business. The acquisition of assets could also be advantageous from an income tax perspective, by allowing the purchaser to allocate the purchase price in the most tax-efficient manner (i.e. to the extent permitted, the purchaser should allocate the purchase price to assets which will give rise to the greatest depreciation deductions) under the Act.

In addition, asset acquisitions also provide more flexibility with respect to the choice of carrying on business through a branch or a subsidiary. If a U.S. corporation acquires the assets of a Canadian target business, the U.S. corporation can continue to carry on that business as a Canadian branch. If it later decides to carry on the business through a Canadian subsidiary, it can generally transfer the assets of the business to a Canadian corporation on a tax-deferred basis under section 85 of the Act. In contrast, if a U.S. corporation acquires the shares of a Canadian company, it would be necessary to wind-up the Canadian target or transfer the assets to a U.S. corporation. Neither of these options can be carried out on a tax-deferred basis and could result in significant Canadian income tax consequences.

Commodity taxes, such as GST, QST, HST, PST or land transfer taxes, may be imposed on the sale of assets, whereas transfer taxes will not be imposed on the sale of shares (please see “Commodity Taxes and Payroll Taxes” above). In addition, a purchaser might be interested in acquiring the shares of the operating company where the company has significant non-capital loss carryovers that might be available to reduce taxes payable in respect of future profits of the Canadian operations, subject to the detailed rules in the Act.

### **Increasing Tax Cost Under ss. 88(1)(d) of the Act**

Generally, if the shares of a corporation are acquired, there is a very limited ability to increase the tax cost of the assets of the corporation. However, in certain situations, if the acquisition is by a Canadian corporation, that Canadian corporation can increase the tax cost base of non-depreciable capital properties of the acquired corporation, such as land, shares and partnership interests, through an amalgamation or wind-up. This step-up in cost base is sometimes referred to as the “88(1)(d) bump.” However, it should be noted that the Act imposes significant limitations on when the “bump” can be utilized.

### **Benefits of Acquiring Canadian Company Using Canadian Holding Company**

Perhaps the simplest way of acquiring a Canadian corporation is to purchase the shares of the corporation directly. However, such direct acquisitions by a non-resident corporation may not be the most tax-efficient means of doing so from a Canadian income tax perspective. Consider the following example where the purchase price for all of the issued shares of a Canadian corporation is less than paid-up capital of the corporation.

Example 1: Foreignco acquires all of the issued shares of the Canadian target corporation, Targetco, for \$100M. The paid-up capital of Targetco is only \$50M. Targetco would only be able to return \$50M on a tax-free basis to its parent, Foreignco, although Foreignco paid \$100M for the issued shares of the company. Foreignco can improve its Canadian tax position by using a Canadian acquisition corporation.

Example 2: Foreignco subscribes for shares of a new Canco in the amount of \$100M. Canco uses the funds to acquire all of the issued shares of the Canadian target corporation, Targetco, for \$100M.

In this example, Canco would have paid-up capital of \$100M, which could be returned to Foreignco on a tax-free basis. Foreignco’s ability to refinance the equity financing with debt has increased from \$33.3M to \$66.6M. Note, however, that this strategy to increase paid-up capital must be executed at the time of the acquisition. Subsequently “rolling over” the shares of Targetco into Canco will not have the desired tax effect.

In addition, if Canco borrows money to finance the acquisition of Targetco, and Targetco and Canco are subsequently combined, the acquisition indebtedness can be converted into operating debt. Interest payments are currently deductible, provided that the amount of interest is reasonable, subject to the thin capitalization rules (discussed above under the section “Thin Capitalization Rules”), and to the potential withholding taxes that may be applicable.

The use of Canco as the acquisition vehicle may also permit an increase in the tax cost of non depreciable assets owned by Targetco (please see “Increasing Tax Cost” under ss. 88(1)(d) of the Act discussed above).

## **Canadian Capital Gains Exemption**

It should be noted that Canadian resident individuals are entitled to a one-time CDN\$750,000 capital gains exemption in respect of the sale of qualified small business corporation (“QSBC”) shares. This exemption can result in a tax saving of approximately \$175,000 for each individual entitled to the exemption. Therefore, if a buyer wishes to purchase shares of a Canadian corporation which qualify as QSBC shares from Canadian resident individuals, the sellers will most likely want to structure the transaction as a share sale, as opposed to an asset sale if they can benefit from the exemption.

## **Section 116 Notification**

As discussed above in the section “Federal Income Taxes,” Canada taxes non-residents on the disposition of taxable Canadian property. Accordingly, if a non-resident sells property which is not taxable Canadian property, there is no Canadian tax payable under the Act. As also discussed above, if the property sold is taxable Canadian property, an applicable tax treaty may exempt the transaction from Canadian tax. It should be noted that if the seller is a non-Canadian resident and the property is taxable Canadian property, in certain situations there is a requirement under section 116 of the Act to notify the CRA and obtain a clearance certificate, even if there is no tax payable under a tax treaty or the sale results in a capital loss. In addition, the purchaser from a non-Canadian resident seller may be required to withhold a portion of the purchase price until the clearance certificate is obtained. (The notification procedure is simplified and the withholding requirement may not apply if the property is “treaty protected property,” as defined in the Act.) In addition to penalties, the Act imposes a joint liability on the purchaser for the non-resident seller’s tax liability if a clearance certificate is not obtained when required under the Act.

## **Conclusion**

Any non-resident buyer of a Canadian business must consider the Canadian and provincial income, commodity and payroll tax issues related to the acquisition, so that the taxes payable in connection with the acquisition and the operation of the Canadian business are minimized. In addition, the buyer must take into account taxes in other relevant jurisdictions. It is critical that tax advice be obtained in the early stages of any acquisition planning so that the transaction can be structured effectively.



# About FMC

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## Our Approach

At FMC, we understand the complexities posed by changing market conditions. We know that to serve your needs effectively, we must understand your business and objectives in a broad context in order to anticipate developments, identify opportunities and respond to challenges.

FMC prides itself on being able to deliver effective solutions which advance the strategic interests of its clients. We do this by combining and leveraging our diverse professional capabilities and strong business acumen, with a clear understanding of our clients' needs and priorities.

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