The Inward Investment And International Taxation Review

Editor
Tim Sanders

Law Business Research

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This article was first published in The Inward Investment and International Taxation Review, (published in January 2011 – editor Tim Sanders).

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THE INWARD INVESTMENT AND INTERNATIONAL TAXATION REVIEW

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Law Business Research Ltd

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN: 978-1-907606-11-3

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: +44 844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

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AFRIDI & ANGELL

ANTIS TRIANTAFYLLIDES & SONS LLC

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PREFACE

The reduction of trade barriers and the increased ease of moving goods and services around the globe via the Internet and modern transportation means that cross-border trading, once the preserve of a small group of multinational companies, is now part of mainstream business activity. Such cross-border activity exposes business and the people they employ to taxes and tax systems in the jurisdictions where customers are based, which brings not only opportunity but also potential issues and conflict between tax systems.

Tax considerations play a significant role in shaping the business and financing structures used by cross-border traders. As taxpayers consider how to optimise their tax position, they do so against a backdrop of a rapidly changing tax landscape, as jurisdictions compete to encourage inward investment on the one hand and on the other introduce increasingly complex rules designed to discourage any diversion of profit from their tax net.

The role of the international tax adviser is to help business reach the desired destination and avoid the hazards. The aim of this book is to provide business and its advisers with topical and current insights of leading experts on the tax issues and opportunities in their respective jurisdictions, or in one case, offered by the European Union. Whilst specific tax advice is always essential, the starting point in any journey is to have a broad understanding of the nature of the potential issues and advantages that lie ahead and this book provides a guide to these.

I should like to thank the contributors to this book for their time, effort and above all their expertise. I should also like to thank the publisher and the team for their support and patience. I hope that you find the work useful and any comments or suggestions for improvement that can be incorporated into any future editions will be gratefully received.

Tim Sanders
Skadden, Arps, Slate, Meagher & Flom LLP
London
January 2011

Chapter 4

CANADA

Alain Ranger[*]

I INTRODUCTION

Canada has an open, fair and efficient system of making and administering its laws. Canadian commercial laws have been greatly influenced by those of England and the United States. They are generally consistent with those in other major trading nations. The results to be expected from using the Canadian legal system are relatively predictable and give certainty to business transactions. Common law is the basis for the legal system in all of the Canadian provinces with the exception of the province of Quebec, which, because of historical reasons, has inherited the civil law system. The presence of a domestic civil law system within Canada gives it special insight into the two distinct legal regimes of Europe and the US.

From its earliest days, Canada has been a strong supporter of foreign investment. Many restrictions on foreign investment have been eliminated over the years, many other business regulations have been liberalised and the tax system has been improved. Key sectors such as transportation, energy, communications and financial services have been deregulated, and many government-owned corporations have been privatised.

In fact, virtually all government activities have been adapted to respect the concerns of business and to respond to market forces. The result is a business and investment environment that many foreign companies consider among the most hospitable in the world.

Canada's regime for foreign investment review is primarily governed by the Investment Canada Act ('the ICA'), which employs a 'net benefit to Canada' test if an investment is subject to review and approval by the Federal Minister of Industry or the Federal Minister of Canadian Heritage. The Minister of Canadian Heritage is responsible for reviewing transactions involving the acquisition of a 'cultural business'

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(e.g., involving print media, film, video, music, radio or television), while the Minister of Industry is responsible for reviewing all other transactions that are reviewable under the ICA. Acquisitions of control of Canadian businesses by non-Canadians, whether direct or indirect, are subject to either notification or ministerial review under the ICA, subject to certain exceptions. A non-Canadian who establishes a Canadian business (as opposed to acquiring one) is also required to file a notification under the ICA, but such transactions are not subject to review under the ICA (except for the establishment of cultural businesses). Subject to limited exceptions, investments will not be subject to review (and only be subject to notification) where applicable thresholds are not exceeded or where an exemption applies. A notification is not burdensome to complete and can be filed either prior to, or within 30 days following, implementation of the investment.

Compliance with the Competition Act may also be required if the proposed transaction involves a merger that is defined broadly and includes the acquisition of control over, or of a significant interest in, the whole or a part of a business. Due to the breadth of this definition, transactions outside Canada can raise issues where the parties own, or have a significant interest in, a business in Canada. Similarly, the mandatory pre-merger notification rules applicable to certain transactions cover both direct and indirect acquisitions. Note that the rules are the same, irrespective of whether the acquirer is Canadian or foreign.

II COMMON FORMS OF BUSINESS ORGANISATIONS AND THEIR TAX TREATMENT

Foreign businesses can establish a separate Canadian vehicle or operate directly through a branch office. Corporations are the most common business entity, but partnerships can also be used to accomplish similar objectives as well as tax objectives. Joint ventures, franchises and cooperatives are less common, but appropriate for some types of enterprise.

i Corporate

Canadian corporations

Canadian corporations utilised by foreign investors are usually created by incorporation under the Canada Business Corporations Act or under similar provincial laws. Both federal and provincial corporations are created by filing articles of incorporation with the appropriate government authority. The articles must include details of the rights, restrictions, privileges and conditions attached to each class of shares.

A federal corporation's articles must also name the first directors, a minimum of 25 per cent of whom must be Canadian residents. Some provincial corporate legislation does not impose a *de minimis* directors' residency threshold, which is often viewed as an advantage by foreign investors. While the directors generally exercise management authority on behalf of the shareholders, their power can be restricted through a unanimous shareholder agreement. The corporation, its shareholders or third parties can hold the directors personally liable for certain limited aspects of their decisions, including the tax administration in case of certain defaults of the corporation, such as default of remitting deductions at source and amounts withheld.

Corporations are taxable entities under Canada taxation system.

Unlimited liability subsidiary company

The provinces of Nova Scotia, Alberta and British Columbia allow for the incorporation of an 'unlimited liability company' as the Canadian subsidiary of a foreign corporation. This type of corporation may be used as an alternative to a branch, as it may allow for losses incurred by the corporation in Canada to be deductible by the foreign corporation in its jurisdiction (for instance, the United States), while still providing the advantages of corporate status in Canada.

While an unlimited liability company may be viewed as a disregarded entity in certain foreign jurisdictions (for instance, the United States), it is considered and taxed as any other corporation in Canada.

ii Non-corporate

Branches of foreign corporations

A foreign entity can carry on business in Canada directly through a branch operation. The taxation of branches and subsidiaries varies considerably and differences exist in the liability of parent companies.

Partnerships

A partnership is a for-profit business owned by two or more individuals or corporations, based on a contract between them. Partnerships are governed by provincial laws and generally must be registered with provincial authorities. In addition, partnerships have no distinct legal personality from their partners. There are essentially two types of partnership: general and limited.

In a general partnership, all partners are subject to unlimited liability. Unless otherwise agreed, the partners have an equal claim on capital and profits, and are equally responsible for all losses, debts and liabilities of the partnership.

A limited partnership consists of both general and limited partners. One or more general partners are responsible for managing the business. One or more limited partners contribute capital, and may work for the firm, but do not participate in its management. Unlike general partners, limited partners are not exposed to unlimited liability unless they take part in the control or management of the business.

A partnership itself is not a taxable entity, but it is rather a flow-through entity for Canadian tax purposes. Each partner is taxed directly on its share of the income of the partnership as allocated (but not necessarily distributed) by the partnership agreement.

Joint ventures

A joint venture is an association of two or more business entities for the purpose of carrying on a single enterprise or specific venture. Joint ventures take several forms. They can be set up through a separate corporation, a general or limited partnership, or the joint venturers can simply jointly own business assets, in which case their relation is governed by a contractual arrangement. Joint ventures between Canadian and foreign companies are an excellent vehicle for combining the strengths of the participating firms, while reducing the risk of taking on new markets.

The joint venturers are liable for the tax on their income earned as participants in the joint venture.

III DIRECT TAXATION OF BUSINESS

i Tax on profits

Overview

Income tax is imposed by the federal, provincial and territorial governments. Federal income taxation is governed by the Income Tax Act (Canada) ('the ITA').

Subject to certain tax treaty concessions, non-residents of Canada are generally subject to Canadian taxation on Canadian-source income, such as income from a business carried on in Canada and capital gains on the disposition of property known as 'taxable Canadian property'.

Further to recent amendments to the ITA, taxable Canadian property includes:

a real property situated in Canada;

b assets used in a business carried on in Canada;

c shares of a private corporation resident in Canada where more than 50 per cent of the fair market value of the shares is derived (or was derived at any time in the previous 60-month period) from real property in Canada, Canadian resource properties, timber resource properties and options in respect of any such property;

d shares of a listed corporation where:
- the holder and persons with whom the holder deals at arm's length hold more than 25 per cent of the issued shares of any class; and
- more than 50 per cent of the fair market value of the shares is derived (or was derived at any time in the previous 60-month period) from real property in Canada, Canadian resource properties, timber resource properties and options in respect of any such property; and

e options in respect of any above-listed property.

Residents of Canada are taxed on their worldwide income.

Determination of taxable profit

The Canadian tax base is a comprehensive one, which taxes income and specifically includes capital gains (see *infra*). All business and property income, whether active or passive, falls within the scope of Canadian taxation. While income is generally subject to tax on an accrual basis, certain reserves may be claimed if the income is related to goods to be delivered or services to be rendered after the end of the year.

Canadian generally accepted accounting principles, subject to certain statutory modifications, are usually used to calculate the income upon which tax is levied. Among these modifications, let us mention two items: (1) the taxpayer can deduct capital cost allowance (to be prorated if the fiscal period has less than 12 months) at rates that in many cases are more generous than the accounting depreciation; and (2) the taxpayer must include in income a portion of the economic gain realised upon the settlement of a debt for less than its principal amount.

Capital and income

One-half of the net capital gains ('taxable capital gains') realised in a year is included in income and only one-half of capital losses ('taxable capital losses') is recognised. Taxable capital losses incurred in a taxation year may be carried back to the three preceding taxation years and may be carried forward indefinitely, but they can only be used to offset taxable capital gains. Taxable capital losses incurred by a corporation are lost upon an acquisition of control (i.e., acquisition of rights conferring more than 50 per cent of the voting rights) of the corporation, subject to a certain election available to use the balance of the taxable capital losses prior to the acquisition of control.

Losses

By opposition to taxable capital losses, 100 per cent of non-capital losses are recognised and can be used to offset any kind of income, including taxable capital gains. They can also be carried back to the three preceding taxation years and forward to any of the 20 following taxation years. Non-capital losses of a corporation can survive an acquisition of control and can be used in any of the taxation years following the acquisition of control provided the business that generated the losses continues, and has continued since the losses were incurred, to be operated with a reasonable expectation of profit, but only against the income generated by such business and any 'similar' business.

Rates

The federal and provincial corporate income tax rates vary depending on the type of income and the industry (general active business income, manufacturing and processing income, investment income), the type of corporation involved (i.e., a Canadian-controlled private corporation ('CCPC') or other corporation) and the provinces in which the corporation has an establishment.[1] For these purposes, a corporation is generally liable to tax in a province if it has an establishment in that province. Where a corporation has business income attributable to establishments in more than one province, such income is allocated among those establishments and is subject to tax in those provinces in which the establishments are located.

The net federal income tax rate (i.e., after taking into account a 10 per cent reduction to the extent the income is also subject to provincial tax) applicable to a non-CCPC is 18 per cent. Provincial tax rates for general active business income vary from 10 per cent to 16 per cent. In Ontario, for instance, the 2010 combined federal and provincial rates for general active business income for a non-CCPC is 30 per cent effective 1 July 2010. This rate is proposed to be reduced to 28 per cent by 2013.

1 Note that a CCPC does not need to be controlled by Canadian residents: it is only required that it is not controlled by non-residents of Canada. A Canadian corporation with equal shareholdings of Canadian and non-Canadian shareholders qualifies as a CCPC. Specific rules are established for the determination of CCPC status. For instance, conditional options to acquire shares are deemed exercised.

The following tables present a snapshot of some of the applicable income tax rates effective for fiscal periods beginning on 1 January 2011:

Combined federal and provincial income tax rates for income earned by a CCPC

Jurisdiction	*Small business income*	*General active business income*	*Investment income*
Quebec	19 per cent	28.4 per cent	46.6 per cent
Ontario	15.5 per cent	28.5/28 per cent	46.7/46.2 per cent
Alberta	14 per cent	26.5 per cent	44.7 per cent
British Columbia	13.5 per cent	26.5 per cent	44.7 per cent

Combined federal and provincial income tax rates for income earned by a corporation other than a CCPC

Jurisdiction	*General active business income*	*Investment income*
Quebec	28.4 per cent	28.4 per cent
Ontario	28.5/28 per cent	28.5/28 per cent
Alberta	26.5 per cent	26.5 per cent
British Columbia	26.5 per cent	26.5 per cent

Administration

Generally speaking, taxpayers are allowed to elect any period not exceeding 53 weeks for a fiscal period. A partnership can generally elect a different fiscal period than of its partners with the result that a tax deferral can be achieved.

While corporations can file their income tax returns up to six months after year-end, they nevertheless have to pay the balance of the tax owed (i.e., further to the monthly tax instalments made during the year) for that year within two months following year-end (three months for a CCPC). It should be noted that the taxation year of a corporation is deemed to end immediately prior to the acquisition of its control so there could be an acceleration of the tax obligations of the corporation, such as the filing of the tax returns and the payment of the balance of tax owed. Depending on the sise of a corporation, audits are not automatically conducted by the tax administration. Any disagreement with the tax administration over a specific item can be discussed prior to and after the assessment. Appeals to the Tax Court of Canada and to the Federal Court of Appeal are allowed outright.

The tax administration encourages taxpayers to voluntarily come forward and correct previous omissions in their dealings with the Canada Revenue Agency ('the CRA') (e.g., failure to report income, information returns and foreign-source income and claim of ineligible expenses for instance). Taxpayers who make a valid disclosure (voluntarily, complete and subject to verification) will have to pay the taxes plus interest, but will avoid the penalties and prosecutions they would otherwise be subject to. The voluntary disclosures programme also applies for excise tax, excise duties, source deductions and GST, HST and QST (defined *infra*). Unlike other countries, the Canadian voluntary disclosures programme is not a temporary measure.

Tax grouping

There is no statutory authority to permit the consolidation of income and losses of corporations in a related group. Consolidation of income and losses within a corporate group can be achieved by different transactions and advanced income tax rulings have been issued by the tax administration confirming the legitimacy and effects of these transactions. The federal government made a commitment in the 2010 Budget to explore new rules for the taxation of corporate groups such as the introduction of a formal system of loss transfers or consolidated reporting.

ii Other relevant taxes

General

Other taxes may be imposed by provinces. For instance, certain provinces impose a capital tax on a corporation having an establishment in the province. Generally, the tax base is the taxable capital employed in the province. The Province of Ontario also imposes a corporate minimum tax ('CMT') on corporations. For taxation years ending after 30 June 2010, the CMT rate is 2.7 per cent and will only apply to corporations with total assets that equals or exceeds C$50 million or with total revenue that equals or exceeds C$100 million. Corporations in an associated group must aggregate their assets and revenues to determine if they are subject to this tax. The CMT is applied against income allocated to Ontario. This tax will be payable in a year only to the extent that it exceeds regular Ontario corporate income tax. The CMT paid may be carried forward for 20 years, and used to reduce regular Ontario corporate income tax, provided that the crediting mechanism does not result in an Ontario corporate tax liability below the level of CMT for the year.

Various payroll and health fund taxes are imposed at different rates by the various provinces.

Goods and services tax

Overview

The Canadian goods and services tax ('GST') is a multi-stage federal-level consumption tax. The GST is levied at the rate of 5 per cent, 12 per cent or 13 per cent and is similar in structure and application to the 'value added taxes' imposed in other industrialised nations. The rate depends, in part, on whether the province in which the supply of goods or services is made has harmonised its retail sales tax regime with the federal GST regime as discussed under 'Provincial retail sales taxes', *infra*. Although the GST is imposed on purchasers of taxable property or services at all levels of trade, it is intended to be borne entirely by the final purchaser or consumer. Businesses throughout the production and distribution chain that have paid GST on their purchases are, therefore, generally entitled to claim a refund of GST expenses they have paid. These refunds, referred to as 'input tax credits' ('ITC'), are paid back by the CRA to qualifying GST registrants. The ultimate consumers of property or services are not entitled to claim input tax credits.

The GST is levied under three separate divisions of Part IX of the federal Excise Tax Act ('the ETA'). The GST levied under Division II of the ETA is applicable to most transfers of property or services that are considered to occur within Canada. The ETA contains specific rules for determining whether any given supply has been made in Canada. The person making the taxable supply (if a GST registrant) is responsible for collecting the Division II GST from the recipient of the supply. Division II GST is applicable at the rate of 5 per cent, 12 per cent or 13 per cent depending upon where in Canada the supply is considered to be made. The supplier must, on a regular and predetermined basis, remit to the federal Minister of National Revenue the amounts collected on account of the GST along with the supplier's GST return.

The GST levied under Division III of the ETA is applicable to most importations of goods into Canada. Division III GST, where applicable, is paid by the importer of record directly to the CRA at the time of importation. Division III GST is levied at the rate of 5 per cent, 12 per cent or 13 per cent depending upon the nature of the goods and the ultimate destination of the goods within Canada.

The GST levied under Division IV of the ETA is applicable to certain property or services that are considered to be supplied outside of Canada and then imported into Canada. Where applicable, the Division IV GST is paid by the importer of the taxable property or service directly to the Canada Border Services Agency on a self-assessing basis. Division IV GST is applicable at the rate of 5 per cent, 12 per cent or 13 per cent depending upon the residency of the importer and upon where consumption occurs within Canada.

Taxable and exempt supplies

Most property or services that are considered to be supplied in Canada are subject to Division II GST. Certain taxable supplies, known as 'zero-rated supplies', are subject to GST at the rate of zero per cent. Although technically the GST is applicable to these supplies, as it is levied at the rate of zero per cent, there is no obligation upon the supplier to collect any GST from the purchaser. Some of the more common examples of zero-rated supplies include certain medical and health-related items, basic groceries and goods exported by the purchaser from Canada for consumption outside Canada. Because a zero-rated supply is considered to be a taxable supply for GST purposes, the supplier is entitled to recover the GST expense it has incurred in order to make the zero-rated supply. The zero-rating mechanism ensures that no GST is collected from the final purchaser of the property or services and that no GST is embedded in the cost of the property or service.

Exempt supplies, on the other hand, are not subject to GST at all. Many financial products and services are specifically deemed by the ETA to be GST exempt. Persons making exempt supplies are not entitled to recover the GST expenses incurred to make those supplies. Accordingly, although GST is not charged to the ultimate consumer of either exempt supplies or zero-rated supplies, with exempt supplies, some GST expense is embedded in the cost of the property or services.

Registration and reporting

As discussed *supra*, businesses that incur GST expenses for the purpose of making subsequent taxable supplies of property or services are generally entitled to claim a refund from the CRA of GST expenses paid. Such refunds are only available to businesses which are GST registrants at the time that they incur the GST expenses. Businesses which are GST registrants are obligated to collect Division II GST in respect of any taxable supplies they make in Canada.

Businesses which make taxable supplies in Canada in the course of a business carried on in Canada must register for GST purposes. This obligation is equally applicable to businesses which are non-resident of Canada. An exception to this rule exists, however, for very small businesses, which are not obligated to register. Non-residents making taxable supplies in Canada but not carrying on business in Canada are entitled to register voluntarily for the GST. Many non-residents do in fact voluntarily register so that they may claim ITC.

Registration for the GST is a straightforward process and there is no cost to register. However, non-residents having no permanent establishment in Canada are obligated at the time of registration to post security with the CRA in a prescribed amount.

GST registrants are required to file GST returns with the CRA on a regular and predetermined basis. In those returns registrants are required to report the amounts of Division II GST which they have collected (or are deemed to have collected) during the applicable reporting period. Registrants may also claim ITC for GST expenses incurred during that same period which are eligible for refund. Where the amounts claimed as ITC in a return exceed the amounts collected (or deemed collected), the registrant is entitled to receive a net refund from the CRA. Where the amounts collected (or deemed collected) exceed the amounts claimed as ITC, the registrant must make a corresponding payment to the CRA.

GST filing frequency is contingent upon the registrant's and its associates' gross annual sales. Registrants with gross annual sales exceeding C$6 million are designated as monthly filers. Most registrants with gross annual sales of less than C$6 million are designated as quarterly filers. However, businesses that are designated as quarterly filers are entitled to elect to report on a monthly basis.

Provincial retail sales tax

Overview

All Canadian provinces, except Alberta, levy a retail sales tax, either independently or in conjunction with the federal GST. The rates of provincial sales tax range from 5 per cent to 10 per cent.

The provinces of British Columbia, New Brunswick, Nova Scotia, Newfoundland and Ontario ('the Participating Provinces') do not levy retail sales tax. They have each entered into agreements with the CRA pursuant to which the CRA now collects harmonised sales tax ('HST') at the rate of 15 per cent for Nova Scotia, 13 per cent for New Brunswick, Newfoundland and Ontario and 12 per cent for British Columbia (i.e., 5 per cent for the GST component and 7 per cent, 8 per cent or 10 per cent for the provincial component) each time that a HST taxable supply is made in one of those provinces. A portion of the HST remitted to the CRA in respect of transactions which occur in the Participating Provinces is forwarded to those provinces by the CRA. The HST generally applies to the same tax base and is subject to the same rules as the GST, although there are some province-specific provisions in certain provinces.

Because GST and HST are part of Canadian federal legislation, it means that any business registered for GST purposes, regardless of where it is located, will be required to charge and collect HST at these new rates on goods and services sold to customers in these HST provinces. The HST is reported and remitted on the ordinary GST returns.

The applicability of Quebec sales tax ('QST') is governed by 'An Act Respecting the Quebec Sales Tax'. Because this tax is based upon the federal GST, it is very similar to the GST in terms of structure and applicability. The QST applies to most property and services that are considered to be supplied in Quebec. Similarly, the QST applies to certain importations into Quebec. To the extent that a QST registered business incurs QST expense in order to make a subsequent taxable supply of property or services, the business is entitled to claim an input tax refund (which is analogous to the GST ITC).

The QST is levied at the rate of 7.5 per cent on the aggregate of the price and the 5 per cent GST, such that the effective rate is approximately 7.875 per cent. The QST rate will increase to 8.5 per cent effective 1 January 2011, and to 9.5 per cent effective 1 January 2012.

Other provinces

Each of Saskatchewan, Manitoba and Prince Edward Island ('the Non-Participating Provinces') levies its own retail sales tax. The basic rates of retail sales tax are 5 per cent in Saskatchewan, 7 per cent in Manitoba and 10 per cent in Prince Edward Island.

These retail sales taxes are generally quite similar. In each of the Non-Participating Provinces the retail sales tax applies to most transfers of tangible personal property and to certain specifically enumerated services provided within the province. The most commonly taxed services are telecommunications services, services relating to the repair or installation of tangible personal property and accommodation (hotel) services. The Non-Participating Provinces do not collect retail sales tax in respect of transfers of real property or fixtures. However, separate legislation exists in each of the Non-Participating Provinces for taxing transfers of land.

Generally, businesses that provide either taxable goods or services in the course of a business carried on in any of the Non-Participating Provinces are required to register for the purpose of collecting retail sales tax. In addition, most of these provinces encourage non-resident businesses that provide taxable goods or services in that particular province to register voluntarily for the purpose of collecting retail sales tax.

Although transfers of tangible personal property are generally subject to retail sales tax in the Non-Participating Provinces, there are exemptions to minimise the cascading of retail sales tax. Unlike the GST, HST and QST, the retail sales taxes of the Non-Participating Provinces do not contain an input tax credit or similar mechanism. To avoid the cascading of retail sales tax, most transfers of raw materials or inventory are exempt from retail sales tax. In addition, most of the Non-Participating Provinces provide an exemption in respect of production machinery or equipment purchased by a manufacturer for the purpose of manufacturing tangible personal property.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

A corporation incorporated in Canada after 26 April 1965 is deemed to be resident in Canada. A corporation incorporated outside of Canada may also be considered to be resident in Canada if its central management and control is located in Canada. Precautions and proper procedures need to be taken and implemented where a non-Canadian incorporated corporation is carrying on business in Canada and Canadian residents are elected as directors.

ii Branch or permanent establishment

Any non-resident corporation carrying on business in Canada is liable to Canadian income tax. For this purpose, a person is deemed to 'carry on business' in Canada if, among other things, it solicits orders or offers anything for sale in Canada through an agent, whether the contract or transaction is completed inside or outside Canada or partly in and partly outside Canada. Under this general principle, no permanent establishment is required to create tax liability. A non-resident corporation carrying on business in Canada is also subject to a branch tax of 25 per cent.

If the non-resident resides in a treaty country, the profits from his activity in Canada will generally escape the Canadian tax regime unless the business activity is carried on through a permanent establishment ('PE') (as defined in the relevant treaty) situated in Canada and then, only the business profits attributable to such PE will be taxed in Canada. Generally, under various treaties, the profits attributable to the branch of a non-resident corporation are determined as if the branch were a separate and distinct person dealing independently with the non-resident corporation and executive and general administration expenses incurred in Canada or elsewhere can be taken into account in determining the profits which will be taxable in Canada. Where a tax treaty exists, the branch tax is reduced to the applicable withholding tax rate allowed under the treaty for dividends, generally between 5 per cent and 15 per cent. Relief from Canadian branch tax is available under the Canada-United States Tax Convention, which provides an exemption on the first C$500,000 of after-tax repatriated income of the branch that is attributable to a permanent establishment in Canada.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

Both the federal and most of the provinces' legislation provides scientific research and experimental development ('SR&ED') incentives through deductions in computing net income; tax credits ('TCs') can also be obtained.

A pooling concept is used to record SR&ED expenditures for tax purposes. In very general terms, the pool is increased by expenditure (both current and capital) made and reduced by government and non-government assistance and contract payments received that the taxpayer is entitled to receive. Pursuant to this pooling concept, expenditures are not required to be deducted in the year incurred and may effectively be carried forward indefinitely.

i Federal SR&ED incentives

The most significant SR&ED benefits are available in the form of TCs, which are computed on qualifying SR&ED expenditures at rates varying from 20 per cent to 35 per cent depending, *inter alia*, on the status of the corporation.

Where a corporation is throughout a year a CCPC whose taxable income and taxable capital for the preceding year (both determined on an associated group basis) does not exceed certain limits, a TC at the rate of 35 per cent is available on the first C$3 million of SR&ED expenditures. This expenditure limit must be shared by associated corporations. The rate is reduced to 20 per cent for those SR&ED expenditures in excess of the expenditure limit of C$3 million. Qualifying CCPCs with TCs in excess of current tax liability may obtain a payment equivalent to such excess from the CRA for current expenditures and a 40 per cent refund on TCs relating to capital expenditures. For other corporations, the TC rate on SR&ED expenditures is 20 per cent and may be claimed against federal income tax payable.

The following table illustrates the TCs available for a corporation which incurs C$5 million of SR&ED in a year:

	Small Canadian-controlled private corporations				**Large Canadian- or foreign-controlled corporations**			
	Credit rate	*Per cent refund*	*Refundable tax credit (cashback)*	*Non-refundable tax credit (reduce taxes)*	*Credit rate*	*Per cent refund*	*Refundable tax credit (cashback)*	*Non-refundable tax credit (reduce taxes)*
First C$3 million in SR&ED expenditures	35 per cent	100 per cent	$1.05 million	n/a	20 per cent	n/a	n/a	$600,000
Remaining C$2 million in SR&ED expenditures	20 per cent	40 per cent	$160,000	$240,000	20 per cent	n/a	n/a	$400,000
Total			$1.21 million	$240,000			n/a	$1 million

ii Provincial SR&ED incentives

In addition to the federal incentives, most provinces provide additional tax incentives for taxpayers who undertake SR&ED within their borders. The rules for deductibility of expenses are generally the same as the federal rules. The main differences are on the availability of tax credits, the applicable rates, the payments on which the credits are based and the fact that they can be refundable. Quebec SR&ED TCs are always refundable.

The following table summarises certain incentives in different provinces:

	Quebec	*Ontario*	*Alberta*	*British Columbia*
Base	RS&ED salaries	RS&ED expenditures	RS&ED expenditures	RS&ED expenditures
Credit rate				
CCPC	37.5 per cent	10 per cent	10 per cent	10 per cent
Non-CCPC	17.5 per cent	4.5 per cent	10 per cent	10 per cent
Refundable?				
CCPC	Always	Yes	Yes	Yes
Non-CCPC	Always	No	No	No

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)

Withholding taxes apply to a broad range of sources of income paid to non-residents, including rents, royalties and dividends. In this later case, the withholding applies to both regular dividends (i.e., declared by corporations) and deemed dividends for tax purposes (for instance, where a corporation redeems shares of its capital for an amount greater than the paid-up capital of the shares (see *infra*)). The general rule is that there is no withholding tax on interest paid to non-related parties provided this is not 'participating interest'. Withholding applies on the payment or credit, or the deemed payment or credit, on account or in lieu of payment or in satisfaction of the specified source of income.

The statutory withholding tax rate in Canada is 25 per cent, which may be lowered pursuant to an applicable treaty.

ii Double tax treaties

Canada has an extensive network of international tax treaties (88 in force in December 2010), including comprehensive treaties with the United States and most of its other major trading partners. Canada generally follows the OECD Model Convention for the Avoidance of Double Taxation and the Commentary thereon in negotiating its tax treaties. These treaties generally reduce the 25 per cent domestic rate of withholding tax applicable to various types of income, and contain other provisions that impact on the tax treatment of non-residents' Canadian-source income. Canada's standard withholding tax rates under its most recent tax treaties are 10 per cent for royalties, 5 per cent for dividends payable to a shareholder who has at least 5 per cent or 10 per cent (depending on the treaty) of voting shares in the paying corporation and 15 per cent for other shareholders.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation

Generally, interest paid by a corporation is a deductible expense. However, the thin capitalisation rules impose a limit on the amount of interest paid to certain non-residents which may be deducted in computing the income of a Canadian corporation. The acceptable ratio of debt to equity is 2 to 1. If the average amount of a subsidiary's outstanding debt exceeds two times its equity, a prorated portion of the interest paid or payable in the year to certain non-residents will not be deductible in computing the income of the Canadian corporation subsidiary and will be definitively lost (i.e., there is no carry-forward possibility).

ii Deduction of finance costs

Interest paid in a year or payable in a year pursuant to a legal obligation to pay interest on borrowed money is deductible in computing income provided the purpose of the borrowing was to earn income from a business or property and the proceeds of the borrowing were and are actually used for an income-earning purpose. A similar rule applies to interest paid for property acquired for the purpose of gaining or producing income from the property or from a business. By opposition, compound interest meeting these conditions is deductible only in the year it is paid.

Financing expenses incurred in the course of borrowing money for the purpose of gaining or producing income from property or from a business or in the course of acquiring property for the purpose of gaining or producing income from property or from a business or in the course of restructuring or rescheduling a debt obligation or issuing shares is generally deductible over a five-year period at a yearly rate of 20 per cent.

By opposition, acquisitions costs incurred in the acquisition of shares of a Canadian corporation and not related to the financing of the transaction are not deductible but rather are added to the cost of the shares.

iii Restrictions on payments

Restrictions on payment of dividends will find their source in the relevant corporate statute. Generally speaking, a corporation shall not declare or pay a dividend if there are reasonable grounds for believing that (1) the corporation is, or would after the payment be, unable to pay its liabilities as they become due or (2) the realisable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes. Directors of a corporation who vote for or consent to the payment of a dividend contrary to the relevant test are jointly and severally, or solidarily, liable to restore to the corporation any amounts so paid and not otherwise recovered by the corporation.

iv Return of capital

There is no requirement in Canada to pay accumulated profits prior to returning capital invested. The return of the 'paid-up capital' is generally not a taxable event for the corporation and the shareholders (subject to certain exceptions applicable to public corporations). In other words, a Canadian corporation can return tax-free to its non-resident shareholders the capital they have invested in subscribing for shares. This tax-free return is limited to the paid-up capital of the shares for tax purposes. When several shareholders are subscribing for shares at different values over time, it is generally advisable to subscribe for different classes of shares having the same or similar attributes in order to preserve the capital subscribed by each of them and avoid any 'dilution' of the capital. Interest paid by a Canadian corporation on a loan used to return capital to its shareholders is generally deductible in computing income.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Given that a corporation can return its paid-up capital tax-free to its non-resident shareholders, it is generally recommended for a non-resident not to acquire directly the shares of a Canadian corporation given that the price paid for the shares is likely to be in excess of their paid-up capital. Rather, it is recommended for the non-resident to incorporate a Canadian acquisition corporation ('Acquisitionco') to proceed with the acquisition of the target corporation ('Targetco') and to amalgamate Acquisitionco with Targetco after. For instance, assume that the shares of Targetco have a fair market value of C$10 million but a paid-up capital of only C$1 million. If the non-resident were to purchase directly the shares of Targetco for C$10 million, the maximum amount it could withdraw free of Canadian withholding tax from Targetco would be limited to the paid-up capital of the shares, namely, C$1 million. Instead of directly purchasing the shares, the non-resident could create Acquisitionco and subscribe for shares of its capital for C$10 million, that is, the non-resident would be able to repatriate free of Canadian withholding tax the C$10 million invested. Acquisitionco would then purchase the shares of Targetco for C$10 million and if desired, Acquisitionco and Targetco could amalgamate to create a single Canadian entity without affecting the rights of the non-resident to withdraw the C$10 million without Canadian withholding tax. Alternatively, the non-resident could use a mix of equity and debt. For instance, he could subscribe for C$4 million worth of shares of Acquisitionco and lend C$6 million with interest (to be within the thin capitalisation ratio). Acquisitionco would then purchase the shares of Targetco for C$10 million and amalgamate with it to form Amalco. Amalco would then be entitled to deduct the interest on the C$6 million loan inherited from Acquisitionco and the non-resident shareholder would still be in a position to repatriate the C$10 million invested without Canadian tax consequences.

ii Reorganisation

Corporate restructurings within Canada, such as amalgamations and liquidations, can generally be carried out without any Canadian income tax consequences. Specific provisions of the ITA also provide for tax-neutral reorganisations of capital, exchanges of shares, transfers of property to Canadian corporations or Canadian partnerships as well as spin-offs and split-ups of Canadian corporations. While certain conditions must be met to benefit from these rollover provisions, the Canadian tax system is quite complete and friendly in terms of corporate reorganisations and restructurings.

iii Exit

As indicated *supra*, the Canadian tax-neutral regime is generally limited to transactions occurring in Canada. The emigration of a corporation from Canada to a foreign jurisdiction triggers realisation of all increases in value on all assets as well as a deemed distribution, subject to Canadian withholding tax, of all earnings that could have been distributed to shareholders.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Canada has had a general anti-avoidance rule ('GAAR') since 1988. According to the Supreme Court of Canada, the basic requirements of the GAAR are the following:

a a tax benefit (i.e., a reduction, avoidance or deferral of tax or other amount payable under the ITA or an increase in a refund of tax or other amount under the ITA) resulting from a transaction (which includes an arrangement or event) or part of a series of transactions;

b the transaction is an avoidance transaction, i.e., it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain the tax benefit; and

c there was abusive tax avoidance, i.e., it cannot be reasonably considered that the tax benefit would be consistent with the object, spirit or purpose of the provisions of the ITA relied on by the taxpayer (misuse and abuse concepts).

When the GAAR is applicable, the tax consequences to a person are determined as is reasonable in the circumstances in order to deny the tax benefit that, but for the GAAR, would result, directly or indirectly, from the avoidance transaction or from a series of transactions that includes the transaction.

The GAAR was amended by the 2004 Budget, effective with respect to transactions entered into after 12 September 1988, to extend the misuse and abuse concepts to tax treaties to address pending cases relating to treaty shopping.

The GAAR has been successfully invoked by CRA in various transactions, including in the context of non-residents owning Canadian corporations and attempting to withdraw Canadian funds without incurring Canadian withholding tax. CRA also tries to invoke the GAAR when non-resident shareholders increase 'artificially' the paid-up capital of a group of Canadian corporations to enhance their ability to withdraw capital from their Canadian subsidiaries without withholding tax.

ii Controlled foreign corporations

The Canadian controlled foreign corporations ('CFC') regime is along the lines of most industrialised countries. Dividends received by Canadian corporations from CFCs resident in countries with which Canada has concluded a tax treaty or a tax information exchange agreement may be exempt from Canadian tax. In such a case, no foreign tax credits are allowed.

iii Transfer pricing

Any transaction (including the sale of goods and the provision of services) between a Canadian resident and a non-resident with whom he does not deal at arm's length must be effected at fair market value or it will be deemed for Canadian income tax purposes to be effected at fair market value. To prevent the double taxation issues that could result from this adjustment, Canada has an advance pricing arrangement ('APA') programme to deal with transfer pricing issues on a prospective basis and a mutual agreement procedure ('MAP') to address existing issues. The APA permits the taxpayer to engage the CRA and the relevant foreign tax authority to review, negotiate and reach an agreement as to the proper transfer price for a determined period of time, thereby providing certainty as to the tax consequences of the proposed transactions. The MAP permits the Canadian taxpayers to request the assistance of Canada's competent authority to negotiate with the authority of a foreign country to eliminate an existing double taxation problem. Both programmes are popular with Canadian businesses.

iv Tax clearances and rulings

Canada has had an advance income tax ruling service since 1972. Advance income tax rulings may be requested by taxpayers to obtain CRA's interpretation of the application of the ITA, the Income Tax Regulations as well as related statutes, including income tax conventions, to proposed transactions. While the provision of advance income tax rulings is an administrative service and there is no specific requirement to issue them, nor is there any legal basis to issue them, advance income tax rulings are regarded as binding upon CRA. Advance income tax rulings may be invalid if there was a material omission or misrepresentation in the description of the relevant facts or the proposed transactions. In such a case, CRA will not be bound by it. While advance income tax rulings may be revoked, it would only happen in very rare occasions where it is determined that the ruling was in error and the contemplated transactions are not yet completed.

No tax clearances or rulings are required for a non-resident to acquire an existing business or an existing Canadian corporation.

X YEAR IN REVIEW

i Section 116 ITA compliance

Recent amendments to the ITA have improved the tax environment for non-residents investing in Canada. Particularly, the 2010 Budget has amended the definition of 'taxable Canadian property' ('TCP') and has to a great extent eliminated one of the most burdensome Canadian tax compliance obligations.

Prior to the amendments, shares of all Canadian private corporations were included in the definition of TCP. Section 116 of the ITA requires a non-resident who disposes of TCP to obtain a certificate of compliance regarding the disposition (a 'Section 116 certificate'). A Section 116 certificate is typically issued by CRA only when the vendor pays an amount equal to 25 per cent of the amount of the gain realised by the vendor on the disposition (or provides acceptable security) or satisfies CRA that any gain from the disposition is exempt from Canadian tax by virtue of an applicable income tax treaty. If no Section 116 certificate is remitted to the purchaser, the purchaser will withhold 25 per cent of the purchase price (and not 25 per cent of the gain) and must remit it to the CRA within 30 days following the end of the month during which the purchase occurred.

The process of obtaining a Section 116 certificate was an onerous one and certificates were often not issued by the CRA until many months after the closing of a transaction. While the CRA usually issued a 'comfort letter' to the purchaser, which permitted the purchaser to remit the withheld amount beyond the prescribed date without incurring potential tax liabilities, the vendors often had 25 per cent of their proceeds tied up in escrow for months, even when no tax was owed. Also, vendors who were entitled to an exemption from Canadian tax by virtue of a tax treaty had to prove this entitlement, which often required the disclosure of significant information regarding their identity and treaty status. Finally, when a payment had been remitted to the CRA, the vendor had generally to file a Canadian income tax return to claim the refund of all or part of the remitted amount (depending on whether a treaty exemption is available).

The change of the definition of TCP to restrict it to situations where the value of the shares of a Canadian private corporation is principally derived from Canadian real estate and Canadian resource properties will simplify the divestiture of investments in Canada. (For an expanded description of TCP, see Section III, sub-section (i), *supra*.)

ii Tax information exchange agreements

Canada has been very active in 2010 in negotiating and concluding tax information exchange agreements. Agreements were signed with the Bahamas, Bermuda, the Cayman Islands, Dominica, the Netherlands Antilles, St Kitts and Nevis, Saint Lucia, St Vincent and the Grenadines, and Turks and Caicos Islands. Canada is currently negotiating with several other countries, including Brunei, the Cook Islands, Liechtenstein, San Marino and Vanuatu.

iii Harmonisation of British Columbia and Ontario with the GST

Effective 1 July 2010, British Columbia and Ontario harmonised their sales tax systems with the GST. The HST applies at a rate of 12 per cent in British Columbia and 13 per cent in Ontario. In each province, the HST replaced the existing provincial retail sales tax system.

XI OUTLOOK AND CONCLUSIONS

Canada's tax environment is one of the most efficient in the world. Its low business income tax rates (scheduled to keep on decreasing in the near future) and its generous SR&ED incentives (refundable in certain provinces, such as Quebec) make it one of the most attractive places for any corporate group to invest and develop. The multiple tax-free reorganisation and restructuring provisions contained in the ITA are well-adapted to today's continuously changing environment. While there is currently no statutory authority to permit the consolidation of income and losses of corporations in a related group, the governments are exploring implementing such a system of loss transfer or consolidated tax reporting. Finally, the repeal of the withholding provisions on interest paid to arm's-length non-resident lenders and the recent amendment to the definition of 'taxable Canadian property' should facilitate the financing and the divestiture of an investment in Canada.

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Alain Ranger is the national head of the taxation practice group at Fasken Martineau. Over the last 25 years, Alain has acquired a reputation for expertise in M&A, cross-border transactions, corporate restructurings, including spin-offs and liquidations of public corporations, foreign investments, structured financing of projects and infrastructures, financial instruments and derivatives and corporate tax planning for public and private clients, nationally and internationally. His expertise is also called upon in litigation files. He additionally acts as an intermediary in efforts to obtain amendments to tax legislation for clients.

Alain has been awarded the highest rating (AV) from Martindale-Hubbell and has continually been rated as 'Consistently Recommended' or 'Repeatedly Recommended' in the area of corporate taxation by the Canadian legal directory *Lexpert*. He is continually recognised as one of the best tax lawyers in *The Best Lawyers in Canada* and has been named by *Chambers Global – The World's Leading Lawyers for Business* and *PLC Which Lawyer?* as one of the leading Canadian practitioners in the area of taxation and as a recommended tax advisor in domestic and international corporate transactions, specifically M&A, corporate restructurings and projects, respectively. He is recognised as an expert in corporate tax in *The International Who's Who of Corporate Tax Lawyers 2009 and 2010* and in *Who's Who Legal: Canada 2010*.

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