CASSELS BROCK
LAWYERS

Taxation

Doing Business In Canada

There are several significant tax implications for companies carrying on business in Canada. Some of the primary tax considerations are described below.

How is Income Taxed in Canada?

Generally, Canada imposes income tax based on a person's residency. Persons who are resident in Canada within the meaning of the *Income Tax Act* ("**the Act**") are liable for tax on their worldwide income. A "person" includes an individual, a corporation or trust. A partnership calculates its income as if it were a person, but the income (or loss) of a partnership is allocated among the partners for tax purposes and the partners are subject to tax thereon. Note that an individual may live outside Canada and still be resident in Canada for tax purposes.

A person who is a non-resident of Canada is subject to Canadian tax on income or gains from a Canadian source, which includes a business carried on in Canada. The amount of Canadian income tax payable may be reduced or eliminated via a tax treaty that Canada has entered into with the non-resident person's country of residence.

How do you Determine Residency for Tax Purposes?

An individual is considered to be a resident of Canada if Canada is the place where that person regularly and customarily lives. Certain rules in the Act also deem an individual to be resident in Canada.

A corporation is deemed to be resident in Canada if it was incorporated in Canada after April 26, 1965 or, if incorporated in Canada before that time, it was resident (or carried on business) in Canada at any time after that date. A corporation incorporated outside Canada is considered resident in Canada if its central mind and management are located in Canada.

Trusts are resident in the jurisdiction where the management and control of the trust takes place.

A person (including a corporation) that would otherwise be considered to be resident in both Canada and another country under their respective domestic laws may be entitled to relief under the "tie breaker" rules contained in a tax treaty between Canada and the other country.

What Constitutes Income from Carrying on Business in Canada?

A non-resident is taxable on its income from carrying on business in Canada, subject to tax treaty relief. Case law considers a business to be "anything which occupies the time and attention and labour for the purpose of profit." The Act defines a business to include a profession, calling, trade, manufacture or undertaking of any kind whatever, including an adventure or concern in the nature of trade. The Act also deems certain activities to constitute carrying on business in Canada.

What Tax Applies to Income from Employment in Canada?

A non-resident is taxable in Canada on income from employment duties performed in Canada, subject to tax treaty relief. Such income is taxed at graduated tax rates for individuals (see below). An employer, including a non-resident employer, paying salary to a non-resident for employment duties performed in Canada must withhold and remit to the Canada Revenue Agency ("**CRA**") Canadian withholding taxes and other source deductions on the salary (unless a waiver has been obtained from the CRA).

Current as of May 2017

How are Gains from the Disposition of Taxable Canadian Property Taxed in Canada?

A non-resident is taxable in Canada on capital gains from the disposition of "taxable Canadian property," subject to the application of a tax treaty. In general terms, taxable Canadian property includes real property situated in Canada, assets used in a business carried on in Canada, and certain equity interests in corporations, partnerships and trusts that at any time in the prior 60 months have derived more than 50% of their fair market value from real property or resource properties situated in Canada. In some cases, a purchaser of taxable Canadian property from a non-resident vendor is required to withhold and remit 25% to 50% of the purchase price to the CRA unless the vendor obtains a clearance certificate indicating that any Canadian tax arising from the disposition has been paid.

What Tax Rates Apply to Income Earned in Canada?

Taxpayers are generally subject to tax at both the federal and provincial level. The calculation of an individual's federal income tax is based on a progressive system. Most provinces also have a progressive tax rate system. The combined (federal and provincial) top personal marginal tax rate for interest and regular income for an individual (depending on the province) ranges from 44% to 54%. Dividends and capital gains receive favourable tax treatment.

Most corporations that are taxable in Canada pay a flat rate (federal and provincial combined) between 26% and 31% on active business income, depending on the province. Canadian-controlled private corporations and corporations involved in manufacturing and processing receive favourable tax treatment. Some provinces also provide tax benefits for new businesses.

Branch Tax

In addition to the tax rates set out above, a branch tax of 25% (which may be reduced by a tax treaty) is generally levied on the after-tax business profits (less certain deductions) of a non-resident corporation carrying on business in Canada through a branch, rather than through a Canadian subsidiary corporation.

Withholding Taxes on Amounts Paid to a Non-Resident for Services Performed in Canada

The Act generally requires every person, including a non-resident, who pays a non-resident person a fee, commission or other amount in respect of services physically performed in Canada to withhold and remit 15% of such payment to the CRA

Withholding Taxes on Passive Income Paid by a Person Resident in Canada to a Non-Resident

The Act requires a person resident in Canada to withhold and remit 25% of the gross amount of certain payments to a non-resident, subject to tax treaty relief to the CRA. The principal payments that may attract withholding tax include:

- Dividends, including dividends deemed to have been paid pursuant to the Act;
- Interest that is: (i) "participating debt interest,"
- or (ii) paid by a Canadian borrower who does not deal at arm's length with the non-resident lender;
- Management and administrative fees; and
- Royalties.

Transfer Pricing

Under the transfer pricing rules in the Act, the CRA may adjust a Canadian taxpayer's income and apply penalties if the Canadian and a non-arm's length non-resident person participate in a transaction the terms and conditions of which differ from those that would have been made between persons dealing at arm's length.

Harmonized Sales Tax

The provinces of Ontario, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland & Labrador (the "Participating Provinces") have combined the 5% federal goods and services tax ("**GST**") and their respective provincial retail sales tax to form a harmonized sales tax ("**HST**"), with HST rates at either 13% or 15%. The federal government administers HST and then remits the appropriate amounts owing to the Participating Provinces. Generally, businesses that supply taxable or zero-rated goods and services can recover the GST/HST paid or payable on goods and services that were acquired in the

course of their commercial activities by claiming input tax credits. The HST is effectively a tax on the end-users of a product or service.

Provincial Sales Taxes

Most of the “non-HST” provinces impose a retail sales tax (ranging from 6% to 8%) on personal property and certain services purchased for consumption rather than resale. Alberta does not impose a provincial sales tax, while Québec’s 9.975% sales tax is similar to the federal GST.

Tax Considerations regarding Canadian Mergers and Acquisitions

There are several Canadian federal income tax considerations applicable to mergers and acquisitions:

Non-Resident Purchaser Income Tax Considerations

It is generally favourable for a non-resident to establish a Canadian acquisition corporation to effect the acquisition. Where a Canadian acquisition corporation is a direct purchaser of a Canadian target: (1) there may be more cross-border paid-up capital to be repatriated free of Canadian withholding tax; (2) the transaction may qualify for a tax-free rollover if there is share consideration payable to the vendors; and (3) it may be possible to invoke the “bump” rules to permit a step-up in the tax cost of qualified property up to fair market value at the time of acquisition of control. A non-resident purchaser should also consider any applicable tax treaty benefits when selecting the entity to make the investment into Canada.

The most tax efficient (internal and/or external) financing of the purchase must be considered, particularly if a significant amount of cash is part of the purchase price. Generally, a Canadian acquisition corporation, as borrower, would amalgamate with the Canadian target so that the interest expense would offset the target’s income. The amalgamation of two or more taxable Canadian corporations can occur on a tax-deferred basis. Withholding tax must be considered if there is a non-resident lender.

A non-resident purchaser should also consider the potential application of certain rules in the Act affecting international tax structures which could lead to unfavourable consequences, including rules dealing with the following:

- Thin capitalization
- Surplus stripping
- “Foreign affiliate dumping”
- “Upstream loans” from foreign affiliates
- “Back –to-back” rules

A non-resident must consider the effects of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (“**MLI**”) when determining the appropriate tax structure.

If the target has foreign subsidiaries, Canadian and foreign tax considerations may apply to the purchaser, including the controlled foreign corporation rules in the Act.

Note that there are potential adverse tax implications for a purchaser who accommodates a full or partial tax-free rollover where the consideration wholly or partly consists of its shares, such as reductions in the tax cost of purchased shares or assets and the amount of cross-border paid-up capital that might otherwise result from a transaction that does not occur on a rollover basis.

A non-resident purchaser should consider the tax attributes and the special status of any outstanding shares of the target. Any post-closing integration and restructuring issues will have tax considerations and associated costs.

Vendor Income Tax Considerations

A vendor who is a non-resident of Canada must consider the tax consequences of a sale transaction in its home jurisdiction and under the Act. For example, a transaction such as a share-for-share exchange that qualifies for tax-deferred treatment in Canada may not so qualify in the vendor’s country of residence. As discussed above, a non-resident vendor is generally not subject to Canadian income tax on a capital gain realized on a disposition of property unless the property is “taxable Canadian property” of the vendor.

It may be possible for a vendor to engage in a pre-closing transaction that reduces the amount of Canadian tax that would otherwise be payable. For example, the payment of a tax-free dividend to (or the creation of a deemed dividend for) a Canadian corporate shareholder of a target pre-closing may reduce the capital gain realized by the vendor on the sale of the target subject to detailed rules.

Vendors must also consider the impact of the acquisition on existing employee bonus, retirement and equity compensation plans.

Target Income Tax Considerations

Where there is an acquisition of control of the corporation, the Act applies rules ranging from tax compliance to more substantive provisions. A target that is a "Canadian-controlled private corporation" prior to the sale may lose this status, resulting in the target's loss of refundable tax credits and the small business deduction.

CASSELS BROCK
LAWYERS

Cassels Brock & Blackwell LLP
Toronto | Vancouver | Calgary
casselsbrock.com