



Government
of Canada

Canadian Income Tax Considerations

for Non-Residents Making Investments in Canada

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Doing Business in Canada

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In acquiring a business in Canada, a determination must be made as to whether it is preferable to purchase the assets of the business or the shares of a Canadian corporation which owns the assets. From a purchaser's point of view, it is often advantageous to purchase the assets of the business so that the cost base of the assets, for tax purposes, will be equal to the purchase price of the assets. In a situation where shares of an existing Canadian corporation are acquired, the cost base of the assets for Canadian federal income tax purposes generally remains at the historical tax cost of such assets to the corporation whose shares are acquired.

Due to differing tax concerns for Canadian sellers and foreign buyers, a purchase and sale may be structured to accommodate potentially conflicting interests. Canadian individual sellers may wish to take advantage of their capital gains exemption by selling shares of Canadian private corporations that meet certain criteria. As of 2022, the amount of the capital gains exemption is C\$913,630 and is adjusted annually as it is indexed to the rate of inflation. A Canadian seller may also prefer to sell shares if there would be significant recaptured capital cost allowance on an asset sale. A non-resident seller of shares of a Canadian corporation may insist on a share sale since unless the value of the shares is derived principally from certain Canadian nexus properties (such as Canadian real estate, Canadian resource property and Canadian timber limits) any gain on the sale of such shares is not likely to be taxable in Canada. Alternatively, a non-resident seller may wish to sell shares of a Canadian corporation in order to take advantage of a treaty exemption for capital gains if such gains might otherwise be taxable in Canada. Conversely, a purchaser may wish to acquire assets directly in order to achieve a "step-up" in their basis of the assets held by a business and retain the opportunity to apply Canadian losses or profits against their profits or losses from other operations.

A foreign purchaser's tax goals normally include the following: minimize Canadian taxation of operating profits; minimize Canadian withholding taxes when funds are repatriated; deferral of foreign taxation on Canadian profits; maximize the utilization of foreign tax credits when Canadian income is taken into account for the foreign purposes; and in the case of a U.S. purchaser, amortize the goodwill for U.S. tax purposes over 15 years on a straight-line basis or reduce Canadian earnings and profits for U.S. tax purposes by goodwill amortization.

CANADIAN BRANCH OR CANADIAN SUBSIDIARY

Where a non-resident purchaser has made a decision to purchase the assets of a Canadian business through a corporation, the purchaser will have to determine whether to acquire the assets using a branch to carry on the business or, alternatively, a corporation formed in Canada. The same determination will have to be made by any non-resident who seeks to open or establish a new business in Canada. Any apparent advantage of conducting business through a branch as opposed to a subsidiary is largely lost once the business is profitable.

Most treaties to which Canada is a signatory include a provision which states that the income earned in Canada by a branch of a foreign corporation is only taxable in Canada if that business is carried on through a "permanent establishment" in Canada. Permanent establishment is broadly defined in most treaties to which Canada is a signatory to include a fixed place of business through which the business of a resident of a contracting state is wholly or partly carried on, including a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, and a quarry or other place of extraction of natural resources. However, the carrying on of business by a non-resident through an independent contractor does not necessarily mean a permanent establishment exists.

A Canadian subsidiary is subject to income tax under Part I of the ITA on its worldwide income. To the extent that the Canadian subsidiary repatriates its profits by paying dividends to its parent, Part XIII of the ITA provides that those dividends will be subject to withholding tax at the rate of 25%. However, this rate may be reduced by treaty.

A branch of a non-resident corporation is subject to Canadian tax as if the branch were a corporation incorporated in Canada. However, in contrast to a subsidiary, a branch is only taxable on its income from business carried on in Canada rather than on its worldwide income.

One advantage of utilizing a branch operation in Canada is that, while the losses of a Canadian subsidiary are generally not available for deduction in the jurisdiction of the parent corporation, the losses of a Canadian branch operation may, subject to the tax laws of the jurisdiction of the parent corporation, be applied against the income of the parent corporation. The advantage provided by a branch operation in this context can only be realized where the parent has sufficient income against which it can offset the losses of the Canadian branch.

In addition to Part I tax, a branch of a non-resident corporation will generally be subject to branch tax under Part XIV of the ITA. Generally speaking, branch tax is levied on the amount of accumulated taxable income in excess of taxes paid or payable as well as an investment allowance. An investment allowance provides the opportunity to defer branch tax to the extent that profits of the branch are reinvested in Canadian business assets and other qualifying assets. The purpose of the branch tax is to equate the Canadian tax position of non-residents who carry on business in Canada through a branch operation with that of non-residents who do so through a Canadian subsidiary. In this way, the branch tax effectively acts as a proxy for dividend withholding tax. As such, the usual rate of branch tax is 25%. However, similar to withholding tax on dividends, many tax treaties to which Canada is a signatory provide that the applicable rate will be reduced to the same rate as the withholding tax rate applicable to dividends under the particular treaty with, in some cases, an exemption from the branch tax up to a cumulative limit. Moreover, the ITA provides that if a non-resident corporation is resident in a country with which Canada has a treaty and on the last day of the year the treaty applies to that corporation, and if the treaty does not address the rate of branch tax, the rate of branch tax will be reduced to the rate which would be applicable to a dividend paid to a corporation resident in that country which owned all the shares of a Canadian subsidiary corporation.

One significant disadvantage of a branch arises where a branch provides services in Canada. Regulation 105 provides that where a non-resident provides services in Canada (whether provided wholly or even partly in Canada), the payer must withhold 15% of the gross amount of the services fee and remit such amount to the Canada Revenue Agency (“**CRA**”) on behalf of the non-resident’s tax liability. This requirement to withhold applies even if the non-resident would not be taxable in Canada because of the application of a treaty (most of Canada’s tax treaties provide that a non-resident person who is resident in a jurisdiction with which Canada has a treaty is not liable to pay income in Canada unless it has a permanent establishment in Canada), unless it obtains a waiver from withholding tax.

UNLIMITED LIABILITY COMPANIES

The laws of Nova Scotia, Alberta, British Columbia and Prince Edward Island provide for the creation of unlimited liability companies. In the United States,

we understand that certain rules permit certain entities, including unlimited liability companies, to be treated as partnerships or disregarded entities for U.S. tax purposes rather than as corporations. The use of a flow-through vehicle may be attractive for U.S. investors.

The shareholders of an unlimited liability company can attempt to restrict their liability by having the corporation contract with third parties to limit their recourse to corporate assets. The shareholders agreement and the articles of an unlimited liability company could be structured to avoid centralized management. We understand that it may be possible to have the unlimited liability company not be characterized as an association for U.S. purposes. It therefore may offer the benefits of the U.S. limited liability corporation for a cross-border transaction.

It is our understanding that unlimited liability companies may be regarded as a partnership (if there is more than one shareholder) or disregarded entity (where there is one shareholder) for U.S. tax purposes. For Canadian purposes, an unlimited liability company is regarded as a Canadian corporation and taxed in Canada as such. Distributions in excess of originally invested capital are treated as dividends (unless effected as a return of capital) and are subject to Canadian withholding tax. However, from a U.S. perspective, we understand that an unlimited liability company has the advantage of being treated as a branch operation. Accordingly, we understand that losses of the unlimited liability company may be applied against U.S. profits. We understand that any dividends paid by an unlimited liability company will be disregarded for U.S. purposes and any interest paid by the unlimited liability company to the U.S. parent would be ignored for U.S. purposes.

In addition, the subsequent sale of an unlimited liability company (as is the case with a regular business corporation) is generally not subject to tax in Canada unless the assets of the company have a significant Canadian real or resource property nexus, but may nonetheless be exempt from tax under Article XIII of the *Canada-U.S. Income Tax Convention* (“**Canada-U.S. Treaty**”) provided that the assets of the unlimited liability company are not primarily Canadian real estate at the time of sale. Use of an unlimited liability company, as opposed to a branch, would obviate the necessity of the U.S. corporation filing a Canadian tax return in respect of all of its operations. Instead, for Canadian purposes, the unlimited liability company would be regarded as a Canadian corporation and would file a Canadian tax return in respect of its operations.

The Fifth Protocol to the Canada-U.S. Treaty has had an impact on the use of unlimited liability companies. Under the anti-hybrid rule in Article IV(7)(b) of the Canada-U.S. Treaty, amounts paid by an unlimited liability company to a U.S. resident are not eligible for the reduced rates of withholding tax available under the Canada-U.S. Treaty. For example, dividends paid by an unlimited liability company to a U.S. resident company that would otherwise be entitled to a 5% rate of withholding are subject to a 25% rate. However, there may be tax planning strategies to ameliorate the effect of the anti-hybrid rules depending on the circumstances. Despite the anti-hybrid rule, most dividend distributions by an unlimited liability company to a regarded U.S. parent corporation can be effected in a manner so as to access the lower 5% rate of withholding.

CAPITALIZING THE NON-RESIDENT OWNED CANADIAN BUSINESS

In determining the appropriate structure for a non-resident purchaser of a Canadian business, it is important to consider how the acquisition is to be financed. Issues such as the deductibility of interest, the possible application of withholding tax on interest payments and the ability to repatriate capital should be considered. Subject to the thin capitalization rules of the ITA, the ITA generally permits the deduction of reasonable interest paid in the year, or payable in respect of that year, under a legal obligation to pay interest on borrowed money used for the purpose of earning income or an amount payable for property acquired for the purpose of earning income, including shares or the assets of a business. Starting in taxation years that begin on or after January 1, 2023, taxpayers will also need to plan around a new excessive interest and financing expense limitation in addition to thin capitalization rules. These rules will limit net interest expense to a fixed ratio of adjusted taxable income (40% for taxation years beginning on or after January 1, 2023, but before 2024, and 30% for taxation years beginning on or after January 1, 2024).

THIN CAPITALIZATION

If a Canadian corporation is formed to acquire shares or assets from an existing Canadian corporation, the Canadian thin capitalization rules should be considered in determining the appropriate mix of debt and equity in the Canadian corporation (and partnerships of which the Canadian corporation is a partner). The ITA denies a deduction for interest paid by a corporation resident in Canada to the extent that the aggregate amount of interest-bearing debt owed to specified non-resident shareholders exceeds the equity contributed by specified non-

resident shareholders by a ratio of greater than 1.5:1. For the purpose of determining a corporation's debt-to-equity ratio, debt obligations of a partnership of which a corporation is a partner may be allocated to the corporation based on the corporation's proportionate share of the partnership's total income or loss for the partnership's fiscal period.

Interest on debt that exceeds the permitted ratio will be non-deductible in computing income, recharacterized as a dividend for non-resident withholding tax purposes and subject to withholding at appropriate rates.

A specified non-resident shareholder is defined in the ITA as a non-resident shareholder who, either alone or together with non-arm's-length persons, owns shares carrying 25% or more of the voting power or representing 25% or more of the fair market value of the issued and outstanding shares. This test is measured on a fully diluted basis with respect to the non-resident shareholder.

The deduction will be denied for that proportion of otherwise deductible interest equal to the amount determined by the following formula:

$$\frac{(A - B)}{A}$$

Where:

A: is the average of all amounts each of which is, for a calendar month that ends in the year, the greatest total amount at any time in the month of the corporation's outstanding debts to specified non-residents, and

B: is 1.5 times the equity amount of the corporation or trust for the year.

The equity amount for a corporation resident in Canada is the aggregate of: (i) the retained earnings of the corporation at the beginning of the year (except to the extent those earnings include the retained earnings of any other corporation); (ii) the average of all amounts, each of which is the corporation's contributed surplus at the beginning of a calendar month that ends in the year, to the extent that it was contributed by a specified non-resident shareholder of the corporation; and (iii) the average of all amounts, each of which is the corporation's paid-up capital at the beginning of a calendar month that ends in the year (excluding the paid-up capital with regard to shares of any class of the capital stock of the corporation owned by a person other than a specified non-resident shareholder of the corporation).

The reference to paid-up capital at the beginning of a month can be problematic when a new acquisition occurs mid-month and is financed, in part, with an interest-bearing loan by a significant shareholder. As there would be no credit for the paid-up capital until the following month, the interest expense may be denied for the initial month.

It also should be noted that the Canadian thin capitalization rules do not apply to an interest-free loan made by a non-resident to a Canadian corporation, as the effect of the rule is to deny the interest deduction on the excess amount owing to a specified non-resident. If the Canadian corporation is required to capitalize interest under the ITA (for example, interest incurred during a construction period), the thin capitalization rules will not apply to the capitalized interest.

Supporting back-to-back loan provisions greatly extend the application of the thin capitalization rules. In very general terms, these back-to-back loan rules provide that where a non-resident who deals not at arm's length with a Canadian borrower provides property in support of a loan made by a third party to a Canadian borrower that is a corporation or trust, the loan may be, in some circumstances, considered to be made by the non-resident to the Canadian borrower for purposes of the thin capitalization rules. In addition, interest paid by the Canadian borrower to the lender may instead be deemed to be paid to such non-resident for purposes of the withholding tax rules in Part XIII of the ITA. The rules may apply to cross-collateralized loans and cash pooling arrangements.

The thin capitalization rules also apply to trusts resident in Canada, non-resident trusts and corporations that carry on business in Canada as a branch, and partnerships in which the aforementioned entities are members.

CANADIAN ACQUISITION CORPORATION

In most cases, non-resident purchasers should interpose a Canadian corporation to acquire the shares of an existing Canadian corporation. This structure may have several advantages, including the ability to benefit from an increase or “bump” in the Canadian tax cost of the non-depreciable capital property (such as shares of subsidiary corporations or land) of the Canadian target corporation(s) if it is subsequently wound-up into or combined by amalgamation with the Canadian holding corporation, and the ability to create an increase in paid-up capital that may subsequently be repatriated on a tax-free basis.

Generally, paid-up capital represents the amount that is paid to a corporation for the issuance of treasury shares. If a shareholder of a Canadian corporation sells those shares to a non-resident purchaser, the non-resident purchaser will not be able to increase the paid-up capital of the shares of the corporation, although the non-resident's adjusted cost base (tax cost) will be equal to the purchase price. The “step-up” in tax cost of the shares for Canadian purposes is of no value to a non-resident shareholder if the disposition of the shares would not be taxable under Canadian domestic law or under a treaty. However, if the non-resident subscribes for shares of a Canadian holding corporation that in turn purchases the shares of a Canadian operating corporation from a Canadian shareholder, the paid-up capital of the non-resident's shares in the Canadian holding corporation will be equal to the amount invested for shares. Dividends could be paid by the Canadian operating corporation to the Canadian holding corporation free of tax under Parts I and IV of the ITA, and the surplus can then be distributed by the Canadian holding corporation as a return of capital to the non-resident up to the amount of the paid-up capital without the imposition of Canadian withholding tax. This is the case whether or not the Canadian group has undistributed earnings and profits.

Similarly, if the Canadian operating corporation is subsequently amalgamated with or wound-up into the Canadian holding corporation, the operating corporation's after-tax profits can be distributed to the non-resident shareholder as a reduction of the paid-up capital until the paid-up capital is exhausted. Also, if the Canadian holding corporation and operating corporation are amalgamated, the interest on funds borrowed by the holding corporation to purchase the shares would be deductible against the operating profits of the business. This potential to increase the paid-up capital and to take advantage of either the “bump” available on the amalgamation or wind-up of a wholly-owned subsidiary or the ability to pay dividends free of tax between related Canadian corporations generally makes the use of a Canadian holding corporation attractive.

STRUCTURING FOR THE EVENTUAL DISPOSITION OF A CANADIAN BUSINESS ENTITY

Canada taxes the disposition of “taxable Canadian property” (“TCP”) by non-residents. The definition of TCP includes real or immovable property situated in Canada and property used in carrying on business in Canada. It also includes a share of a private corporation, and an interest in a partnership or trust

where at any time in the 60-month period prior to the date of disposition, more than 50% of the fair market value of the share, partnership interest or trust interest, is derived directly or indirectly from one or any combination of: (a) real or immovable property situated in Canada; (b) Canadian resource properties; (c) timber resource properties, and (d) options in respect of, or interests in, or civil law rights in, property described in subparagraphs (a)–(c), whether or not the property exists. If the shares of a corporation are listed on a designated stock exchange or a trust is a mutual fund trust, the shares or units are TCP only if the above test is met at any time in the 60-month period prior to the date of disposition and, at the particular time in which that test is met, the non-resident person, alone or together with non-arm's length persons, owned 25% or more of the issued shares of any class, or 25% or more of the issued units of the mutual fund trust.

A section 116 clearance certificate must be obtained from the Minister of National Revenue in connection with the disposition of TCP (other than excluded property). Publicly listed shares are excluded property. Unfortunately, the process to obtain a section 116 certificate is slow and it can be expensive and time consuming. The requirement to obtain a section 116 certificate is particularly problematic for foreign funds which are formed as partnerships investing in TCP, particularly where the fund has other funds (as partnerships) as an investor. If a person acquires TCP (other than excluded property) from a non-resident without obtaining a section 116 certificate from the vendor, the purchaser is generally required to remit 25% of the gross purchase price (or 50% in the case of certain TCP). Accordingly, where a non-resident owns TCP, it may be desirable to hold such investments through a blocker corporation resident in a jurisdiction which has a treaty with Canada which contains an appropriate capital gains exemption.

ENTITIES OWNING REAL ESTATE

If a Canadian corporation to be acquired by a non-resident Canadian owns real estate as well as an operating business, consideration should be given as to whether a non-resident purchaser should acquire the Canadian real estate in a separate corporation. This may attract land transfer tax depending on the province in which the property is located. However, if the real estate is in the operating company and has significant value, then on the disposition of shares of the Canadian subsidiary, the value of the real estate may result in the shares being TCP and the disposition being subject to Canadian tax, unless there is relief from Canadian tax under

a capital gains exemption under an applicable tax treaty. Some treaties exclude from the definition of real property, property from which the business of the corporation is carried on. Depending on the provisions of the relevant treaty, separating the Canadian corporation's assets into separate Canadian corporations for the business and the real estate may preserve the ability of the non-resident to benefit from the capital gains exemption under the relevant treaty should the shares of the Canadian corporation operating the business subsequently be sold.

ACQUISITION OF CONTROL

An acquisition of control of a corporation creates certain tax consequences to the Canadian target, and all underlying corporations controlled by it, including a deemed year end. Under this provision, the corporation's year end is deemed to end immediately before the acquisition of control. A deemed year end gives rise to the requirement to file the corporation's federal and provincial or territorial tax returns (within six months from the date of the deemed year end) and may accelerate the payment of taxes due.

Where a Canadian corporation is a Canadian-controlled private corporation ("CCPC"), it will be deemed to have a year end immediately prior to ceasing to be a CCPC. A non-resident is deemed to own any shares that it has a right (including a contingent right, such as one under a purchase agreement) to acquire. As a result, a corporation will often lose its status as a CCPC as soon as an agreement of purchase and sale to acquire all the shares of the corporation is signed. This may trigger a year end, followed by another year end on the actual closing of the share purchase.

There are a number of other tax consequences arising from an acquisition of control. For example, a deemed year end shortens the period for non-capital loss carry-forwards and carry-backs. The general rule is that non-capital losses may be carried back three years and forward 20 years. Following the acquisition of control, non-capital losses (business losses) are generally only deductible if the corporation continues to carry on the same business in which the losses arose, or a similar business, throughout the taxation year with a reasonable expectation of profit. Net capital losses incurred prior to the acquisition of control expire and are not deductible in any period subsequent to the acquisition of control. However, an election may be made under the ITA in the taxation year ending immediately prior to the acquisition of control to

deem the corporation to have disposed of capital properties for an amount up to the fair market value thereof (thereby creating capital gains in the pre-acquisition of control year, using up the capital losses and increasing the adjusted cost base of such non-depreciable capital properties).

INCREASING THE TAX COST OF CANADIAN ASSETS

When a controlling interest is acquired in a Canadian corporation, any net capital losses carried forward will be lost. An election may be made under paragraph 111(4)(e) of the ITA in the taxation year which is deemed to end immediately prior to the acquisition of control for the Canadian corporation to increase the tax basis of any capital properties owned by the subsidiary Canadian corporation up to the lesser of their fair market value and the greater of the adjusted cost base of the property and the amount designated by the corporation in respect of the property to the extent of any net capital-loss carry-forwards.

When a wholly-owned Canadian subsidiary is amalgamated or wound up into its parent, and both the subsidiary and its parent are taxable Canadian corporations, it is possible to increase the tax basis of non-depreciable capital property owned by the subsidiary, in general terms, to the extent that the adjusted cost basis of the shares of the Canadian subsidiary exceeds the net tax value of its underlying assets. The step-up in the basis of any asset is limited to the fair market value of such asset.

Subsection 88(1) of the ITA provides rules for the winding-up of a taxable Canadian corporation into its parent if not less than 90% of the issued shares of each class of capital stock of the subsidiary are held by a parent which is also a taxable Canadian corporation. In general, a tax-free rollover is available with respect to the assets distributed on the winding-up. If a parent receives capital property other than depreciable property, it may increase its basis in the capital property over the basis that the subsidiary had in the property. This “bump” in basis will occur if the adjusted cost base (tax cost) of the shares of the subsidiary immediately before it is wound-up exceeds the aggregate of the net tax value of the subsidiary property and the amount of any dividends paid by the subsidiary to the parent. Subsection 87(11) of the ITA provides for an identical “bump” on a vertical amalgamation between a parent and a subsidiary. Both the parent and subsidiary must be governed by the same corporate statute for an amalgamation. The “bump” in basis on an amalgamation is only available if the parent

owns all of the shares of the subsidiary (compared to the 90% requirement on a winding-up).

If the Canadian target corporation owns non-depreciable capital property, such as land or shares of other Canadian or non-resident corporations, it may be possible to wind-up the Canadian target corporation and to increase the tax basis of its non-depreciable capital property to the extent of the positive difference between the purchase price of the shares and the tax basis of the assets, provided that the tax basis of the assets may not exceed fair market value. This increase in basis is only available with respect to non-depreciable capital property that was owned by the subsidiary at the time the parent last acquired control of the subsidiary. Moreover, the availability of the “bump” is restricted if, as part of the series of transactions, any property, or property substituted for such property, that is distributed to the parent on the winding-up, is acquired by certain persons (which, in general terms, includes persons who own more than 10% of the issued shares of any class but who are not related to the corporation). There are a myriad of technical rules that may deny the “bump” in various circumstances which need to be looked at and considered very carefully.

If a U.S. purchaser formed a new Canadian corporation to purchase the shares of an existing Canadian corporation with a U.S. subsidiary (“USCo”) from Canadian sellers, it would be possible to subsequently wind-up the existing Canadian corporation and to increase the Canadian tax basis of the shares of the USCo. The USCo could then be transferred directly to the U.S. purchaser without any tax in Canada. One method of accomplishing the distribution without attracting Canadian withholding tax would be to reduce the paid-up capital of the shares of the new Canadian holding corporation by an amount equal to the fair market value of the shares of the USCo. Alternatively, if the new Canadian holding corporation was funded by a combination of shares and debt, the shares of the USCo could be transferred to new U.S. purchasers and the principal amount of the debt would be reduced by an amount equal to the fair market value of the shares of the USCo. The removal of the USCo from below the Canadian holding company would have the added advantage of enabling the U.S. purchaser to report the operations of the USCo on a consolidated basis.

We understand that while the pre-acquisition amalgamation or winding-up of the Canadian target into its parent is one way to get a step-up for U.S. purposes, the more common way is to structure the acquisition as a “qualified stock purchase,”

entitling the purchaser to make a section 338(g) election under the U.S. Internal Revenue Code. We understand that the section 338(g) election results in a stepped-up basis in the Canadian target's assets, but only for U.S. purposes. We understand that an election is usually available under section 338(g) if the buyer (e.g., a Canadian holding corporation) acquires at least 80% of the shares of the target corporation by way of purchase.

USE OF EXCHANGEABLE SHARES

In some sales of businesses, Canadian sellers are required to take back shares in a foreign corporation as all or part of the sale price. The problem that this creates is that there is no tax deferral available in Canada for an exchange of shares of a Canadian corporation for shares of a foreign corporation. Under the current law, a Canadian seller in such a situation is taxable in Canada on the full capital gain based on the fair market value of the shares of the foreign corporation received as consideration. This may create a cash flow problem as there are no cash proceeds available to discharge the resulting tax liability. In many situations, exchangeable shares have been used to avoid this problem.

In addition, the Canadian shareholder may be faced with double withholding tax if he, she or it owns shares of a foreign corporation that in turn owns shares of a Canadian corporation. The Canadian corporation would be subject to Canadian withholding tax on the distribution of dividends to the foreign corporation and the foreign corporation may be subject to foreign withholding tax on the distribution of dividends to the Canadian shareholders.

If the shares of the foreign corporation subsequently decline in value, the Canadian shareholder may be faced with a capital loss. If that loss is incurred more than three years after the date of the share sale, the loss may not be carried back to offset any capital gain that arose on the original share exchange.

Generally speaking, in an exchangeable share transaction, the foreign purchaser forms a subsidiary ("**Newco**") in Canada which acquires the shares of the Canadian target in exchange for exchangeable shares of Newco, which are economically equivalent to the shares of the foreign purchaser. The Canadian shareholders can benefit from a rollover under subsection 85(1) of the ITA, in the case of a transfer of shares of the target to Newco, or section 86 of the ITA, in the case of a reorganization of the capital of the target corporation, permitting the Canadian holders to defer tax until the disposition of the exchangeable shares. The transaction may be

structured to enable the Canadian vendors to claim their Canadian capital gains exemptions, if available.

The Newco exchangeable shares would have a dividend entitlement that would match the dividends that would be paid on the common shares of the foreign corporation. The Newco exchangeable shares also would be redeemable and retractable for a predetermined number (usually 1 for 1) of shares of the foreign corporation or a related corporation. The Canadian shareholders may wish to ensure that they have voting rights in the foreign corporation. The Canadian shareholders may wish, at a minimum, to have a "put" of the exchangeable shares to the foreign corporation if Newco subsequently becomes insolvent.

Newco, or more usually a related Canadian corporation, will ultimately purchase the exchangeable shares in exchange for shares of the foreign corporation. The transaction would be structured to increase the paid-up capital of Newco to reflect the purchase price, thus facilitating the future repatriation of the purchase price free of Canadian withholding tax. The Canadian shareholder would typically trigger the exchange of the exchangeable shares only when the shareholder wishes to dispose of the shares of the foreign corporation. Although the exchange of the exchangeable shares for shares of the foreign corporation will be taxable in Canada, there is a matching of the Canadian gain with the receipt of the sale proceeds.

These transactions must be carefully structured to ensure that the Canadian shareholders benefit from a rollover, whether automatically or by way of a required joint election, and are not deemed to receive any taxable benefit. In addition, from the perspective of the Canadian corporation, it may be important that the transaction be structured to avoid Part VI.1 and IV.1 tax. If the exchangeable shares are taxable preferred shares or short-term preferred shares, Part VI.1 of the ITA imposes a tax on the payer in respect of certain dividends paid on the shares and Part IV.1 imposes a tax on the corporate recipient of dividends in certain circumstances. If the exchangeable shares are taxable preferred shares or short-term preferred shares (which they would likely be if they are retractable by the holder at any time pursuant to the share provisions), this tax is avoided by enabling a corporation other than the corporation which issued the exchangeable shares to purchase the exchangeable shares once the Canadian seller has requested a redemption, but before the redemption is completed (the redemption, if completed, may trigger the Part IV.1 tax and the Part VI.1 tax).

INTEREST PAYMENTS

There is no Canadian withholding tax on interest paid by a resident of Canada to an arm's-length lender provided that the interest is not participating debt interest. Canadian withholding tax of 25% (unless reduced by a treaty) will apply to interest paid by a Canadian borrower: (i) to a non-resident lender with which the Canadian borrower does not deal at arm's-length, or (ii) on "participating debt interest." Participating debt interest is generally interest all or any portion of which is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criteria or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of the corporation. The interest on certain convertible debt may be considered to be participating debt interest.

Under the Canada-U.S. Treaty, withholding tax on interest paid to a related person who is a "qualifying person" for purposes of the Canada-U.S. Treaty is 0%. Canada does not currently have any other treaties with a 0% rate of withholding tax on interest. Most of Canada's other treaties reduce the rate of withholding tax on interest to 10%.

No Canadian withholding tax arises on the repayment of capital, even if the Canadian corporation has earnings and profits.

DISTRIBUTION BY WAY OF DIVIDENDS

If a non-resident investor has invested directly in a Canadian corporation and this corporation pays dividends to the non-resident investor, those dividends would be subject to Canadian withholding tax at 25% unless the rate is a reduced rate under an applicable tax treaty^{1,2}.

DISTRIBUTION BY WAY OF ROYALTIES

Where a resident of Canada pays or credits, or is deemed to pay or credit an amount, to a non-

resident person, on account, or in lieu of payment of, or in satisfaction of a rent, royalty or similar payment, the non-resident is subject to withholding tax of 25% on the gross amount of the payment, unless reduced by treaty. Many of Canada's treaties reduce the rate of withholding tax on royalties. For example, pursuant to Article XII of the Canada-U.S. Treaty, the rate of withholding tax on royalties is limited to 10% of the gross amount of the royalty. For purposes of the Canada-U.S. Treaty, the term "royalty" means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, any patent, trademark, design or model, plan, secret formula or process, or for the use of tangible personal property or for information concerning industrial, commercial or scientific experience.

Many of Canada's treaties provide an exemption from Canadian withholding tax on certain types of royalties. Paragraph 3 of Article XII of the Canada-U.S. Treaty also provides for the exemption of withholding tax in respect of the following types of royalty payments: (a) copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (other than payments in respect of motion pictures and works on film, videotape or other means of reproduction for use in connection with television); (b) payments for the use of, or the right to use, computer software; (c) payments for the use of, or the right to use, any patent or any information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement); and (d) payments with respect to broadcasting as may be agreed for the purposes of this paragraph in an exchange of notes between Canada and the United States.

MANAGEMENT FEES

The payment of reasonable management fees by the Canadian corporation gives rise to a deduction in Canada but is subject to withholding tax at a rate of 25% (unless modified by treaty or unless the management fees constitute a reimbursement for specific expenses). However, to the extent that the non-resident resides in a jurisdiction with which Canada has a tax treaty, management fees generally escape Canadian withholding tax on the basis that they constitute business income if the entity providing the management services does not maintain a permanent establishment in Canada.

If the services are rendered by a non-resident in Canada, GST may have to be charged. In addition,

1 Under most treaties, the rate of withholding tax is reduced to 15%, but may be reduced further to 5% if the beneficial owner of the dividends is a corporation that meets a certain level of ownership in or control over the dividend paying company (some treaties contemplate the requirement to directly own at least 10% of the voting shares, some treaties contemplate the need of the corporate beneficial owner of the dividend to control, directly or indirectly, at least 10% of the voting power of the Canadian corporation, etc.). The terms of each particular treaty need to be considered. Further, the terms of some treaties may require a minimum holding period in order to access these benefits).

2 If the Canadian payer is an unlimited liability company and the recipient is a U.S. person, the anti-hybrid rules in the Fifth Protocol to the Canada-U.S. Treaty may apply so that there is no reduction in the rate and withholding tax is levied at 25%. There are techniques to avoid the application of the anti-hybrid rules. However, the withholding tax rate on dividends paid by an unlimited liability company to a U.S. LLC will be 25%.

Regulation 105 of the ITA imposes a separate withholding tax of 15% in respect of all fees paid to a non-resident for services rendered in Canada. The non-resident may apply for a waiver from this 15% tax (which may be difficult to obtain) or claim a refund of the tax by filing a Canadian tax return and taking the position that the non-resident is entitled to the protection of a treaty and does not have a permanent establishment in Canada.

SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT ("SR&ED") TAX INCENTIVE PROGRAM

The ITA contains a series of generous tax incentives in support of SR&ED in Canada. These tax incentives are provided through a system of tax deductions and credits to taxpayers that incur qualifying SR&ED expenditures, and engage in SR&ED activities in Canada. Taxpayers that are CCPCs are afforded additional benefits under the SR&ED regime. Tax credits range from 15% to 35% of an entity's qualifying SR&ED expenditures, and may be refundable if the taxpayer is a CCPC. Other than capital expenditures, taxpayers may generally deduct the full amount of any qualifying expenditures, including overhead expenditures, in the year in which they were incurred. Conversely, the deduction of these qualifying expenditures may also be deferred. Almost all of the provinces in Canada provide similar tax incentives for SR&ED activities.

There are no restrictions on the ownership of intellectual property that are funded by the SR&ED tax incentives. Hence, it would be possible for a non-resident corporation to set up a Canadian subsidiary to carry out its SR&ED activities in Canada on its behalf so as to take advantage of the SR&ED tax incentives. With proper agreements between the non-resident and its Canadian subsidiary, ownership of any resulting intellectual property from the activities of the Canadian subsidiary may vest in the non-resident corporation. Such an arrangement is particularly useful if the non-resident parent resides in a lower tax jurisdiction.

TRANSFER PRICING AND NON-ARM'S LENGTH TRANSACTIONS

Canada's transfer pricing regime closely follows the transfer pricing guidelines set out by the Organization for Economic Cooperation and Development. Under the ITA, transactions between a Canadian taxpayer and a related non-resident must be carried out on terms and prices that would have prevailed had the Canadian taxpayer and non-resident been acting at

arm's length. This "arm's-length principle" is meant to prevent taxpayers from engaging in improper tax planning by manipulating prices for transactions between related members of a corporate group with the goal of shifting profits from high tax rate jurisdictions to low tax rate jurisdictions. The "arm's length principle" applies to all non-arm's-length inter-company transactions involving tangible and intangible property, and services. Generally, under Canada's transfer pricing regime, profits from transactions between non-arm's length entities are allocated based on the respective entity's functions, assets and risks. The entity that has the greater functions, assets and risks is expected to earn a larger share of the profit.

The ITA allows CRA to adjust the terms, conditions and prices of transactions between a Canadian taxpayer and a non-arm's length non-resident that it concludes are inconsistent with the "arm's length principle." CRA may further levy a 10% penalty on any resulting net transfer pricing adjustment. In addition to increasing the Canadian taxpayer's taxable income, the transfer pricing adjustment may also result in a "secondary adjustment" particularly in situations where the non-arm's length non-resident is a shareholder of the Canadian taxpayer. This "secondary adjustment" pertains to the benefit accruing to the non-arm's length non-resident from the inappropriate transfer prices. If CRA determines that the non-arm's length transfer prices resulted in a benefit to the non-resident shareholder of the Canadian taxpayer, the ITA would treat this benefit as a deemed dividend, subject to applicable withholding taxes, from the Canadian taxpayer to the non-resident shareholder.

Any Canadian taxpayer that engages in transactions with a non-arm's length entity is obligated to create and retain certain documentation that generally sets out the rationale for the prices used in the non-arm's length transactions. The failure to provide this documentation when requested by CRA may result in significant penalties should there be a subsequent transfer pricing adjustment.

INCOME TAX FILING AND RECORD KEEPING OBLIGATIONS

Every non-resident corporation that carries on a business in Canada, either directly or through a partnership, is required to file a Canadian income tax return within six months of the corporation's fiscal year end. The filing obligation remains even if the non-resident corporation does not have any profits or is exempt from Canadian tax pursuant to a tax treaty. Corporations are not allowed to file consolidated

returns. Therefore, each corporate entity in a corporate group is required to file separate returns.

Any non-resident that disposes of taxable Canadian property or has a capital gain is required to file an income tax return. However, if a capital gain is sheltered by an applicable tax treaty or the non-resident obtained a section 116 clearance certificate for each disposition of taxable Canadian property, the non-resident is not required to file an income tax return.

Non-residents carrying on a business in Canada must also maintain books and records in Canada or otherwise make these books and records available to CRA for audit purposes.

MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING (“MLI”)

The MLI is a multilateral convention sponsored by the OECD. It is designed to reduce opportunities for multinational enterprises to use tax treaties to avoid tax.

The MLI applies to tax treaties where each of the parties to the treaty have (i) brought the MLI into force, (ii) listed the treaty as being covered by the MLI, and (iii) to the extent that both countries have chosen that a particular provision of MLI should apply. Canada has listed over 80 of its tax treaties as being covered by the MLI. The MLI is in force in Canada.

One of the most significant treaty modifications for Canada under the MLI is the addition of a broad anti-abuse rule, commonly referred to as the “principal purpose test” (“**PPT**”). Under the PPT, a treaty benefit is denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain that treaty benefit. However, an exception is available where it can be established that granting that treaty benefit would be in accordance with the object and purpose of the relevant provisions of the treaty. At this time, the impact of the PPT on Canadian tax planning is uncertain.

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