Corporate Taxation in Canada: A Cross-Border Perspective

Nathan Boidman
nboidman@dwpv.com

Michael Kandev
mkandev@dwpv.com
Corporate Taxation in Canada: A Cross-Border Perspective

This article describes the principal features of Canada’s corporate tax system, focusing on selected aspects of interest in a cross-border context. The topics discussed include, among others, entity classification for Canadian income tax purposes, liability to corporate tax, the corporate tax rates and tax base, tax-deferred reorganization facilities, withholding taxes, and anti-avoidance rules. The article also considers matters of particular relevance to foreign investors, such as the main considerations in establishing a business presence in Canada, acquiring a Canadian business and using a Canadian holding corporation.

1. Introduction
This article provides a review of the principal features of Canada’s corporate tax system and focuses on selected aspects that may be of interest in a cross-border context. The first part of the article is an overview of Canada’s corporate tax rules. The second part discusses matters of particular relevance to foreign investors, including the main considerations in establishing a business presence in Canada, acquiring a Canadian business and using a Canadian holding corporation.

2. Corporate Taxation in Canada
Under Canada’s Constitution, both the federal government and Canada’s provinces can impose a corporate income tax. At the federal level, the corporate tax is levied under the Income Tax Act (the “Act”). Each province has its own corporate tax legislation, but all provinces, except Alberta and Quebec, have harmonized their laws with the Act to effectively piggyback on the federal tax system. This article focuses principally on the features of the federal Act.

2.1. Entity classification for Canadian income tax purposes
Canada’s income tax system distinguishes between individuals, corporations, trusts and partnerships. This article focuses on the income tax treatment of corporations.

2.1.1. Meaning of “corporation” and characterization of foreign entities under the Act
The Act does not contain an exhaustive definition of the term “corporation”, but merely stipulates that a corporation “includes an incorporated company.” It is accepted that Canadian corporations formed under the law of one of the provinces or under the federal Canada Business Corporations Act qualify as corporations for tax purposes.

The matter of entity classification arises in particular with respect to unincorporated foreign entities. The traditional administrative position of the Canada Revenue Agency (CRA) is generally consistent with the holding in Canada’s only entity classification case, *Economics Laboratory (Canada) Ltd. v. Canada*. The CRA’s position on when the CRA will view a foreign entity as a corporation for purposes of the Act has been that (emphasis added):

> “Corporation” includes an incorporated company.5 It is accepted that Canadian corporations formed under the law of one of the provinces or under the federal Canada Business Corporations Act qualify as corporations for tax purposes.

The first part of the article is an overview of Canada’s corporate tax rules. The second part discusses matters of particular relevance to foreign investors, including the main considerations in establishing a business presence in Canada, acquiring a Canadian business and using a Canadian holding corporation.

2. Corporate Taxation in Canada
Under Canada’s Constitution, both the federal government and Canada’s provinces can impose a corporate income tax.5 At the federal level, the corporate tax is levied under the Income Tax Act (the “Act”). Each province has its own corporate tax legislation, but all provinces, except Alberta and Quebec, have harmonized their laws with the Act to effectively piggyback on the federal tax system. This article focuses principally on the features of the federal Act.

2.1. Entity classification for Canadian income tax purposes
Canada’s income tax system distinguishes between individuals, corporations, trusts and partnerships. This article focuses on the income tax treatment of corporations.

2.1.1. Meaning of “corporation” and characterization of foreign entities under the Act
The Act does not contain an exhaustive definition of the term “corporation”, but merely stipulates that a corporation “includes an incorporated company.” It is accepted that Canadian corporations formed under the law of one of the provinces or under the federal Canada Business Corporations Act qualify as corporations for tax purposes.

The matter of entity classification arises in particular with respect to unincorporated foreign entities.6 The traditional administrative position of the Canada Revenue Agency (CRA) is generally consistent with the holding in Canada’s only entity classification case, *Economics Laboratory (Canada) Ltd. v. Canada*. The CRA’s position on when the CRA will view a foreign entity as a corporation for purposes of the Act has been that (emphasis added):

> “Corporation” includes an incorporated company.5 It is accepted that Canadian corporations formed under the law of one of the provinces or under the federal Canada Business Corporations Act qualify as corporations for tax purposes.

The first part of the article is an overview of Canada’s corporate tax rules. The second part discusses matters of particular relevance to foreign investors, including the main considerations in establishing a business presence in Canada, acquiring a Canadian business and using a Canadian holding corporation.

2. Corporate Taxation in Canada
Under Canada’s Constitution, both the federal government and Canada’s provinces can impose a corporate income tax.5 At the federal level, the corporate tax is levied under the Income Tax Act (the “Act”). Each province has its own corporate tax legislation, but all provinces, except Alberta and Quebec, have harmonized their laws with the Act to effectively piggyback on the federal tax system. This article focuses principally on the features of the federal Act.

2.1. Entity classification for Canadian income tax purposes
Canada’s income tax system distinguishes between individuals, corporations, trusts and partnerships. This article focuses on the income tax treatment of corporations.

2.1.1. Meaning of “corporation” and characterization of foreign entities under the Act
The Act does not contain an exhaustive definition of the term “corporation”, but merely stipulates that a corporation “includes an incorporated company.” It is accepted that Canadian corporations formed under the law of one of the provinces or under the federal Canada Business Corporations Act qualify as corporations for tax purposes.

The matter of entity classification arises in particular with respect to unincorporated foreign entities.6 The traditional administrative position of the Canada Revenue Agency (CRA) is generally consistent with the holding in Canada’s only entity classification case, *Economics Laboratory (Canada) Ltd. v. Canada*. The CRA’s position on when the CRA will view a foreign entity as a corporation for purposes of the Act has been that (emphasis added):

> “Corporation” includes an incorporated company.5 It is accepted that Canadian corporations formed under the law of one of the provinces or under the federal Canada Business Corporations Act qualify as corporations for tax purposes.

The first part of the article is an overview of Canada’s corporate tax rules. The second part discusses matters of particular relevance to foreign investors, including the main considerations in establishing a business presence in Canada, acquiring a Canadian business and using a Canadian holding corporation.
A corporation is an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it.10 But in Income Tax Technical News No. 38 (22 September 2008), the CRA acknowledged a change in its administrative position to the effect that separate legal entity status is no longer a distinctive feature of corporations alone. The CRA’s current approach to classifying foreign entities for purposes of domestic taxation is as follows: (1) determine the characteristics of the foreign entity under the foreign legislation, and (2) compare those characteristics with those of recognized categories under Canadian commercial law.11

Interpretation Bulletin IT-343R provides a list of foreign entities which the CRA treats as corporations for purposes of the Act. In addition, in Income Tax Technical News No. 38, the CRA stated that it also considers Dutch cooperatives, Chilean special contractual mining companies and Chinese–foreign contractual joint ventures to be corporations for federal income tax purposes, while the CRA considers the following to be partnerships: partnerships created under the Delaware Revised Uniform Partnership Act and the Delaware Revised Uniform Limited Partnership Act (which have legal personality), Australian limited partnerships and French “sociétés en nom collectif”.

Notably, unlike in the United States, it is not possible to recharacterize an unincorporated association, such as a partnership, as a corporation for Canadian tax purposes.

2.1.2. Classifying corporations under the Act

Corporations are classified under the Act in several categories for tax policy reasons. An important distinction is drawn between Canadian corporations12 that are public and those that are private.13 Private corporations are eligible for some tax advantages that are denied to public corporations, but in some cases, public corporations are treated more favourably.

The Act also has several important favourable provisions that are applicable only to Canadian–controlled private corporations (“CCPCs”). A CCPC is a private corporation that is a “Canadian corporation”14 that is not “controlled, directly or indirectly in any manner whatever” by non-residents of Canada or by public corporations. Certain aspects of the relevance of these classifications are discussed below.

Of course, an important distinction, discussed below, is between resident and non-resident corporations.

2.2. Liability to Canadian corporate tax

A Canadian resident corporation is subject to tax on worldwide income,15 with a credit granted for foreign taxes on foreign-source income.16 The relevant nexus criterion, as discussed in greater detail below, is “residence”.

A non-resident corporation is subject to Canada’s mainstream income tax only if it carries on a business in Canada or disposes of taxable Canadian property.17 Further, Part XIII of the Act imposes a withholding tax on certain listed types of property income derived by a non-resident of Canada.

The nexus criterion for purposes of provincial corporate taxation is the presence of a “permanent establishment” (PE) in the particular province.

2.2.1. Corporate residence under the Act and Canada’s tax treaties

Canada treats corporations formed or continued under Canadian federal or provincial corporate law as residents, regardless of any other factor.18 Unlike the United States, but like the United Kingdom and many other countries, corporations formed outside of Canada may, under case law principles, also be treated as residents if their central ‘mind and management’ is exercised in Canada.19

Canada has an extensive network of tax treaties, with 87 treaties currently in force. Under Canada’s tax treaties, which are based on the OECD Model Tax Convention, a corporation is generally a “resident of a Contracting State” if, under the laws of that state, it is liable to tax therein by reason of domicile, residence, place of management or any other criterion of a similar nature.

Highlights

12. According to Sec. 89(1), “Canadian corporation” generally means a corporation that is resident in Canada and was incorporated in Canada.
13. Sec. 89(1) defines “public corporation” essentially as a corporation resident in Canada whose shares are “listed on a designated stock exchange in Canada”. Sec. 89(1) defines “private corporation” as a corporation resident in Canada which is not a public corporation and is not “controlled” by one or more public corporations.
14. See note 12, supra.
15. The Act’s main charging provision, Sec. 2(1), applies to every “person resident in Canada”. A corporation is a “person” as defined in the Act.
16. See Sec. 126. Foreign taxes are sometimes deductible instead of creditable; see Secs. 20(11) and (12).
17. See Sec. 2(3) and the definition of “taxable Canadian property” in Sec. 248(1). Regarding non-resident individuals, Sec. 2(3) also extends to employment in Canada.
18. This is the general rule applicable to corporations formed in Canada after April 1965; see Sec. 250(4).
19. In Canada, it is well settled that a corporation is resident “where its real business is carried on” and that a corporation’s “real business is carried on where its central management and control actually abide”, which is the place where the supervening authority over the company is exercised, which in turn is considered to be the place where the meetings of the board of directors are held. These principles were developed in the UK decision DeBeers Consolidated Mines Ltd. v. Howe, 5 T.C. 198 (1906), and have been consistently followed in Canada: see Yamaska Steamship Company Limited v. MNR, 61 D.T.C. 716; Sifreens v. MNR, 68 D.T.C. 522; Zeidner & Co. v. MNR, 70 D.T.C. 6064; and Bedford Overseas Freighters Limited v. MNR, 70 D.T.C. 6072. II, however, the directors fail to exercise the powers given to them and the powers are exercised by somebody else, the place where the powers are actually exercised will determine the location of central management and control; see Unit Construction Co. Ltd. v. Bullock (1959), 38 T.C. 712. Exceptionally, one Canadian case, MNR v. Crorey Carpets (Canada) Ltd., 69 D.T.C. 5015, extended the notion of corporate residence to encompass the situation of a UK corporation that was run by a Canadian resident manager who consulted on policy matters with one of the British directors who visited Canada approximately four months every year.
Hence, a corporation that is resident in Canada under the Act is, a priori, also a resident for treaty purposes. Most of Canada’s tax treaties have a tie-breaker rule for dual-resident corporations, which is typically based on mutual agreement (but in some cases is based on incorporation).20

Significantly, if a determination is made against Canada pursuant to a treaty tie-breaker rule, a domestic rule in the Act operates to “boot out” the corporation (i.e. deny it residence status) for all other Canadian tax purposes, which can trigger the departure tax.21

2.2.2. Provincial PEs

All the Canadian provinces use the criterion of “permanent establishment” to establish whether a corporation is a resident for treaty purposes.

An important recent change added new Para. (e.1) to the PE definition in Regulation 400(2) effective for the 2009 and subsequent taxation years. Para. (e.1) undermines the cornerstone requirement of the PE notion that there must be a business being carried on by providing that “if, but for this paragraph, a corporation would not have a permanent establishment, the corporation is deemed to have a permanent establishment at the place designated in its incorporating documents or bylaws as its head office or registered office.”22

2.3. Corporate tax rates

2.3.1. Overview

Corporations, both resident and non-resident, are taxed – in theory but not in fact – at a single “posted” flat federal rate of 38% on their taxable income or taxable income derived in Canada. However, the effective general federal corporate tax rate is currently 19% and is scheduled to decrease to 15% by 2012. The link between the posted and effective rates is two rate reductions: the general rate reduction and the provincial abatement.

Sec. 123.4(2) provides for a general rate reduction of 9 percentage points for 2009. This reduction will increase to 10 percentage points in 2010, 11.5 in 2011 and 13 in 2012 (thus bringing the posted rate down to 25%). The general rate reduction does not apply to certain types of income, such as the income of CCPCs which is either investment income or income eligible for the small business deduction (discussed below).

The provincial abatement is the mechanism by which the federal tax system is integrated with that of the provinces since the provincial income taxes in Canada do not constitute a deduction in computing taxable income for federal purposes (as in the United States). The federal tax is integrated with the provincial corpo-

rate taxes, currently imposed at general rates ranging from 10% to 16%,23 pursuant to Sec. 124(1), which allows a deduction, known as “an abatement”, of 10% of the corporation’s taxable income derived in the year in a province. Whether a corporation has such income is determined pursuant to the regulations. This determination depends on whether the corporation has a PE in one or several Canadian provinces.

Considering the above, the 2009 combined federal-provincial effective general corporate tax rate in Canada is as low as 29% (in Alberta) and as high as 35% (in Nova Scotia and Prince Edward Island). By 2012, the lowest combined federal-provincial general corporate tax rate will be 23% (in New Brunswick). This compares very favourably to the corporate tax rates in the United States.24

2.3.2. CCPCs

The general corporate tax rate, discussed above, is subject to two main exceptions applicable to CCPCs. First, there is a refundable tax on the investment income of CCPCs, which adds 6% percentage points to the posted tax.25

The Canada–United States tax treaty has slightly more complicated tie-breaker rules to deal with specific matters arising out of corporate migration. Originally, Art. IV(3) of the 1980 treaty provided a simple rule for resolving the residence of a corporation having dual residence: the country of incorporation took precedence. The 1995 protocol to the treaty added a rule applicable where the dual residence of a corporation stems from corporate migration. A corporation can be formed under the corporate law of one country and move through ‘corporate continuance’ to the other country. If, as a result of such continuance, dual residence arises, it would be resolved in favour of the country of continuance. This would occur if, for example, the corporation is not discontinued in its country of formation. This change resulted in an issue from a US tax perspective because, under the laws of Delaware (as amended in 1997), a corporation can be formed under the laws of Delaware and be continued under the laws of Nova Scotia without the laws of either Delaware or Nova Scotia requiring that the corporation discontinue under the laws of Delaware. Thus, the corporation would have ‘dual’ incorporation and be governed by the corporate laws of both Delaware and Nova Scotia. It would also have dual tax residence. As a result of the 1995 protocol amending Art. IV(3), however, the corporation could claim status as a treaty resident of Canada only. Apparently, the US saw this as giving rise to potential US tax avoidance because (1) the continuing US residence under US domestic law would mean that a form of US departure tax is not triggered, and (2) the corporation was ostensibly entitled to relief from US tax to the extent available to a treaty resident of Canada. As a result, on 18 September 2000, the governments of Canada and the United States announced that the then forthcoming fifth protocol would treat any corporation establishing dual incorporation after 17 September 2000 as a resident, for treaty purposes, of both countries and that the corporation would not be entitled to any treaty benefits except to the extent agreed upon by the competent authorities. The principles set forth in the September 2000 announcement were incorporated into the treaty by the amendment to Art. IV(3) of the treaty made by the fifth protocol, which entered into force on 15 December 2008.26

21. See Sec. 230.5. See also Sec. 128.1
22. See Boidman, N. and M. Kendig, “Reg 400: Surprise”, 17(3) Canadian Tax Highlights 2 (2009). This change to Regulation 400 together with certain additions to the Canada–US tax treaty may adversely affect US persons investing in Canada through a Nova Scotia unlimited liability company; see 3.3.2.
23. The provincial corporate tax rates are: 10% in Alberta; 11% (10% by 2011) in British Columbia; 12% effective 1 July 2009 (and eventually 11%) in Manitoba, subject to its balanced budget requirements; 13% (8% by 2012) in New Brunswick; 14% in Newfoundland and Labrador; 11.5% in the Northwest Territories; 16% in Nova Scotia; 12% in Nunavut; 14% (10% by 1 July 2013) in Ontario; 16% in Prince Edward Island; 11.9% in Quebec; 12% in Saskatchewan and 15% in the Yukon Territory.
tax rate of 38% and then reduces the tax on that class of income after distribution to shareholders by 26% percentage points. This ensures that the favourable corporate tax rates are not used by Canadians to defer taxation of investment income. Second, the small business deduction in respect of qualifying active business income of CCPCs reduces the tax on the first CAD 500,000 of that class of income to 11%. This, in essence, is a tax subsidy to small and medium-sized Canadian businesses.

2.4. The corporate tax base

2.4.1. Overview

Canadian resident corporations pay the corporate tax based on their worldwide “taxable income”. The Canadian tax base for non-resident corporations is their “taxable income earned in Canada”. The starting point for computing the “taxable income” of residents is the taxpayer’s “income” from all sources. For non-residents, the starting point for computing the “taxable income earned in Canada” is the taxpayer’s “income” from the Canadian sources listed in Sec. 2(3) (see Division D).

Generally speaking, the rules for computing “income” and “net income” under the Act are the same for corporations and individuals. In very general terms, “income” for purposes of the Act means income from an office, employment, business or property. Income from business or property is generally equivalent to the profit from the business or property calculated in accordance with “well accepted principles of business (or accounting) practice” or “well accepted principles of commercial trading”, as adjusted as required by specific rules in the Act.

Income also includes one half of the capital gain (referred to as the “taxable capital gain”) realized on a disposition of capital property net of any allowable capital losses. The amount of the capital gain generally equals the proceeds of disposition less the sum of the “adjusted cost base” of the property under the Act (roughly the cost of acquisition) and any costs of disposition.

Regarding the computation of income, the Act allows significant deductions in respect of tax depreciation and interest (discussed below).

Regarding the computation of taxable income, the important deductions for corporations are loss carryovers and the deductions for intercorporate dividends (discussed below).

2.4.2. Tax depreciation

Taxpayers are permitted capital cost allowance deductions at prescribed rates in respect of classes of depreciable capital property used in a business, including machinery and equipment, buildings and certain intangible property (Sec. 20(1)(a)). A similar deduction is permitted in respect of certain otherwise non-deductible capital expenditures incurred for the purpose of earning income from a business, including purchased goodwill.

2.4.3. Interest and other financing costs

Generally, reasonable interest expense on borrowed capital or in respect of property acquired for the purpose of earning income from business or property is deductible on an accrual or cash basis (depending on the method regularly followed by the taxpayer). Non-interest financing costs, including commissions and fees, incurred to borrow money or issue debt for an income-earning purpose or to issue treasury shares are generally deductible on a straight-line basis over five years. In a cross-border context, the most significant limitation on interest deductibility is Canada’s thin capitalization rule (discussed below).

Significantly, the March 2007 Federal Budget proposed, as part of the government’s International Tax Fairness Initiative, a highly controversial measure to eliminate altogether the deductibility of interest on debt incurred by Canadian corporations to finance their foreign subsidiaries. Faced with a wave of indignation from businesses and their advisers for having put into question one of the cornerstones of Canada’s tax system – interest deductibility – Finance Minister Jim Flaherty was forced to retreat on this measure. As a result, a new tamed-down proposal – the Anti-Tax-Haven Initiative – was put forward in May 2007 and enacted into law as new Sec. 18.2 in December 2007. Its stated intent was to “prevent multinational corporations from using tax havens and other tax avoidance structures to generate two expense deductions for only one investment, so-called ‘double dipping’.”

Pursuant to the Anti-Tax-Haven Initiative, beginning in 2012, Sec. 18.2 would block such arrangements by disallowing the interest deduction of a Canadian corporation except to the extent that the interest expense exceeded the operating income shifted to a financing subsidiary. In carrying out consultations on how to enhance Canada’s international tax system, the

25. The provinces also provide small business tax rates.
26. See Sec. 2(2): “taxable income of a taxpayer… is the taxpayer’s income for the year plus the additions and minus the deductions permitted by Division C.”
27. See Canderel Limited v. The Queen, 98 DTC 6100 (SCC). The Supreme Court made it clear that these expressions do not necessarily mean “generally accepted accounting principles” (GAAP).
28. Secs. 20(1)(b) and 14. These entail the notion of “eligible capital property”.
29. Sec. 20(1)(c). For this paragraph, see also Secs. 18(4) and 20(1)(e) and (f).
30. Simply put, “double dip” refers to an outbound financing arrangement whereby a Canadian company with foreign operations borrows to invest in shares of a financing subsidiary, which in turn lends the same funds to an operating foreign affiliate of the Canadian parent at a commercial rate of interest. A double interest deduction results because both the Canadian parent and the foreign operating subsidiary have an interest deduction. The ultimate benefit of this financing structure is that it reduces the overall tax bill on the foreign operations of the Canadian company. The reason is that the deductible interest paid by the operating subsidiary is taxed in the hands of the financing subsidiary, which is normally resident in a low-tax jurisdiction that has a tax treaty with Canada, such as Barbados. Sec. 95(2)(a) of the Act condones this result in that interest income, such as the interest income derived by the financing company in this example, is specifically carved out of Canada’s anti-deferral rules applicable to foreign passive income and can be repatriated to Canada as tax-exempt dividends.
31. The denial would be permanent, and it would not be possible to carry forward the lost deduction.
Advisory Panel on Canada’s System of International Taxation (“Advisory Panel”), which was established pursuant to the 2007 Budget, heard strong opposition to Sec. 18.2 and proposed unequivocally that Sec. 18.2 be repealed. In this year’s Budget, the government followed the Advisory Panel’s advice and repealed the “anti-double dip” provision before it became effective in 2012.

2.4.4. Loss carry-overs

A taxpayer’s non-capital losses from business or property can generally be carried back three years or forward 20 years to reduce the taxpayer’s taxable income. Net capital losses may be carried back three years or forward indefinitely, but can only be applied against taxable capital gains. Various anti-avoidance rules may apply to limit the availability of losses, including those that may be used after an acquisition of control of a corporation (Sec. 111(4) et seq.).

The Act does not permit formal loss consolidation or other types of corporate group relief. There are, however, accepted planning techniques for utilizing losses within the same corporate group.

2.4.5. Income from shares and Canada’s foreign affiliate system

Taxable dividends received by a Canadian resident corporation from a “taxable Canadian corporation” are generally fully deductible to the recipient corporation, permitting dividends to pass through a chain of taxable Canadian corporations without multiple taxation. Dividends received by a Canadian resident corporation from a non-resident corporation are included in income, subject to certain deductions permitted under Canada’s foreign affiliate system and subject to the foreign tax credit rules.

Canada’s foreign affiliate system in essence consists of two separate but interrelated sets of rules. First, the surplus rules are intended to provide relief from double taxation for income earned by a “foreign affiliate” of a Canadian corporate taxpayer by providing for either an exemption from Canadian tax (in respect of “exempt surplus”) or an effective credit against Canadian tax (in respect of “taxable surplus”) upon the payment of dividends by a foreign affiliate (Sec. 113). More specifically, the active business income earned by a foreign affiliate resident in a “designated treaty country” from carrying on business in such a country or under the application of the deeming rules in Sec. 95(2)(a) is included in the foreign affiliate’s exempt surplus at the affiliate’s year-end. The March 19, 2007 Federal Budget extended this treatment to active business income from non-treaty jurisdictions that agree to exchange tax information with Canada. This regime affords some tax planning opportunities for Canadian-based multinational enterprises, but at present, Canada has not concluded any tax information exchange agreements. Moreover, in its Final Report, the Advisory Panel recommended that the exemption from Canadian tax be extended to all active business income from all countries and to capital gains on the sale of shares of foreign affiliates.

Second, the foreign accrual property income (“FAPI”) rules are anti-deferral provisions that subject a Canadian taxpayer to current taxation of income that is passive or otherwise considered to be highly mobile, derived indirectly through a “controlled foreign affiliate”, regardless of whether the income is repatriated to Canada.

In considering the features of Canada’s foreign affiliate system, reference should also be made to the controversies described above regarding the financing of foreign operations.

2.4.6. Tax incentives

The federal government and many provincial governments provide tax incentives (other than reduced tax rates) in the form of tax credits and accelerated write-offs of qualifying expenditures for certain business activities. In addition, special tax regimes may apply to certain undertakings, notably, the exploration and development of resource properties. The applicable rules and eligibility criteria are complex and beyond the scope of this summary, but some of the more common tax incentives available federally and provincially are those for scientific research and experimental development and film and video production.

2.4.7. Transfer pricing

Canada regulates international intercompany transfer pricing matters on the basis of the arm’s length principle and has thus rejected formulary approaches to income taxation for income that is passive or considered to be highly mobile, derived indirectly through a “controlled foreign affiliate”. The charging provision is Sec. 91(1). Amounts in respect of foreign operations may also be attributed to a Canadian person under the non-resident trust and foreign investment entity rules in Secs. 94 and 94.1.


34. A taxable Canadian corporation is any “Canadian corporation” that is not exempt under the Act (i.e. other than Crown corporations and pension corporations).

35. But see Part IV of the Act on refundable tax.

36. A “foreign affiliate” (defined in Sec. 95(1)) of a taxpayer resident in Canada is a corporation not resident in Canada in respect of which the Canadian taxpayer’s “equity percentage” is not less than 1% and the total equity percentages of the taxpayer and of persons related to the taxpayer is not less than 10%. The terms “equity percentage” and “direct equity percentage” are defined in Sec. 95(4). The result of the combined operation of these expressions is to look through various levels of corporations to determine the Canadian taxpayer’s effective equity interest in the particular foreign corporation.

37. Defined in Regulation 5907(3): the term “designated treaty country” refers to a country with which Canada has entered into a comprehensive tax treaty that is in force and has effect for the taxation year of the affiliate in which it earned the active business income in question.


39. Sec. 95(1): “controlled foreign affiliate” of a taxpayer resident in Canada is mainly a “foreign affiliate” of the taxpayer controlled by the taxpayer.

40. The charging provision is Sec. 91(1). Amounts in respect of foreign operations may also be attributed to a Canadian person under the non-resident trust and foreign investment entity rules in Secs. 94 and 94.1.
allocation between units of a multinational group. Sec. 247(2) of the Act embodies Canada’s transfer pricing rule. Unlike the United States’ approach, ostensibly authorized by Sec. 482 of the US Internal Revenue Code, Sec. 247 of the Act contemplates determinations on a transaction-by-transaction basis only, although, in practice, profit comparisons and profit splits dilute the purity of this paradigm. Regarding both inbound and outbound transactions, the Act requires that the intercompany prices not differ from “those that would have been made between persons dealing at arm’s length”. Since 1999, Canada, following the lead of the US, has specific transfer pricing-related penalties and associated contemporaneous documentation requirements.41

In 2008, the Tax Court rendered Canada’s first “modern era” transfer pricing decision in GlaxoSmithKline Inc. v. Canada, 2008 DTC 3957, holding that Glaxo Canada acquired ranitidine (the active ingredient for its Zantac ulcer medication) from Glaxo Switzerland at an amount significantly in excess of the fair market value of ranitidine. The case, which has significant implications for Canadian transfer pricing disputes, has been appeal to the Federal Court of Appeal. The central issue on appeal is whether the Tax Court was correct in rejecting the relevance of related licensing arrangements between Glaxo Canada and the UK parent of the Glaxo group. The outcome of this litigation is closely watched in Canada and abroad.

2.5. Corporate distributions and appropriations

Actual and deemed dividends42 are generally taxable to the relevant shareholder. Dividends received by a Canadian resident individual are taxable on a grossed-up basis, subject to a dividend tax credit which reduces the effective tax rate on dividends paid by a taxable Canadian corporation and is intended to compensate (partly) for the underlying corporate tax paid by the payer. The dividend tax credit for certain “eligible dividends” paid after 2005 more fully compensates individual shareholders for the underlying corporate tax paid. As discussed above, taxable dividends received by a Canadian resident corporation from a taxable Canadian corporation are generally fully deductible to the recipient corporation.

Non-resident corporate and individual shareholders of Canadian corporations are subject to the dividend withholding tax on corporate distributions and appropriations (discussed below in 2.7.).

A shareholder of a Canadian private corporation, whether a Canadian resident or a non-resident, is generally entitled to the return of share capital free from Canadian tax (including Canadian withholding tax). This is an important planning point for non-residents acquiring shares of a Canadian private corporation, especially since its capital may be returned without first distributing earnings and profits by way of dividends (unlike in the United States).

2.6. Tax-deferred reorganization facilities

The Act permits many standard corporate reorganizations to be effected on a tax-deferred basis, but generally only in a purely Canadian domestic context. Unlike the potentially broader rules in Sec. 367 of the US Internal Revenue Code, Canadian corporations generally cannot effect, on a non-recognition basis, an “outbound” transfer of property to a foreign subsidiary unless the property constitutes shares of a foreign affiliate.43

Mergers between Canadian corporations are generally permitted on a rollover basis, and upstream (i.e. inbound) mergers of foreign subsidiaries into Canadian parents may also qualify for non-recognition treatment (Sec. 88(3)).

Reorganizations in respect of and involving only foreign subsidiaries in a group owned by a Canadian-based multinational often qualify for non-recognition treatment.44 Some reorganizations, such as share-for-share exchanges, are relatively straightforward from a technical perspective, but others, such as tax-deferred spin-offs, have complex statutory and administrative restrictions (see Sec. 55).

2.7. Withholding taxes

2.7.1. Non-final withholding taxes

To protect the government’s ability to collect tax from non-residents, the Act provides for two types of non-final withholding taxes in respect of the Canadian-source income derived by non-residents.45 First, fees, commissions and other amounts for services rendered in Canada by a non-resident are subject to a 15% non-final withholding tax, whether or not the amounts are exempt under an applicable tax treaty.46 Second, as described in greater detail in 2.9.2., a specific reporting and withholding mechanism applies to dispositions of most kinds of taxable Canadian property by non-residents.

2.7.2. Final withholding taxes

An actual or deemed resident of Canada who makes a payment to a non-resident in respect of most types of passive income, including interest, dividends, rents47 and royalties, is generally required to withhold tax at 25% on

.................................................................


42. Deemed dividends may be realized on certain transactions involving a Canadian corporation, such as redemptions, increases in stated capital, etc. See Sec. 85.1. But see Sec. 85.1(5) et seq. in respect of foreign-to-foreign portfolio share exchanges.

43. See Secs. 367(2)(c)-(e) as well as Secs. 87(8) and (8.1).

44. This is in addition to the deductions at source applicable to the employment income of both residents and non-residents.

45. If the services are rendered in Quebec, an additional 9% withholding tax applies. The Advisory Panel recommended that the withholding tax not be levied if a non-resident certifies that the income is exempt from Canadian tax under a treaty, see Final Report, supra note 32, Recommendation 7.3.

46. With respect to rent on real property situated in Canada, Sec. 216 allows a non-resident to pay the mainstream tax (under Part I of the Act) on the net income from real property instead of the final withholding tax (under Part XIII of the Act) on the gross rent.
the gross payment under Part XIII of the Act. Since 1 January 2008, however, interest that is not "participating debt interest" paid by a Canadian resident to an arm's length non-resident is exempt from withholding tax.

The 25% domestic withholding rate may be reduced by an applicable tax treaty. The typical treaty rate for interest is 10%. Significantly, further to the fifth protocol, the Canada–US tax treaty alone provides a zero rate of withholding for non-arm's length interest, to be phased in by 2010. For dividends, the typical treaty rate in most of Canada's treaties is 15%, but the rate is generally reduced to 5% if the recipient is a significant corporate shareholder (typically, a corporation that beneficially owns 10% or more of the voting shares of the dividend-paying corporation). None of Canada's treaties offers a withholding tax exemption for dividends. The typical treaty rate for royalties is 10%, but an exemption is generally provided for certain copyright royalties and, in some treaties, for patent and know-how royalties.

A partnership any of whose members is a non-resident is itself deemed to be a non-resident under the Act. Consequently, a payment by a Canadian resident to a partnership with any non-resident members, such as a foreign private equity or venture capital fund, is subject to the full withholding tax. Administratively, however, the CRA may permit the payer to look through the partnership and withhold based on the residence and treaty status of the members of the partnership.

Although the withholding tax is imposed on the non-resident recipient, the resident payer is required to deduct the tax and remit it to the CRA on behalf of the non-resident, failing which the resident payer becomes liable for the tax. A non-resident carrying on business through a Canadian branch may be deemed to be a resident of Canada for purposes of the withholding tax rules. The effect of these rules is to make certain payments, e.g. deductible interest, made by a non-resident to another non-resident subject to Canadian withholding tax.

2.8. Capital tax

The federal government imposes a capital tax on financial institutions at a rate of 1.25% of the "taxable capital employed in Canada" in excess of CAD 1 billion. The capital tax on corporations that are not financial institutions was abolished by the federal government for 2006 and subsequent taxation years.

Some provinces, including Ontario and Quebec, also impose their own capital tax on the taxable capital employed in the province. Ontario's capital tax is proposed to be phased out by mid-2010, and Quebec's capital tax by 2011.

2.9. Tax reporting and compliance

2.9.1. Tax returns

Canadian resident taxpayers are generally required to file an annual tax return (Sec. 150). A non-resident of Canada who, in a taxation year, has a taxable capital gain or disposes of taxable Canadian property (even absent a gain) is required to file a Canadian tax return in respect of that year unless the gain or disposition pertains to an "excluded disposition".

A non-resident corporation is required to file a Canadian tax return for any taxation year in which it carries on business in Canada directly or through a partnership. The filing obligation applies regardless of whether the non-resident is entitled under an applicable tax treaty to relief from Canadian tax. A non-resident individual carrying on business in Canada directly or through a partnership is also required to file a Canadian tax return, but only in respect of a taxation year in which the non-resident owes Canadian tax on the income from that business.

2.9.2. Sec. 116 certificates

A specific reporting and tax collection mechanism applies to dispositions of most kinds of taxable Canadian property by non-residents. A non-resident vendor must notify the CRA of such a disposition by filing a form with the particulars of the transaction. The non-resident is entitled to a certificate (commonly called a "Sec. 116 certificate") from the CRA if the non-resident satisfies the CRA that no Canadian tax is due or if the non-resident pays 25% of the gain on account of the ultimate tax liability.

In the absence of a Sec. 116 certificate, any person, whether a resident or non-resident of Canada, who acquires taxable Canadian property from a non-resident is required to withhold and remit to the CRA 25% of the purchase price or, if the non-resident vendor provides a Sec. 116 certificate, 25% of the amount (if any) by which the purchase price exceeds the limit indicated in the Sec. 116 certificate. The rate is increased to 50% for certain types of property, including depreciable property (e.g. machinery and equipment and buildings). If the property is "taxable Quebec property", an additional withholding applies (at 12%, or 30% if the 50% federal rate applies), and a separate provincial certificate must be obtained from the Quebec tax authorities. In other words, if the purchaser fails to obtain a satisfactory Sec. 116 certificate from the non-resident vendor or, in the alternative, fails to make the required withholding and remittance, the purchaser is liable for the amounts that should have been withheld and remitted.

These requirements do not apply to certain "excluded property" such as listed shares, units of a mutual fund trust and debt securities. Shares of a Canadian private corporation are not treated as excluded property and are, therefore, normally subject to the certificate regime. Effective 1 January 2009, as part of an initiative to reduce the administrative burden imposed by Sec. 116, the definition of "excluded property" was extended to include

48. Withholding does not apply if the amounts are attributable to a Canadian PE of the non-resident; see Regulations 400 and 805.
50. The capital tax is deductible for federal tax purposes.
“treaty-exempt property.” Under new Sec. 116(6.1), property will be treaty-exempt property at the time of its disposition by the non-resident if, at that time, it is treaty-protected property and, in the case of a disposition between related persons, the purchaser sends to the CRA, within 30 days after the date of disposition, a notice to be provided in new Sec. 116(5.02) setting out basic information about the transaction and the vendor.

The key notion, treaty-protected property, is defined in Sec. 248(1) as property any income or gain from the disposition of which by the taxpayer would, because of a tax treaty with another country, be exempt from Canada’s mainstream tax under the Act.

To deal with any uncertainty regarding the residence element of the status as treaty-protected property of the property being disposed of, new Sec. 116(5)(a.1) provides a supplemental rule which ensures that the purchaser of property from a non-resident vendor does not need to withhold if the following requirements, contained in new Sec. 116(5.01), are met: (a) the purchaser concludes, after a reasonable inquiry, that, under Canada’s tax treaty with a particular country, the vendor is resident in that country; (b) the property would be treaty-protected property of the vendor under that tax treaty if the vendor were resident in that country; and (c) within 30 days after the date of disposition, the purchaser sends to the CRA the notice provided in new Sec. 116(5.02), as described above. The reasonable inquiry safe harbour, however, does not apply to a determination of whether certain property is treaty-protected, thus leaving the purchaser exposed to liability under Sec. 116(5) if the conditions for treaty protection are not in fact met.

2.10. Anti-avoidance rules

The Act contains a broadly worded general anti-avoidance rule (“GAAR”) in Sec. 245 to prevent abusive avoidance transactions. The GAAR supplements the specific anti-avoidance provisions in the Act and the judicially developed anti-abuse doctrines. The GAAR is not intended to apply to a transaction which is undertaken primarily for bona fide commercial purposes other than to obtain a tax benefit or which does not result in an abuse of the provisions relied on by the taxpayer. If the GAAR applies, the CRA may redetermine the tax consequences of a transaction or series of transactions resulting in a tax liability for one or more participants in the transaction(s). The relevant case law shows that, in practice, there may be substantial uncertainty regarding the circumstances where the GAAR applies. A clear demonstration of this is the recent case, Lipson v. Canada, 2009 D.T.C. 5528, in which the Supreme Court split 4-2-1.

3. Canadian Corporations in Cross-Border Transactions

3.1. Establishing a business presence in Canada

3.1.1. Canadian branch versus Canadian corporation

In general, for foreign enterprises, there is little difference from a Canadian income tax perspective between carrying on business through a Canadian branch of a non-resident entity and carrying on business through a wholly-owned Canadian subsidiary. A Canadian-incorporated subsidiary of a non-resident corporation is a Canadian resident for Canadian income tax purposes and is therefore subject to tax in Canada on its worldwide income. Certain types of payments (including dividends, interest, rents and royalties) made by a subsidiary to its non-resident parent are normally subject to withholding tax, as discussed above (see 2.7.).

Similarly, Canada’s corporate tax will apply at the general rates to the profits attributable to an unincorporated branch of a non-resident corporation carrying on business in Canada. The Act imposes a 25% branch profits tax on the after-tax profits of the Canadian branch which are not reinvested in Canada. The branch profits tax is intended to parallel the dividend withholding tax.

Typically, for commercial reasons, it is preferable to carry on a Canadian business through a Canadian corporation. This is in part because the allocation of items of income and expense between the head office and Canadian branch and intercompany transactions may be unclear and can result in ambiguity in computing the branch’s income for purposes of the Act.

3.1.2. Capitalizing a Canadian corporation

A Canadian corporation may be capitalized with equity or with a combination of debt and equity. As noted above, the share capital of a Canadian private corporation can generally be returned to the shareholders free from Canadian tax, including the Canadian withholding tax applicable to non-resident shareholders. A distribution to a shareholder in excess of such share capital is a dividend for purposes of the Act. Deemed dividends to non-resident shareholders are subject to withholding tax in the same manner and at the same rate (including any reduced treaty rate) as regular dividends. Dividends are not deductible in computing the income of the payer corporation.

Repayment of the principal loaned to a Canadian corporation by a non-resident shareholder is not subject to withholding tax but, where applicable, tax must be withheld on the interest paid or credited on the loan. Subject to the thin capitalization rule discussed below and the general limitations on interest expense and losses described above, a Canadian subsidiary may deduct the

52. The Advisory Panel recommended further amendments to Sec. 116; see Final Report, supra note 32, Recommendations 7.4 and 7.5.
54. Its rate is reduced in accordance with dividend withholding tax rates in Canada’s treaties.
55. See Cudd Pressure Control Inc. v. R., 98 D.T.C. 6630 (FCA), which dealt with the treatment of intercompany rent under the 1942 Canada–US tax treaty; see also Annex B to the fifth protocol to the 1980 Canada–US tax treaty.
interest paid or credited by it to a non-resident in computing its income.

Considering the above, if a foreign corporation is subject to an effective foreign tax rate that is lower than the Canadian rate applicable to the Canadian investee corporation, it would seem desirable to structure an investment in the Canadian subsidiary through interest-bearing debt. In planning such a basic earning stripping arrangement, of prime importance is Canada's thin capitalization rule in Sec. 18(4) et seq.

The rule is intended to prevent a Canadian-incorporated subsidiary from excessively reducing its taxable Canadian profits, and hence its Canadian tax liability, by maximizing its interest expense to related non-resident creditors. In very general terms, under Sec. 18(4) et seq. of the Act, the interest paid on loans to foreign shareholders is normally fully deductible except to the extent of the interest relating to that portion of the loans received from 25% or greater foreign shareholders which exceeds two times the equity of the corporation attributable to such shareholders (measured by reference to paid-in capital and retained earnings). In this respect, compared to the more complex and uncertain thin capitalization effects of Secs. 385 and 163(j) of the US Internal Revenue Code, Canada's statutory thin capitalization rule is relatively well understood and conceptually simple. Also, under the current rules, the thin capitalization restrictions apply only to corporate borrowers.

Foreign multinational enterprises seeking to reduce their overall tax burden may depart from the basic earning stripping model and implement a more complex financing structure involving intermediary financing companies. In this respect, at present, the case law provides comfort with regard to properly implemented non-abusive inbound treaty shopping structures involving Canada's treaties.

3.2. Purchase and sale of a Canadian business

3.2.1. Overview

As in countries like the United States, in general terms under Canadian tax law, a purchaser wants to buy assets and a seller wants to sell shares. An asset acquisition permits the full price paid to be allocated to the various assets acquired for purposes of tax deductibility. Subject to certain constraints (see Sec. 68), a purchaser would seek maximum allocation to assets that are eligible for the fastest deductions, such as inventory and depreciable capital property with a high write-off rate.

Conversely, a seller generally desires a share sale because it provides for capital gain treatment (effectively, taxation of only half the gain) or, in the case of a non-resident seller, the gain may be eligible for treaty exemption; whereas an asset sale has the opposite of the effects noted above for the purchaser in an asset transaction, namely, possible full tax liability on certain items sold, such as inventory or depreciable capital property (where the capital cost allowance previously claimed must be recaptured).

3.2.2. Benefits of an acquisition corporation

If a Canadian business is acquired by way of a purchase of shares, it is generally advisable for the purchaser to interpose a special purpose Canadian “acquisition” corporation, which provides four main benefits. First, it ensures that the foreign investor’s equity can eventually be extracted from Canada free from Canadian tax. Second, it can allow for a step-up in basis. In this respect, in a share acquisition, the purchaser inherits the historical cost base of the target’s assets. If, however, the acquisition is structured through a Canadian acquisition corporation, a post-acquisition merger may permit a tax-free step-up in the cost base of non-depreciable capital property. Third, using a Canadian acquisition company provides a basis for efficient financing. Finally, it accommodates exchangeable-share transactions of the type discussed below.

3.2.3. Exchangeable-share transactions

An exchangeable-share structure is used mainly in merger and acquisition situations where a foreign party takes over a Canadian target in a share-for-share transaction and where the selling Canadian shareholders of the Canadian target want the sale to be effected on a tax-deferred basis.

56. The Advisory Panel suggested that the debt-to-equity ratio be reduced to 1.5:1. See Final Report, supra note 32, Recommendation 5.1. See also Boidman, supra note 33.

57. The Advisory Panel suggested that the thin capitalization rule be extended to partnerships, trusts and Canadian branches of non-resident corporations; see Final Report, supra note 32, Recommendation 5.2.


59. See Kandev, M., “Treaty Shopping in Canada: The Door is Still Open”, Bulletin for International Taxation 10 (2008), at 463; and Boidman, N. and M. Kandev, “News Analysis: Canadian Taxpayer Wins Prévost Appeal,” 53(10) Tax Notes International 862 (9 March 2009). In recommending that there be no additional initiatives against treaty shopping, the Advisory Panel stated: “The Panel believes that businesses should be able to organize affairs to obtain access to treaty benefits”, Final Report, supra note 32, Para. 5.68.

60. In its recent decision in Collins & Aikman Products Co. v. Canada, 2009 TCC 299, the Tax Court of Canada stated (Para. 88): “Non-residents holding their Canadian operating companies through a Canadian holding company is pretty much standard operating procedure. It is fair to say that not to do so is the exception. This is Tax 101.”

61. See Secs. 88(1)(c) and 87(11). This may be of particular interest in respect of the post-acquisition spin-off of unwanted subsidiaries or divisions (pre-packaged subsidiaries prior to acquisition). See Boidman, N. et al., “M&A Forum: Unwinding or Otherwise Dealing With ‘sandwich’ Structures Resulting from an International Merger or Acquisition,” 34(6) Tax Notes International 601 (10 May 2004).


An exchangeable-share transaction involves a selling Canadian shareholder exchanging its shares of the Canadian target for the ‘exchangeable shares’ of either a Canadian subsidiary (used to acquire the target) of the foreign purchaser or the target itself. Such shares are designed to track the common shares of the foreign purchaser and can be exchanged for those shares. Certain safeguards may be implemented, such as through a support agreement and/or a voting and exchange trust agreement, in order to protect the rights of the holders of the exchangeable shares. For Canadian tax purposes, the acquisition of exchangeable shares qualifies for rollover treatment, and a capital gain is recognized only when the exchangeable shares are ultimately exchanged for shares of the foreign purchaser. An exchangeable-share structure effectively allows a selling Canadian shareholder to economically exchange its shares of the target for shares of the purchaser on a tax-deferred basis.

An exchangeable-share transaction is a practical, but complex, solution to the absence of rollover treatment under the Act for a Canadian resident shareholder who exchanges shares of a Canadian corporation for shares of a foreign corporation (i.e. an outbound rollover). In 2000, the Federal Department of Finance announced that it would develop a cross-border share-for-share exchange rollover rule to apply to share-for-share exchanges where a Canadian resident shareholder receives only share consideration on the exchange. Unfortunately, while the government’s commitment to this measure was reaffirmed on several subsequent occasions, it now seems to be accepted that no such rule will be implemented in the near future.

3.3. Canadian corporations as holding entities

The Act, unlike the tax laws of other countries, does not offer a special regime for holding entities. Nonetheless, it may be desirable for a non-resident of Canada to hold Canadian or foreign investments through a Canadian corporation.

3.3.1. Taxation of Canadian holding corporations

Before 2009, a passive holding corporation would, subject to uncertainties due to factual matters and the rebuttable presumption that a corporation has a business, generally be subject only to the federal tax in Canada at the unabated corporate tax rate (currently 29%) and would not have any provincial tax liability.

Effective 2009, this has changed with the addition of the deeming rule in new Regulation 400(2)(e.1) (described above). In essence, the general effect of the change is that every corporation formed in Canada that is completely passive is entitled to the abated (i.e. reduced by 10 percentage points) corporate tax rate and that corporations formed under the laws of the provinces which piggyback on the federal corporate tax system (all but Quebec and Alberta) are subject to provincial taxation in the province of formation.

Therefore, for a holding corporation, Regulation 400(2)(e.1) makes the choice of the place of incorporation very important because, as mentioned above (see 2.4.1.), the current provincial corporate tax rates range from 10% to 16%. The new system applicable to holding corporations currently does not allow for any arbitrage compared to the provincial abatement (10 percentage points), but this will change as New Brunswick will reduce its corporate tax rate to 8% by 2012. Moreover, regarding holding corporations formed in Quebec, Regulation 400(2)(e.1) seems to have created a unique planning opportunity: because Quebec does not piggyback on the federal corporate tax system and does not have a deemed PE rule similar to the new rule, a Quebec holding corporation with no PE in Quebec would seem to be entitled to the abated federal corporate tax rate and would not be subject to a provincial tax. The resulting current tax rate in this case would be 19% and, by 2012, 15%. Unless the Quebec government decides to eliminate this situation, this may make Quebec an internationally competitive location for holding corporations.

3.3.2. Unlimited liability companies

One specific type of Canadian entity, called “unlimited liability company” or “ULC”, has been very popular with US investors, particularly as a holding corporation. The widespread use of ULCs arose out of the adoption of the US check-the-box rules in 1997, which was accompanied by a proliferation outside the US of hybrid entities that are regular corporations in their home jurisdiction, but can elect flow-through tax treatment for US purposes. In this context, lawyers in the province of Nova Scotia dusted off an antiquated piece of provincial legislation that provides for the creation of ULCs under Nova Scotia law. More recently, Alberta and British Columbia amended their corporate statutes in 2005 and 2007, respectively, also to allow for the creation of ULCs.

For Canadian tax purposes, a ULC is a regular corporation, but for US tax purposes, it is not a per se corporation and is treated as a flow-through entity.

ULCs have been used by US investors because, from the standpoint of US tax planning, the preferred strategy has been to elect flow-through status for US-owned business...
vehicles, whether formed in the US or abroad. The traditional benefit of this choice has been to avoid classical corporate-shareholder double taxation on distributed profits of an association taxable in the US as a corporation.\(^{72}\) In addition to the base strategy of avoiding double taxation, the use of flow-through hybrid entities in an international context has provided US parties with opportunities to reduce their overall group taxes. This is seen, for example, in the way US multinational enterprises have been financing and structuring their controlled foreign affiliates.\(^{73}\)

Now, however, the use of ULCs (and, in particular, Nova Scotia ULCs) has been compromised.\(^{74}\) This is because, under new Art. IV(7)(b) of the Canada–US tax treaty, effective after 2009, treaty benefits may be denied to US residents in respect of payments made by ULCs. In addition, new Regulation 400(2)(e.1), discussed above, may significantly increase the tax burden on certain US-owned Nova Scotia ULCs. Under the current rules, a Nova Scotia ULC that is a completely passive investment holding corporation would not have a PE in Nova Scotia under Regulation 400 and hence would be taxable only at the unabated federal rate (29% in 2009). Under the new rules, however, that Nova Scotia ULC will be subject to the combined provincial-federal rate (35% in 2009), i.e. a 60% increase in the provincial element of its tax burden and a 20% increase in its total tax bill. Considering the above, US investors using ULCs may want to take steps to restructure their arrangements.

### 3.3.3. Holding foreign investments through a Canadian corporation

It may sometimes be beneficial for foreign multinational enterprises (especially those based in the US) to organize partial or complete ownership of their foreign operating subsidiaries under a Canadian top holding corporation. Such arrangements usually arise only if there is a profitable Canadian subsidiary in the group. In those circumstances, there can be various Canadian tax benefits which may not necessarily be clawed back under the tax laws of the residence country of the group’s ultimate parent.

For example, using the profits of a Canadian operating subsidiary to fund third-country group members can defer the Canadian withholding tax on distributions to the parent. Funding third-country group members through the borrowings of a Canadian subsidiary can reduce the exposure to Canada’s mainstream corporate tax.\(^{75}\) In addition, the foreign affiliate rules described above can accommodate various types of intercompany licensing or financing arrangements, which may serve to reduce the taxable operating income of a third-country subsidiary, while not attracting FAPI attribution to the Canadian top holding corporation.\(^{76}\)

---

72. This benefit was substantially reduced when the US adopted a 15% tax for US individual taxpayers on US (and certain other, including Canadian) corporate dividends. However, the sunset of this relief, scheduled for 31 December 2010 (which would, if not extended, terminate this special rate) still makes it generally desirable to choose flow-through treatment. See Boidman, N., “Financing U.S.-owned Canadian Subsidiaries – An Update in Light of Recent U.S. Legislation”, Tax Management International Journal (11 August 2006), at 404. Separately, President Obama’s February 26, 2009 Budget proposed to increase this rate to 20%.

73. In some cases, however, the enactment in 2006 (with a sunset) of Sec. 954(c)(6) of the US Internal Revenue Code obviated the need to use hybrid entities to achieve financing-related group benefits.


75. Some of these arrangements may come within tax planning structures called ‘debt-dumping’, criticized by the Advisory Panel in its Final Report, supra note 32. The Advisory Panel recommended that the government further study this matter, as fully described in Boidman, supra note 33. As well, amendments to Sec. 17 about ten years ago curtailed some of the financing-related arrangements, such as those that survived a government challenge in Univar Ltd. v. Canada, 2005 D.T.C. 1478 (TCC).

76. As noted earlier (see note 30, supra), Sec. 95(2)(a) reclassifies, in appropriate circumstances, what would otherwise be passive intercompany payments included in FAPI as active business income, which can also be eligible for tax-free repatriation to Canada.