# Canada: Taxation Law Overview


Stikeman Elliott LLP

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# Canada: Taxation Law Overview

## Income Tax

### General

Residents of Canada are subject to tax on their worldwide income (including capital gains) under the *Income Tax Act* (Canada) (the "ITA") and the relevant provincial tax legislation. Non-residents of Canada are generally subject to tax only on their Canadian source income, including income from a business or employment carried on or performed in Canada, and taxable capital gains from the disposition of "taxable Canadian property" (as defined). Although each province has also enacted provincial income tax legislation, only Alberta and Quebec administer their own corporate income taxes, and only Quebec administers its own individual income taxes. Other provinces rely upon the federal government to collect taxes on their behalf.

### Taxation of Canadian Residents (Basic Principles)

#### Individuals

An individual who is resident in Canada is subject to tax on his/her worldwide income (including capital gains). Whether an individual is resident in Canada is a question of fact to be determined on a case-by-case basis. However, as a general rule, an individual is considered to be resident in the country in which he or she "ordinarily resides", being generally the place where he or she maintains a home to which he or she regularly returns, or the place where he or she maintains significant social, economic or family ties. Further, an individual is deemed to be resident in Canada throughout the year if he or she "sojourns" (is physically present) in Canada for an aggregate of 183 days or more during the calendar year. An applicable tax treaty might resolve questions as to which of two countries an individual is resident.

Federal individual tax rates are progressive, and tax brackets are indexed annually for inflation. Generally, the provinces/territories utilize a "tax-on-income" system, in which they levy provincial/territorial income tax as a percentage of the federal calculation of taxable income. The 2017 marginal federal income tax rates for individuals range from 16.5% to 33%, with the highest marginal rate applicable to taxable income in excess of $202,800. The top marginal federal and provincial/territorial combined rates vary by province/territory from 44.50% in Nunavut to 54% in Nova Scotia.

#### Corporations

Like individuals, corporations resident in Canada are taxed on their worldwide income. Whether a corporation is resident in Canada is also a question of fact to be determined on a case-by-case basis. A corporation is generally considered to be

resident in Canada for income tax purposes if its central management and control is exercised in Canada. Further, a corporation is deemed by the ITA to be resident in Canada if it was incorporated or continued into Canada. An applicable tax treaty might resolve questions as to which of two countries a corporation is resident.

In general, the federal income tax rate for general corporations for the 2017 taxation year is 15%. Provincial corporate income tax rates for 2017 range from 11% to 16%.

### Partnerships

Partnerships are not themselves subject to Canadian income tax, as partnerships are treated as flow-through entities for Canadian income tax purposes. However, partnerships are treated as separate entities solely for purposes of computing the income or loss of the partners thereof. Once income is computed at the partnership level, such income is allocated among the partners of the partnership in accordance with their respective interests in the partnership. Partnership losses also flow-through to the partners, although special rules may apply to limit the amount of losses that may be claimed by limited partners in certain circumstances.

### Trusts

In general, trusts resident in Canada are taxed as separate legal entities in a similar manner to the taxation of individuals. However, *inter vivos* trusts (trusts arising other than on the death of the settlor) do not benefit from graduated tax rates, but rather are taxed only at the highest marginal rate. Amounts distributed to beneficiaries are generally deductible in computing the trust's income such that, to the extent all income of the trust is paid or payable to the beneficiaries each year, the trust would have no liability for income tax. In general, trusts are deemed to realize any accrued gains and losses on the property of the trust every 21 years.

Publicly traded trusts and limited partnerships and their unitholders are taxed in a manner similar to corporations and their shareholders pursuant to Canada's "specified investment flow-through" entity rules. However, .important exemptions from such rules exist for certain real estate investment trusts (REITs) and cross-border oil and gas trusts and royalty trusts.

## Taxation of Non-Residents of Canada (Basic Principles)

Non-residents of Canada are subject to Canadian tax on employment income performed in Canada, income from a business carried on in Canada, and taxable capital gains from the disposition of "taxable Canadian property" except, in all cases, to the extent exempted by an applicable tax treaty. In general, taxable Canadian property includes:

- real property situated in Canada;
- property used in carrying on business in Canada;

- unlisted shares of corporations or interests in partnerships or trusts, if more than 50% of the value of which was derived from one or a combination of real properties situated in Canada, Canadian resource properties or timber resource properties at any time during the 60 months that ends at the date of disposition; and
- listed shares of a corporation if at any time during the 60 month period that ends at the date of disposition both: (A) more than 50% of the value of such share was derived from one or a combination of real properties situated in Canada, Canadian resource properties or timber resource properties; and (B) the taxpayer, persons with whom the taxpayer did not deal at arm's length and partnerships in which the taxpayer or a person with whom the taxpayer is not dealing at arm's length holds a membership interest, owned 25% or more of the issued shares of any class of shares of the corporation.

Provincial income taxes will generally be payable by a non-resident of Canada on taxable income earned in a province where the non-resident carries on business through a permanent establishment situated in that province (or is otherwise deemed to have a permanent establishment in a province) and on employment income reasonably attributable to duties performed in that province.

### Carrying on Business in Canada

The ITA provides that a non-resident of Canada is subject to Canadian income tax if the non-resident is carrying on business in Canada, but only to the extent of the income earned from that business. Under the common law principles, generally a person is considered to carry on business in Canada if the person concludes contracts in Canada or if the operations from which the profits arise are located in Canada. The ITA otherwise extends the common law principles in this respect by deeming a person to be carrying on business in Canada if the person:

- produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada; or
- solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is completed inside or outside Canada or partly in and partly outside Canada.

### Treaty Relief from Canadian Taxation of Business Profits

Canada's tax treaties generally follow the OECD Model Tax Convention on Income and Capital. Under Canada's tax treaties, business profits are generally only taxable in Canada to the extent that the non-resident has a "permanent establishment" in Canada. A permanent establishment generally means a fixed place of business in Canada through which the business of the entity is wholly or partly carried on. Under the Canada-U.S. Income Tax Convention, for example, the term "permanent establishment" includes a place of management, branch, office, factory, workshop, and a mine, oil or gas well, a quarry, or any other place of extraction of natural resources. Generally, tax treaties also provide that if a non-resident person carries on business in Canada through an agent, the non-resident has a permanent

establishment in Canada if the agent habitually exercises authority in Canada to conclude contracts in the name of the non-resident.

### Withholding Taxes

Amounts paid or credited by a resident of Canada to a non-resident person with respect to most forms of passive income (including dividends, interest, rents and royalties) are generally subject to Canadian non-resident withholding tax on the gross amount of such payments. The rate of Canadian non-resident withholding tax under the ITA is 25%, subject to reduction under an applicable tax treaty. For example, the Canada-U.S. Income Tax Convention limits the Canadian withholding tax on dividends paid by a corporation resident in Canada to a resident of the U.S. to 15% (or 5% where the recipient is a corporation that owns at least 10% of the voting shares of the payor).

Under the ITA, there is no Canadian non-resident withholding tax on interest paid or deemed to be paid by a Canadian resident person to a non-resident person with which the payor deals at arm's length and where the interest is not considered to be "participating debt interest". Under the Canada-US Income Tax Convention, Canadian withholding tax on arm's length and non-arm's length payments of non-participating debt interest to U.S. persons is generally nil.

### Disposition of Property by Non-Residents

Subject to certain exceptions, section 116 of the ITA requires a non-resident vendor of "taxable Canadian property" (defined above) to apply to the Canada Revenue Agency (CRA) for a clearance certificate with respect to the disposition or proposed disposition of such property either before the disposition or within 10 days after the disposition. A clearance certificate will be issued if the non-resident either pays 25% of the (estimated) capital gain on the (proposed) disposition as a pre-payment of the non-resident's Canadian tax payable, or furnishes security acceptable to the CRA in lieu thereof.

The above requirement does not apply to certain types of excluded property, which includes listed shares, units of a mutual fund trust, bonds, debentures and property any gain from the disposition of which would, because of a tax treaty with another country, be exempt from Canadian tax (provided, in certain cases, notification is given to the CRA).

In an arm's length sale of such property, the purchaser will generally require the section 116 certificate on the closing date, absent which they will generally withhold 25% of the purchase price until such a certificate is provided (as the failure to obtain a section 116 certificate or, in the alternative to make the required 25% withholding and remittance, will make the purchaser liable for the amounts that should have been withheld and remitted).

Similar rules also apply at the Quebec level if the non resident disposes of "taxable Quebec property".

## Types of Income

### Capital Gains and Capital Losses

One of the most important Canadian income tax incentives is the effective reduction in the rate of tax on capital gains. Only one-half of any realized capital gains are included in the calculation of a taxpayer's taxable income. Correspondingly, one-half of any capital loss is deducted from any taxable capital gains of the taxpayer in the year the capital loss arose, and any excess net capital losses may be carried back to any of the three previous taxation years or carried forward to any subsequent taxation year.

### Dividends

Generally, dividends received by Canadian resident individuals from corporations resident in Canada are subject to a "gross-up and credit" mechanism designed to compensate for the fact that the dividend has effectively already been taxed in the hands of the corporation. The gross-up and tax credit mechanisms help to provide a rough level of parity between income earned directly by the individuals (or through a partnership) and income earned through a corporation (referred to as "integration"). The dividend tax credit for "eligible dividends" more fully compensates Canadian individual shareholders for the underlying corporate tax paid. Eligible dividends are, generally, any taxable dividends designated by the corporation and paid from a pool of income that was not subject to a reduced or preferential corporate tax rate. The effect of this gross-up and credit is an effective reduction in the tax rate for dividends. If the dividend is paid by a non-resident corporation, the gross-up and credit mechanism is not available.

Generally, dividends received by a corporation resident in Canada from another corporation resident in Canada are included in, and then fully deductible from, the recipient's income provided such dividends were paid from the retained earnings of the corporate payor. Consequently, dividends paid between two Canadian resident corporations generally flow tax free. However, private corporations and certain other corporations must pay a refundable tax of 38 1/3 % of the dividends received, which taxes can be recovered once they will pay dividends to their shareholders. Dividends received by corporations resident in Canada from corporations not resident in Canada are fully included in the recipient's income without a corresponding deduction, unless such dividends are paid out of the active business income of a non-resident corporation that is a "foreign affiliate" of the Canadian resident corporation resident in a specified treaty jurisdiction.

### Foreign Source Income

Canadian residents are taxed on their worldwide income, including foreign source income. Where another country also taxes that foreign source income, an applicable tax treaty may resolve which country has jurisdiction to tax that foreign source income. Where tax is imposed by both countries, Canada has a foreign tax credit

system that provides relief, where certain conditions are satisfied, with respect to such foreign taxes.

Certain types of passive income, defined in the ITA as foreign accrual property income (FAPI), are included in the income of a Canadian taxpayer when earned by a "controlled foreign affiliate" (CFA) of the taxpayer. The ITA also contains a set of rules that deal with investments in offshore investment fund property which includes interests in non-resident entities (other than CFAs) that are established for tax deferral / avoidance purposes.

## Employment Income

Employment income is subject to deductions at source. All employers that have employees carrying out their duties of employment in Canada, regardless of their residency status, are required to register with the CRA and must withhold and remit tax to the Canadian taxing authority with respect to salaries, wages and taxable benefits paid to such employees. Employers are also required to pay and remit certain payroll taxes with respect to the Canada Pension Plan (or Quebec Pension Plan), Employment Insurance, a workers' compensation program and, in certain provinces, health and training taxes.

The Canada Pension Plan (CPP) contribution rate for 2017 applicable to both employers and employees is 4.95%. The maximum pensionable earnings for 2017 is $55,300 with a maximum contribution by each of the employer and the employee of $2,564.

The Employment Insurance contribution rate for 2017 applicable to employers is 2.28%, and the contribution rate applicable to employees is 1.63%. The maximum insurable earnings for 2017 is $51,300, resulting in a maximum contribution by employers of $1,171 and a maximum contribution by employees of $836.

The grant of employee stock options is generally not considered a taxable benefit to employees resident in Canada. However, once the option is exercised (and assuming the issuer is not a "Canadian-controlled private corporation" ("CCPC"), as a further deferral may be available), the employee is deemed to have received a taxable employment benefit equal to the difference between the exercise price and the fair market value (FMV) of the shares on the date of exercise. Provided that certain conditions are satisfied, only one-half of the employment benefit is included in the employee's income (with the consequence that the employment benefit is effectively taxed at the same rate as a capital gain). These conditions include a requirement that the exercise price must be at least equal to the FMV of the underlying shares on the date of grant of the option.

## Other Income Tax Issues

### Non-Capital (or Operating) Losses

Non-capital losses (business losses) are deductible against business income in the year such losses arise. In addition, excess non-capital losses can be carried back three years or forward twenty years to reduce taxable income in those years. There are no consolidated returns in Canada, such that the profits of one corporation in a related group cannot simply be offset by losses in another, absent the use of certain loss-utilization transactions.

### Anti-Avoidance

The ITA and most provincial income tax legislation contain a general anti-avoidance rule known as the "GAAR". The GAAR can allow the recharacterization of the tax consequences of a particular transaction where (1) a tax benefit results, directly or indirectly, from the transaction or a series of transactions; (2) the transaction or series of transactions cannot reasonably be considered to have been undertaken or arranged primarily for a *bona fide* purpose other than obtaining a tax benefit; and (3) the transaction or series of transactions has resulted in a misuse or abuse of the provisions of the relevant acts, regulations and treaties, read as a whole. A tax benefit is defined as a reduction, avoidance, or deferral of tax or other amount payable under the ITA or an increase in a refund or other amount under the ITA.

### Transfer Pricing

Transactions between a corporation resident in Canada and a non-resident corporation with which it does not deal at arm's length (essentially, any non-resident entity within a related group) are subject to Canadian income tax as if such transactions had taken place between arm's length persons. In this regard, Canada generally follows the OECD transfer pricing guidelines. The terms and conditions of transactions may be adjusted under the ITA so that prices charged on the transfer of property or provision of services between non-arm's length parties reflect the prices that would have been adopted had those parties been dealing at arm's length. The ITA provides for certain contemporaneous documentation reporting requirements with respect to non-arm's length transactions. Furthermore, a penalty may be applicable at a rate of 10% of any net adjustment made by the CRA to the transfer prices of a Canadian affiliate. This penalty may be avoided if the taxpayer demonstrates that it has made reasonable efforts to meet the transfer pricing rules in its determination of the transfer prices.

### Governmental Tax Incentives

The Canadian tax system provides for preferential tax treatment in certain situations based on the nature of the taxpayer and the nature of the income being earned. In particular, the ITA contains a number of fiscal incentive regimes designed to encourage investment in particular sectors of the Canadian economy, including,

small business, oil and gas exploration, and certain scientific and experimental developments.

The Canadian federal government and, in particular, the government of each of the provinces provide generous tax incentives for the performance of scientific research and experimental development (SR&ED) in a particular province. Where a corporation incurs expenditures that qualify as SR&ED for the purposes of the ITA, such expenditures may generally be deducted in the current year in computing taxable income. In addition, a federal investment tax credit equal to 15% (or 35% in respect of CCPCs, subject to certain limitations) of qualifying SR&ED expenditures may be available. The determination of whether certain activities constitute SR&ED is very technical and fact specific. Most provinces provide similar tax incentives with respect to expenditures relating to SR&ED.

## Goods and Services Tax and Harmonized Sales Tax

The comprehensive federal Goods and Services Tax (GST) generally applies to the supply of goods and services made in, or imported into, Canada. The rate of the tax is currently 5%.

The GST applies at each stage of production. However, if the purchaser is involved in a commercial activity and is a qualified GST registrant, it will generally be entitled to claim a refund, called an "input tax credit", for GST paid.

GST on taxable imported goods and services is payable by the importer of record, while exported goods and services are generally "zero-rated" (GST technically applies, but at a rate of 0%). A business that provides zero-rated supplies will generally still be entitled to an input tax credit for the GST expenses that it has paid, whereas a business that makes exempt supplies will generally not be entitled to an input tax credit.

Pursuant to the federal *Excise Tax Act*, a business, whether resident or non-resident, will normally be required to charge and collect GST from its customers on taxable goods and services supplied by it in Canada in the course of a business carried on in Canada. Businesses that make taxable supplies in the course of a business carried on in Canada must also become GST registrants unless they are "small suppliers" (generally very small businesses making less than $30,000 in taxable supplies in a 12 month period). GST registrants are required to file yearly, quarterly or monthly returns depending on the registrants' annual sales.

The provinces of Nova Scotia, New Brunswick, Newfoundland and Labrador, Ontario and Prince Edward Island have harmonized their provincial sales taxes with the GST to form a single Harmonized Sales Tax (HST). The HST is also imposed under the *Excise Tax Act*, and has essentially the same rules as the GST. Further, the HST uses the same registration number as the GST (no separate registration is required), and is reported on the registrant's GST return. The HST includes both a provincial component and the federal GST for a combined rate of 13% in Ontario, and 15% in

New Brunswick, Newfoundland, Nova Scotia, and Prince Edward Island (depending on where the supply is made).

Although Quebec is not a HST-harmonized province, it levies its own Quebec Sales Tax (QST), which is a value-added tax applied and administered separate from, but is legally harmonized with the GST regime (although there are certain differences). The QST of 9.975% is a tax on the consumption of goods and services in Quebec. Suppliers require a separate registration number for QST purposes.

## Provincial Sales Tax

Saskatchewan, British Columbia and Manitoba each impose a provincial sales tax or retail sales tax (each a PST) on most sales of tangible personal property and certain specified enumerated services within the particular province. Each separate PST has distinct but similar rules. The rates for these taxes are 6% in Saskatchewan, 7% in British Columbia and 8% in Manitoba. These taxes must generally be collected and remitted by the vendor of the property or services. However, each province has a number of exemptions for certain goods (production machinery, inventory for resale, etc.).

As mentioned above, Newfoundland and Labrador, Nova Scotia, New Brunswick, Prince Edward Island and Ontario have harmonized their provincial sales taxes with the GST to form the HST. Quebec also levies its own value-added tax (QST) that is applied and administered separate from the GST and HST. While British Columbia harmonized its sales tax effective July 1, 2010, it ceased being a harmonized province and reintroduced its provincial sales tax, effective March 31, 2013. The rules pertaining to the HST are essentially the same as those for the GST and are discussed under the GST/HST section above.

Alberta and the Canadian territories (Yukon, Nunavut and Northwest Territories) do not levy provincial sales taxes.

## Provincial Payroll Tax

Manitoba, Newfoundland, the Northwest Territories, Nunavut and Ontario levy a payroll tax on employers that is calculated as a percentage of total remuneration paid in the province, above a certain threshold. In Ontario, for example, the rate of Employer Health Tax is generally 1.95% of remuneration in excess of $450,000. Quebec levies similar taxes calculated on the amount of remuneration paid in Quebec. These taxes take the form of employer contributions to a provincial health services fund, to a workplace training fund (if a minimum amount is not spent on training in the company), to a parental insurance plan and to fund a labour relations commission.

## Taxes on Real Property

Property taxes on real property are an important source of revenue in Canada, particularly for municipalities. Many provinces also levy transfer taxes on the purchase of land and impose various other taxes on mines, timber property and similar properties.

## Methods of Carrying on Business in Canada

There are three basic options for a non-resident corporation to carry on business in Canada. The first is to operate the business in Canada through a wholly-owned Canadian subsidiary of the non-resident corporation (the "Canadian Subsidiary"). The second is for the non-resident corporation to carry on the business in Canada directly as an unincorporated branch (the "Canadian Branch"). Finally, assuming that the non-resident corporation is resident in a country with which Canada has an international tax treaty, the third option involves the non-resident corporation carrying on the business in Canada but restricting its Canadian presence such that it does not have a permanent establishment in Canada.

### Canadian Subsidiary

A Canadian Subsidiary of a non-resident corporation will be a resident of Canada for the purposes of the ITA and will be subject to Canadian income tax on its worldwide income. Dividends paid by a Canadian Subsidiary to any non-resident corporation will be subject to Canadian withholding tax at 25%. This rate may be reduced by an applicable tax treaty (it is generally reduced to 5% under the Canada-U.S. Income Tax Convention if the shareholder owns at least 10% of the voting stock of the payor). As noted earlier, under Canada's domestic rules, there is generally no withholding tax on interest paid to arm's length persons, and under the Canada-US Income Tax Convention, withholding tax on non-arm's length interest paid to U.S. persons is generally nil.

### Canadian Branch

A non-resident corporation carrying on business in Canada through a Canadian Branch is liable for income tax on its Canadian-source business income at the same rates that apply to Canadian residents. Such a corporation is also subject to an additional "branch tax" of 25% on (generally) the after-tax branch profits that are not reinvested in the Canadian business. The branch tax approximates the rate of withholding tax on dividends that would apply if a Canadian Subsidiary had been used to carry on the business instead of a Canadian Branch. The rate of branch tax may be reduced by an applicable tax treaty. For example, under the Canada-U.S. Income Tax Convention, the branch tax is limited to 5% and is not applicable to the first $500,000 of branch profits.

## Branch or Subsidiary

There are a number of important considerations to be weighed by a non-resident corporation in deciding whether to carry on business in Canada through a Canadian Branch or through a Canadian Subsidiary.

In both cases, the profits of the Canadian operation will be subject to Canadian income tax. If the business is carried on through a Canadian Branch, there will be branch tax to consider. If a Canadian Subsidiary is used, withholding taxes on dividends and interest may be imposed. An important difference between the branch tax and the withholding tax on dividends is that withholding tax applies only if and when a dividend is paid or credited to the non-resident shareholder, while the branch tax may be applicable, regardless of whether profits are remitted to the non-resident corporation.

In general, a non-resident holder of shares of a Canadian Subsidiary will not be subject to tax under the ITA in respect of the disposition of such shares, provided that the shares are not "taxable Canadian property" to such non-resident holder at the time of disposition. In the event that the shares are taxable Canadian property, the non-resident holder will generally be subject to Canadian tax on the capital gain realized upon their disposition. There are also circumstances where an applicable tax treaty may exempt any such gain from taxation in Canada even if the shares are taxable Canadian property. However, shares of a Canadian corporation that derive their value principally from Canadian real property, including resource property, do not generally benefit from such treaty exemptions. In comparison, a sale of a branch operation to an arm's length party would likely be subject to Canadian tax. However, it may be possible to transfer the assets and liabilities of a Canadian Branch to a Canadian corporation in exchange for shares of the corporation on a tax-free basis, thus "converting" a Canadian Branch into a Canadian Subsidiary.

### Thin-Capitalization Rules

The "thin-capitalization" rules in the ITA must also be considered. These rules are designed to discourage non-residents from investing in Canada in a form such that virtually all of the investment is by way of loan and as little as possible by way of equity, thereby maximizing the amount of profits that can be returned to the non-resident in the form of tax deductible interest payments. A Canadian Subsidiary generally may not deduct interest paid by it to "specified non-resident shareholders" to the extent that the relevant debt-to-equity exceeds a ratio of 1.5:1 (the same concept applies to a Canadian Branch but the debt-to-ratio is effectively replaced with a 3:5 debt-to-net asset ratio). Any interest which is denied a deduction under the thin-capitalization rules is also deemed to be a dividend for withholding tax purposes (and hence potentially subject to the higher rate of withholding). A specified non-resident shareholder is defined as any non-resident who alone or in combination with other persons with whom it does not deal at arm's length owns 25% or more of the voting shares or of the fair market value of all issued shares of the subsidiary.

### Unlimited Companies

There are a number of other matters to be considered when deciding whether a Canadian Branch or a Canadian Subsidiary should be used. For example, if a new Canadian venture is expected to operate at a loss in its initial stage, it may be preferable to establish a branch of the non-resident enterprise so as to permit the latter to deduct the loss in computing its tax liability in its home jurisdiction, assuming the tax rules in that jurisdiction permit it to do so. However, the use of an Alberta, British Columbia or Nova Scotia unlimited company (ULC) as the Canadian subsidiary may provide the same result for certain jurisdictions if they treat such an entity as a pass-through (for example, by using the check-the-box rules in the U.S.). ULCs are treated no differently than any other corporation resident in Canada for Canadian income tax purposes. However, the Canada-US Income Tax Convention may limit the treaty benefits that are available to unlimited liability companies in certain situations.

There are some minor differences between the unlimited liability regimes in Alberta, British Columbia and Nova Scotia. For example, while the liability of each shareholder (or member, in the case of a Nova Scotia ULC) for Alberta, British Columbia and Nova Scotia ULCs is unlimited, the liability is joint and several in nature for shareholders of Alberta ULCs from the time of incorporation, while joint and several liability of the members or shareholders of Nova Scotia and British Columbia ULCs only applies upon a winding up of the company. As well, the liability of shareholders of Alberta ULCs is broader than that of members or shareholders of Nova Scotia ULCs and British Columbia.

### Accounting and Reporting

A possible perceived disadvantage of using a Canadian Branch is that the CRA may insist on auditing all of the books and records of the non-resident corporation for the purpose of assessing the taxpayer's allocation of various items of income and expense to the Canadian Branch. Another practical difficulty is preparing annual statements for the Canadian Branch that are satisfactory to both the authorities in Canada and the country of residence of the non-resident corporation.

## Acquiring a Canadian Resident Corporation

### Canadian Acquisition Company

In acquiring the shares of a Canadian resident corporation (the "Target Corporation"), non-resident purchasers should generally consider using a Canadian acquisition corporation (CAC) in order to maximize the cross-border paid-up capital available to the purchaser. This is advantageous since a Canadian resident corporation can generally return profits to its foreign parent corporation, up to the amount of the paid-up capital of the shares, without Canadian non-resident

withholding taxes. Distributions of profits in excess of the paid-up capital would be subject to Canadian withholding tax.

Typically, the amount of the paid-up capital of the shares of the Target Corporation would be less than their acquisition cost to the non-resident purchaser (the fair market value). To ensure that the non-resident purchaser has shares with paid-up capital equal to the investment made by the non-resident, the non-resident purchaser may subscribe for shares in a CAC that will have a cost and paid-up capital equal to the purchase price of the Target Corporation's shares. The CAC would then use the proceeds of this share subscription to acquire the shares of the Target Corporation which, in turn, would be followed by an amalgamation of the CAC and Target Corporation. As profits are earned by the amalgamated corporation these amounts can subsequently be paid by such corporation to the non-resident parent as a tax free return of capital, thus permitting the investment cost to be returned to the non-resident parent free of Canadian withholding tax. A CAC can also be used to push any acquisition debt and corresponding interest expense into the operations of Target Corporation.

It should be noted that the above analysis regarding the utilization of a CAC may not necessarily apply in the case of a Target Corporation that derives more than 75% of its value from foreign subsidiaries (as Canada's "foreign affiliate dumping" rules (the "FAD Rules") may apply). In general, the FAD Rules apply to investments in foreign subsidiaries (which, for these purposes, includes Canadian corporations that derive more than 75% of their value from foreign subsidiaries) made by Canadian corporations that are controlled by a non-resident corporation. Under these rules, the investment (ie. the acquisition of the shares of Target) may result in the Canadian corporation being deemed to have paid a dividend to its non-resident parent in the amount of the investment made in the foreign subsidiary. The deemed dividend is subject to Canadian dividend withholding tax.

Alternatively, the rules may apply to reduce the paid-up capital of the shares of the Canadian corporation which, in turn, reduces the amount of internal debt that may be used to fund the Canadian corporation under Canada's thin capitalization rules. In the context of a Target Corporation that derives more than 75% of its value from foreign subsidiaries, it may still be beneficial to utilize a CAC (despite that the FAD Rules may apply). However, this determination is not automatic as it will depend upon a number of factors, including the Target Corporation's historical paid-up capital and the acquiror's intentions to keep the foreign subsidiaries in Canada (or, more precisely, underneath the Canadian Target Corporation) in the future.

### Exchangeable Shares

An exchangeable share structure should also be considered in circumstances where the shares of a non-resident purchaser are to be offered as consideration for shares of a Target Corporation, and the shares of the Target Corporation have significant capital gains accrued to the holders thereof.

Under the ITA, a share-for-share exchange can occur on a rollover basis (no immediate taxation) if the exchange is of shares of two Canadian resident corporations or the exchange is of shares of two foreign corporations. However, the ITA does not currently provide a rollover when shares of a Canadian corporation are exchanged for shares of a foreign corporation. Accordingly, a non-resident corporation acquiring a Target Corporation may wish to employ an exchangeable share structure in order to provide Canadian resident shareholders of the Target Corporation with rollover relief.

Very generally speaking, an exchangeable share structure involves the creation of two new Canadian subsidiary corporations of the non-resident purchaser, "Callco" and "Exchangeco". As consideration for selling the Target Corporation shares, the Target Corporation shareholders are issued exchangeable shares of Exchangeco, which, due to various support agreements, have the same economic attributes as the shares of the non-resident purchaser. As Exchangeco is Canadian, the Target Corporation shareholders are entitled to a rollover of their shares, which defers their tax liability until they dispose of the exchangeable shares. The holders of the exchangeable shares usually have up to ten years or more in which to exchange their exchangeable shares for shares of the non-resident purchaser, which exchange occurs through Callco. However, the use and consequences of employing an exchangeable share structure must be carefully considered, as it will add complexity and expense to the transaction.

# About the Firm

When Heward Stikeman and Fraser Elliott first opened the firm's doors in 1952, they were united in their pledge to do things differently to help clients meet their business objectives.

In fact, they made it their mission to deliver only the highest quality counsel as well as the most efficient and innovative services in order to steadily advance client goals.

Stikeman Elliott's leadership, prominence and recognition have continued to grow both in Canada and around the globe. However, we have remained true to our core values.

These values are what guide us every day and they include:

- Partnering with clients – mutual goals ensure mutual success.
- Finding original solutions where others can't – but they must also be grounded in business realities.
- Providing clients with a deep bench of legal expertise – for clear, proactive counsel.
- Remaining passionate about what we do – we relish the process and the performance that results from teamwork.

A commitment to the pursuit of excellence – today, tomorrow and in the decades to come – is what distinguishes Stikeman Elliott when it comes to forging a workable path through complex issues. Our duty and dedication never waver.

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