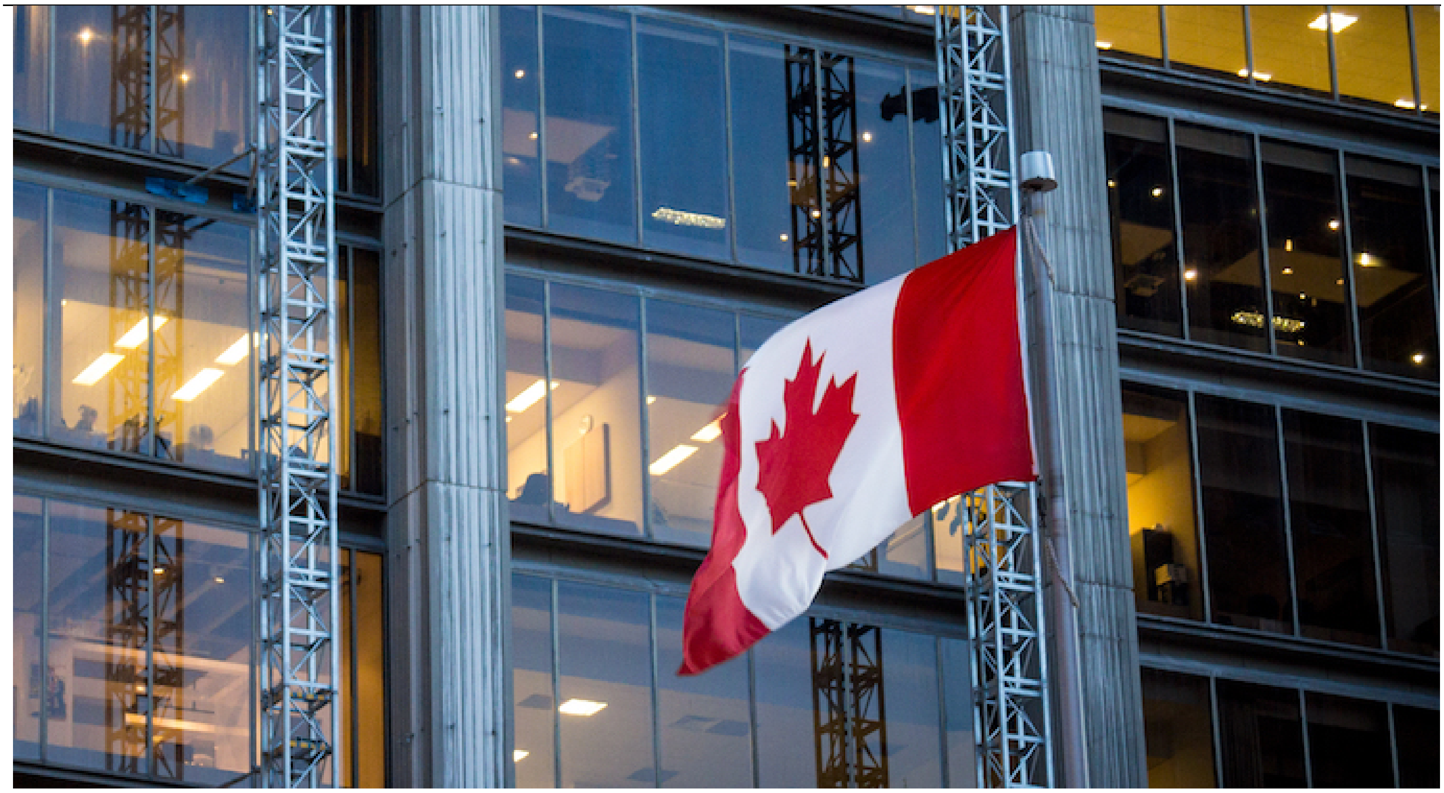
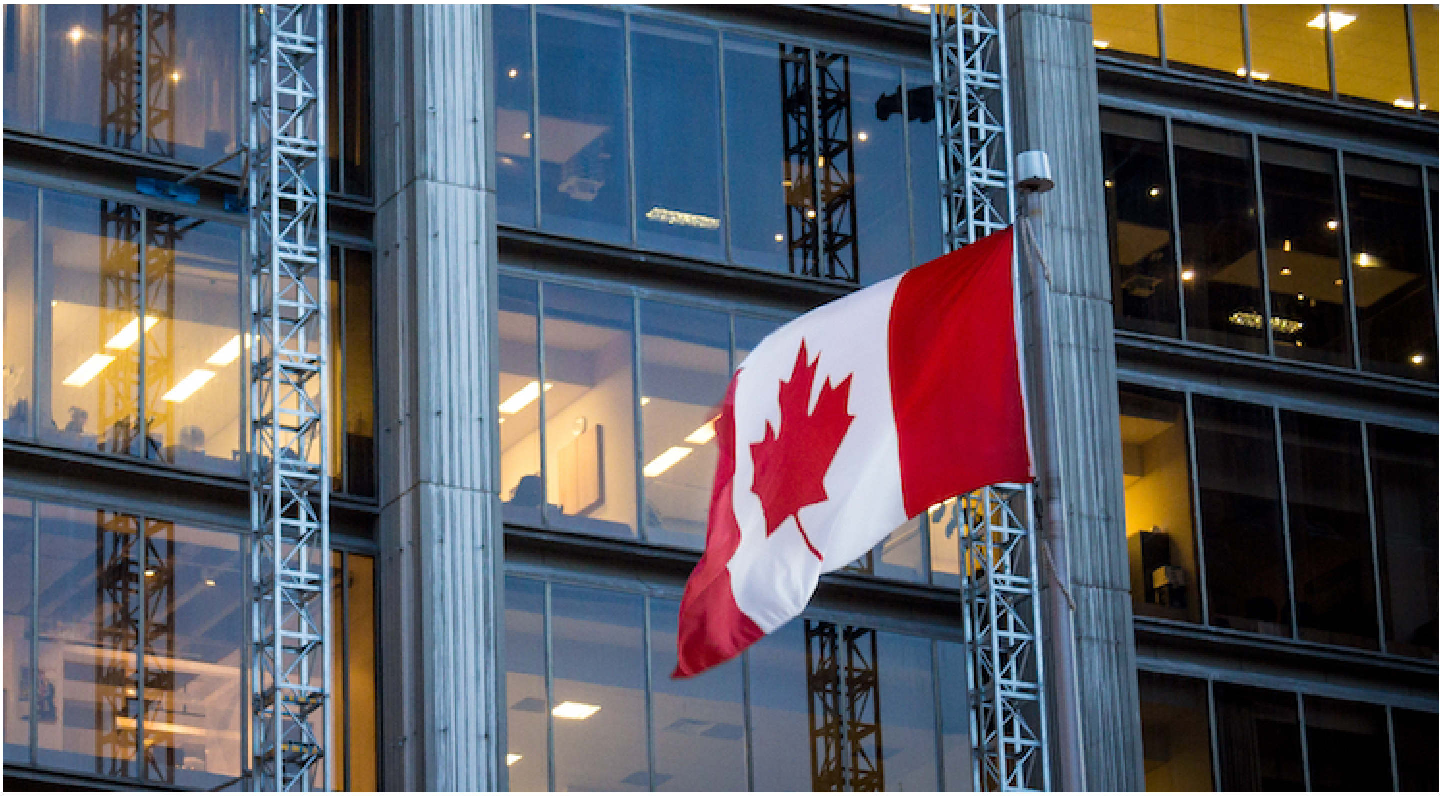
Expanding a US Business into Canada: Common Canadian Tax Issues to Consider

Compliance and Ethics





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US companies that are looking to expand internationally often look to Canada first as a place to test the waters. Canada's geographic proximity, similar legal system, culture, and language all make it a good place to start for a US company interested in international opportunities. However, there are significant differences between the Canadian and US tax systems that often catch US residents off guard. This article will provide an overview of common taxation and structuring issues that US companies face when expanding organically into Canada. The unique issues that arise where a US company chooses to expand into Canada by acquiring an existing Canadian business are beyond the scope of this article and will not be discussed.

One general aspect of Canadian tax law that is often surprising to US tax advisors is the emphasis on legal form over economic substance. In Canada, the corporate form of a transaction matters is usually determinative of the tax treatment of the transaction absent the application of various anti-avoidance rules. Generally, there are fewer opportunities than in the United States for taxpayers to elect to treat a transaction differently for tax purposes than it is treated for purposes of corporate law. For example, there is no ability to elect a pass-through treatment for an entity classified as a corporation under Canadian law and no equivalent to the section 338 election that can be used to step-up the cost base of underlying depreciable property on a purchase of shares. There is also no requirement that a transaction have a "business purpose," although there is a statutory general anti-avoidance rule (GAAR) that applies where a transaction with no primary business purpose has produced a tax benefit in an abusive manner.

> *Only Alberta and Quebec still require the filing of a separate provincial corporate income tax return.*

Corporate income taxes are imposed at both the federal and provincial levels in Canada, with combined rates ranging from 25 percent to 31 percent for active business income earned by non-Canadian controlled corporations. Most of the provinces have harmonized their income tax statutes with the federal government, adopting the federal definition of taxable income and allowing the federal government to administer the collection and enforcement of provincial income taxes. Only Alberta and Quebec still require the filing of a separate provincial corporate income tax return.

Generally, non-residents of Canada are subject to Canadian income tax if they "carry on business" in Canada, are employed in Canada, or dispose of a "taxable Canadian property" at any point during a taxation year. However, US companies conducting business in Canada will frequently be exempt from Canadian income tax by virtue of the Canada-US Income Tax Convention (the US Treaty) if they do not carry on their business through a "permanent establishment" in Canada.

Carrying on business in Canada

The concept of carrying on business has a common law definition that is supplemented by an extended meaning of the term in the federal tax legislation. Assuming that a non-resident is carrying on a business, the place where the business is carried on is a question of fact that is determined by considering all relevant circumstances, including: the place where contracts are made, the place where goods are delivered or services are performed, and the location of the profit-making operations. In addition to the common law test, the federal tax legislation deems several activities to constitute carrying on business in Canada including producing or manufacturing goods in Canada, offering anything for sale or soliciting orders in Canada through an agent or servant, and the sale of real property or resource property located within Canada. The threshold for carrying on business in Canada is low and it is often difficult to come to a definitive conclusion given the fact-based nature of the test.

A non-resident corporation that is carrying on business in Canada is required to file a Canadian tax return and will be subject to Canadian income tax on the income from the Canadian business. Failing to file a return as required does not result in substantial penalties where no tax is payable (maximum CA$2,500 per year), but it does leave the statutory limitation period for the Canada Revenue Agency (CRA) to reassess a taxpayer's results for a taxation year open indefinitely. US corporations with uncertain tax positions relating to their business dealings in Canada are therefore often advised to err on the side of filing in order to avoid having these positions open to challenge indefinitely.

US Treaty

As noted above, US corporations may be exempt from income tax on their "business profits" by virtue of the US Treaty if they are eligible to claim the benefits of the treaty and they do not have a permanent establishment in Canada. However, the US Treaty contains a detailed limitations on benefits (LOB) clause that may prevent a US resident from relying on its provisions. US corporations should always ensure that these provisions do not apply to deny them treaty benefits prior to relying on an exemption or reduced rate of withholding under the US Treaty. US corporations should also be cautious when using US limited liability companies (LLCs) in Canadian investment structures. LLCs are treated as corporations in Canada and the hybrid nature of an LLC treated as a flow-through for US tax purposes can cause issues in the application of the US Treaty in Canada.

Permanent Establishment

A permanent establishment is a fixed place of business through which the business of a US company is carried on, and includes: a place of management, a branch, an office, a factory, a mine, oil and gas well, or other place where natural resources are extracted. US companies may also have a permanent establishment if they do business through a representative in Canada that habitually exercises authority to contract on their behalf, if they provide services in Canada through an individual located in Canada for more than 183 days in a 12-month period and revenues from those services are the majority of the business's gross active business revenues, or if they provide services in Canada with respect to the same or connected project for more than 183 days in a 12-month period and the customers to whom the services are provided meet certain requirements.

> *In addition, the US Treaty exempts from the branch tax the first CA$500,000 of profits earned by a US corporation in Canada.*

US corporations carrying on business through a permanent establishment in Canada will also be subject to Canada's branch tax on their Canadian after-tax profits. The statutory rate of the branch tax is 25 percent; however, in the case of a US corporation that qualify for the benefits of the US Treaty it is reduced to five percent, which is equal to the rate of withholding on dividends from companies in which the recipient has a significant ownership interest (10 percent or more). In addition, the US Treaty exempts from the branch tax the first CA$500,000 of profits earned by a US corporation in Canada.

The thin capitalization rules applicable to Canadian corporations also apply to a Canadian permanent establishment of a US corporation.

Withholding tax

It is important to recognize that even where the US Treaty applies to exempt a US corporation from Canadian income tax, withholding obligations may still apply both in respect of amounts paid to the US corporation and amounts paid by the US corporation to employees performing their duties in Canada. Two common problem areas are Regulation 105 and Regulation 102 withholding.

Regulation 105 requires every person who pays a fee to a non-resident in respect of services rendered in Canada (with very few exceptions) to withhold and remit 15 percent of the gross amount to the government. Non-resident recipients of such amounts who are not taxable in Canada may apply for and obtain a waiver from the Canada Revenue Agency (CRA) to avoid this withholding. However, the time period for processing waiver applications is often lengthy, so non-residents who anticipate receiving payments subject to Regulation 105 withholding would be well advised to apply for the waiver far in advance.

US resident employees who perform employment duties in Canada are subject to Canadian income tax on remuneration received for such employment duties. However, the US Treaty provides an exemption if the employee's remuneration from the employment duties performed in Canada does not exceed CA$10,000 or if the employee is not present in Canada for more than 183 days in any relevant 12-month period and their remuneration is not paid by, or on behalf of, a Canadian resident and is not borne by a permanent establishment in Canada. Regulation 102 requires employers paying remuneration to employees to deduct and withhold certain amounts in respect of the employees' income tax obligations. This withholding obligation applies to US-resident employers paying US-resident employees when those employees perform some or all of their employment duties in Canada, even where the exemption in the US Treaty applies, unless the employer has applied for and received certification as a "qualifying non-resident employer" and the employee is a "qualifying non-resident employee." A waiver may also be obtained where the remuneration will be exempt from tax due to the US Treaty. Seconding US employees to a Canadian subsidiary is another method often used to simplify compliance requirements. US businesses should obtain advice with respect to their Canadian compliance responsibilities prior to sending employees to Canada for any work-related purpose.

Incorporating a Canadian subsidiary

US companies expanding into Canada with a permanent establishment will typically choose to incorporate a Canadian subsidiary to keep the Canadian business activities ring-fenced in a distinct legal entity, limit withholding tax issues, and reduce the risk of audit of the US resident itself by the CRA. In this respect, several options are available depending on the needs of the US resident. A US resident can either incorporate a subsidiary federally or under one of the various provincial corporate statutes. Non-residents may wish to incorporate in one of the Canadian provinces that does not require Canadian-resident directors, such as British Columbia.

Additionally, the corporate statutes of British Columbia, Alberta, and Nova Scotia allow for the incorporation of Unlimited Liability Companies (ULCs). ULCs do not offer the limited liability of an ordinary corporation, but they can be attractive to US residents because they are treated as corporations for Canadian tax purposes but as pass-through entities for US tax purposes. It should be noted, however, that the anti-hybrid rules added to the US Treaty in 2010 have made structuring with Canadian ULCs more complex and care should be taken to ensure that any structure involving ULCs does not run afoul of these rules.

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Capitalizing and repatriating income from Canadian subsidiaries debt financing via loans from non-resident related persons is often used to capitalize Canadian subsidiaries, as interest on borrowed money is generally deductible for Canadian tax purposes. In addition, interest paid by Canadian subsidiaries to US parents is typically exempt from withholding tax where the US Treaty applies. The amount of interest that may be paid on related-party debt is restricted by Canada's transfer pricing and thin capitalization rules.

The US Treaty reduces the rate of withholding on dividends paid by Canadian corporations to US corporations from the statutory rate of 25 percent of the gross amount of the dividends to a rate of five percent where the US resident owns 10 percent or more of the voting stock of the payer company, and 15 percent in all other cases.

Other taxes

Canada imposes a five percent federal sales tax called the "goods and services tax" (GST) on all taxable supplies of goods and services made in Canada. Several provinces have harmonized their provincial sales taxes with the GST, resulting in combined "harmonized sales tax" (HST) of up to 15 percent. Though not harmonized, Quebec imposes a sales tax that is similar to the GST. Three provinces (British Columbia, Saskatchewan, and Manitoba) still impose a separate provincial sales tax that should be considered by non-residents operating in those provinces.

The meaning of "carrying on business" for GST/HST purposes is not identical to the meaning of the term for income tax purposes, and it is therefore possible that a US resident could be considered to be carrying on business in Canada for purposes of GST/ HST but not for income tax and vice versa. In addition, a non-resident that carries on business in Canada but does not have a permanent establishment is not necessarily exempt from the requirement to collect GST/ HST, a point that can sometimes be missed by income tax practitioners.

The provinces impose various other taxes that should also be considered depending on the location of business activity and the particular industry involved.

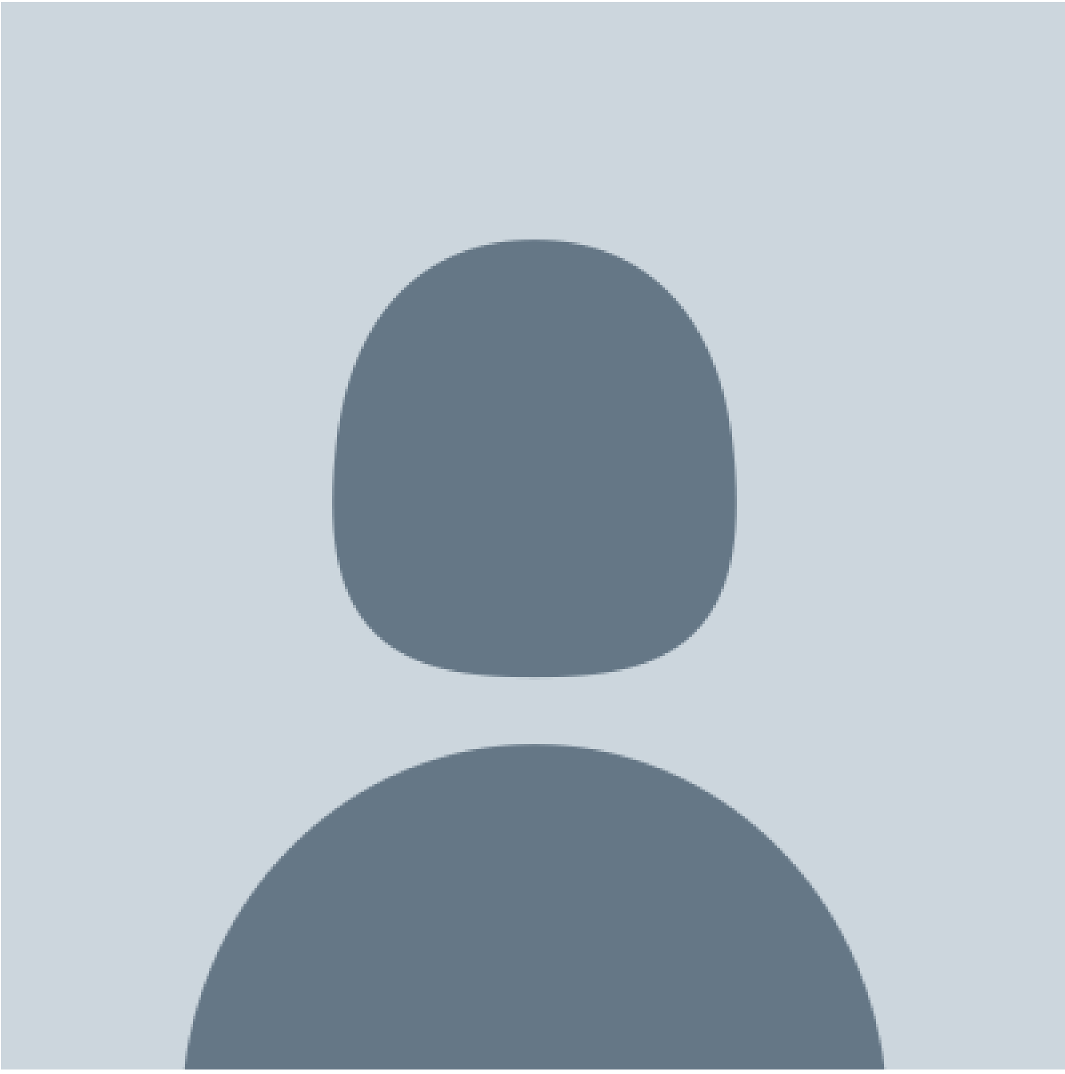
Recent developments

Canada signed the OECD's Multilateral Instrument (MI), developed as part of its base erosion and profit shifting (BEPS) initiative, on June 7, 2017. Although not expected to apply to the US Treaty, the anti-treaty shopping provisions in the MI may affect structuring involving the use of an intermediary in a third jurisdiction for investment into Canada. Although it is common for US corporations to hold Canadian subsidiaries directly, investing through a holding company located in a third jurisdiction may make sense in some circumstances for larger and more sophisticated taxpayers.

Conclusion

Canadian tax rules, though often similar, are in some respects significantly different from equivalent US rules. Canadian tax advice should always be sought by US residents wishing to expand their business into the Canadian market, even where the Canadian activity appears limited in scope, in order to prevent potentially costly missteps.

Kirsten Kjellander



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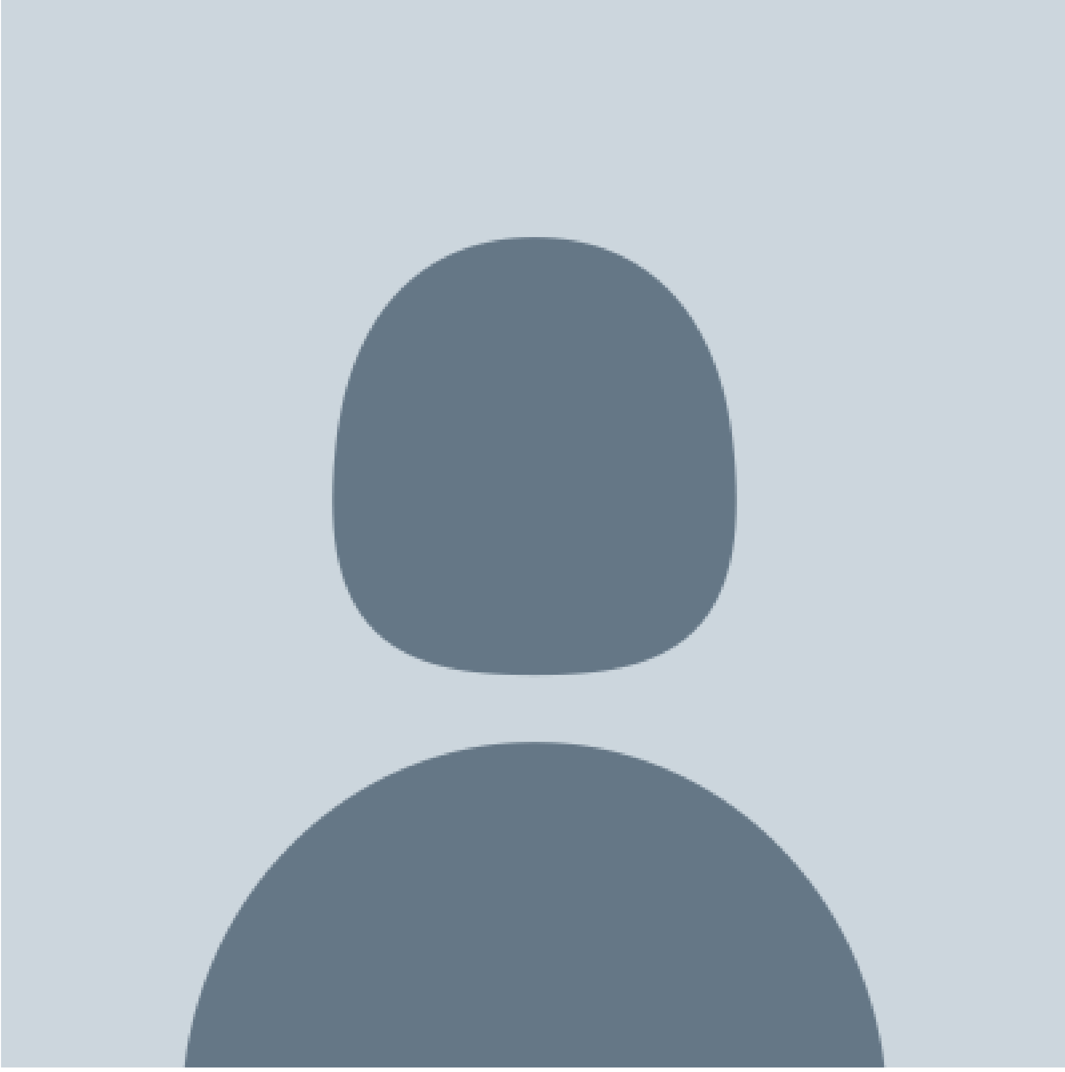

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