e | Taxation

In Canada, an income tax is levied at the federal and provincial levels, and a variety of other taxes are also imposed. This section focuses on income tax and discusses some of the principal income tax considerations that apply to non-residents of Canada who wish to invest or carry on a business in Canada. Although a variety of structures are available, the following discussion is limited to the income tax considerations that apply to Canadian branches and subsidiaries.

Since Canadian income tax rules are complex and subject to change, the information here is not intended to be comprehensive, and this discussion is not intended to be tax advice.

1. General Application of Canadian Taxation to Non-residents

The Canadian federal government imposes income tax under the *Income Tax Act* (ITA) on a taxpayer's income for each taxation year. Residents of Canada are taxed on their worldwide income. Non-residents are only subject to Canadian income tax on their Canadian source income.

Non-residents who were employed or carried on a business in Canada during the year or disposed of "taxable Canadian property" are liable to pay income tax on that portion of their taxable income earned in Canada. Non-residents are also subject to withholding tax on passive income such as dividends, rent and royalties from Canadian sources. A non-resident of Canada who resides in a country with which Canada has entered into a tax treaty may benefit from exemptions or reduced rates of tax in Canada under that treaty.

a. Taxable Canadian Property

Capital gains realized by a non-resident on the disposition of "taxable Canadian property" are usually taxed in the same way as a capital gain realized by a Canadian resident. (The taxation of capital gains is discussed further in this section under "Canadian Taxation of a Canadian Resident Subsidiary.")

For this purpose, "taxable Canadian property" includes:

i. Real or resource property located in Canada;

ii. Eligible capital property or inventory that was used in carrying on a business in Canada (with some limited exceptions);

iii. A share of the capital stock of a corporation not listed on a designated stock exchange or an interest in a partnership or trust (other than a mutual fund trust or an income interest in a trust resident in Canada) at a particular time, if at any time during the previous 60-month period, more than 50 per cent of the fair market value of the share or interest was derived from certain Canadian properties (e.g., real property situated in Canada, Canadian resource properties, timber resource properties or options/interests in such properties);

iv. A share of the capital stock of a corporation that is listed on a designated stock exchange, or a share of a mutual fund corporation or a unit of a mutual fund trust at a particular time, if both of the following conditions applied at any time during the previous 60-month period:

- The taxpayer (not including people dealing at arm's length with the taxpayer) owned 25 per cent or more of the issued shares of any class of the capital stock of the corporation; and
- More than 50 per cent of the value of the shares was derived from certain Canadian properties (e.g., real property situated in Canada, Canadian resource properties, timber resource properties or options/interests in such properties).

v. Options or interests in the properties described in (i) to (iv).

Subject to certain exceptions, non-residents of Canada must file a notice with the Canada Revenue Agency (CRA) applying for a clearance certificate no later than 10 days after disposing of taxable Canadian property. The purchaser is required to withhold tax from the purchase price for taxable Canadian property where the vendor is a non-resident. It is usually advantageous for the non-resident to obtain a clearance certificate from the CRA, since a clearance certificate will be issued on payment of a withholding tax based on the gain arising from the sale of taxable Canadian property. Without a clearance certificate, the withholding tax is based on the gross selling price of the property. These withhold-

ing and notification requirements arise under Section 116 of the ITA and apply even if a loss arises on the disposition.

b. Carrying on Business in Canada

i. Income Tax

Whether a non-resident is considered to be carrying on business in Canada for income tax purposes depends on all of the facts. The courts use a two-pronged test to determine whether a business is being carried on in Canada, taking into consideration the place where the contract is concluded and the place of operations from which profits arise.

Additionally, a non-resident will be deemed to be carrying on business in Canada for purposes of the ITA if the non-resident does any of the following:

- Produces, grows, mines, creates, manufactures, improves, packs, preserves or constructs, in whole or in part, anything in Canada, regardless of whether the non-resident sells it or exports it from Canada without selling it;
- Solicits orders or offers anything for sale in Canada; or
- Disposes of timber resource property, Canadian real property (other than capital property) or, in certain circumstances, Canadian resource property.

If a non-resident does carry on business in Canada in a year, the ITA requires that the non-resident file an annual Canadian income tax return. A corporation must file a return regardless of whether it has realized a profit in Canada or whether its income is exempt from Canadian tax under an applicable income tax treaty. If such an exemption is available, it is claimed when filing the Canadian tax return.

In addition to Canadian federal income tax, income tax may be imposed by one of Canada's provinces and territories pursuant to the applicable provincial or territorial statute. A detailed discussion regarding the provincial and territorial statutes is beyond the scope of this publication.

ii. Value-added Taxes (VAT)

A non-resident that carries on business in Canada may be liable to collect, remit or pay a Goods and Services Tax (GST) or Harmonized Sales Tax (HST). A non-resident that carries on business in Canada may be required to register for GST/HST purposes. A non-resident that does not have a permanent establishment in Canada is required to post a recoverable security with the CRA in order to register for GST/HST purposes. One advantage for a non-resident in using a Canadian subsidiary corporation to carry on its business in Canada is that the subsidiary need not post such security.

The GST/HST applies to most supplies of property and services made in Canada in a commercial operation and most importations of goods into Canada. The GST applies at a rate of 5 per cent and the HST at a rate of between 12 and 15 per cent, depending on the province in which the supplies are made or deemed to be made.

The GST/HST paid by a business is generally recoverable if the business is registered for the GST/HST and makes GST/HST-taxable supplies. Certain supplies are considered to be exempt from GST/HST, including certain supplies of financial services, residential real property, health care and educational services. Businesses that make exempt supplies may not be permitted to fully recover GST/HST paid or payable on property and services acquired for related purposes.

In addition, the province of Québec imposes a VAT in the form of the Québec sales tax (QST) at a rate of 8.5 per cent (to be increased to 9.5 per cent as of January 1, 2012) on the GST-included value of property and services, creating an effective combined rate of 13.925 per cent. The QST is administered by a separate tax authority under distinct legislation from the GST/HST, such that separate registrations are required.

iii. Provincial Sales Tax

Saskatchewan, Manitoba and Prince Edward Island each impose their own form of provincial sales tax (PST) similar to state sales-and-use taxes in the U.S. There must be a degree of connection to a province in order for a seller to be obliged to register to charge and collect the PST for that province. The required degree of connection depends on the provincial rules. Saskatchewan imposes its PST at a rate of 5 per cent, Manitoba at a rate of 7 per cent and Prince Edward Island at a rate of 10 per cent (the latter includes GST in the tax base), but these rates can vary for certain supplies. In a 2011 referendum, British Columbia voters chose to extinguish the HST that applies in that province. As a result, PST will be reinstated in British Columbia in due course at a rate of 7 per cent.

Most supplies of goods, including the majority of computer-software products, are subject to PST, while real property is not. PST also applies to a limited range of taxable services that vary from province to province. Each province also provides for different exemptions from tax, though all provinces have a general exemption for goods purchased for resale purposes.

iv. Books and Records

In addition to the taxes imposed, persons carrying on business in Canada must maintain books and records with respect to Canadian operations at a Canadian place of business or otherwise make them available for audit by the CRA. Recent court decisions have confirmed the CRA's ability to make wide requests for documents and information in the context of an audit. Failure to comply with such a request would result in the documents and information not being available in the defence of an arbitrary assessment. Accordingly, many non-residents use a Canadian subsidiary for their Canadian operations to limit the scope of such audit requests.

2. Definitions and General Concepts in the ITA

a. Residence in Canada

Income tax is based on a taxpayer's residence. Although residence is generally a question of fact, there are a few specific rules. For example, a corporation is deemed to be resident in Canada for purposes of the ITA if it was incorporated under Canadian federal or provincial law anytime after April 26, 1965.

A corporation incorporated outside of Canada can also be resident in Canada if its "central management and control" are located in Canada. Factors important to this determination include the residency of the corporation's directors and where the corporation's board of directors meets.

b. Sources of Income

Canadian resident corporations are taxable on their worldwide income from every source, including business income, property income and gains arising on the disposition of capital property (i.e., capital gains).

Income is usually classified as business income where a certain degree of commercial activity is present. Property income is derived from passive activities such as the collection of interest, dividends, rents and royalties. Property is generally considered to be capital property if it is held as an investment and not as a trading asset in the business that is being carried on. For example, the building in which a business has its offices would normally be considered capital property, as would a piece of equipment or machinery that is used by the business in the course of earning income. When the property is acquired solely for the purpose of generating a profit on resale, it will generally be considered inventory as opposed to capital property. Under current ITA rules, only 50 per cent of capital gains are taxable, so the classification of property for tax purposes is important.

c. Canadian-controlled Private Corporations

A Canadian-controlled private corporation (CCPC) receives preferential tax treatment, including reduced rates on a specified amount of its active business income. Special planning is required if a non-resident wishes to carry on business in Canada through a CCPC. This is because a CCPC is a private corporation that is not controlled directly or indirectly by non-residents, public corporations or any combination of the two. A "private corporation" is essentially a corporation that (i) is resident in Canada, (ii) does not have shares listed on a designated stock exchange in Canada, and (iii) is not controlled by one or more public corporations (subject to certain limited exceptions).

For this purpose, control includes not only holding a sufficient number of shares to control the corporation by votes, but also the ability to control the corporation in fact. In determining whether there is control by a non-resident or a public corporation, all shares held by non-residents and public corporations are aggregated. Therefore, even if 51 per cent of the voting shares of a corporation were widely spread among a very large number of non-resident persons or public corporations, the corporation would not be considered a CCPC.

Where 50 per cent of the voting shares of a private corporation are held by a Canadian resident and 50 per cent of the voting shares are held by a non-resident, it may be possible for the corporation to qualify as a CCPC, provided that no other facts give the non-resident control.

d. Withholding Tax on Passive Income of Non-residents

The ITA imposes withholding tax at a rate of 25 per cent on the gross amount of certain payments made by a resident of Canada to a non-resident, including management fees, dividends, rents and royalties, subject to an applicable tax treaty.

Effective January 1, 2008, Canadian withholding tax on interest paid to an arm's-length non-resident has been eliminated, except for participating debt interest (i.e., interest determined with reference to receipts, sales, income, profits or other cash flow of the debtor or a related person).

Non-arm's-length interest is subject to Canadian withholding tax, except where exempt under an applicable tax treaty. Interest paid to U.S. residents entitled to the benefit of the *Canada-U.S. Income Tax Convention (1980)*, commonly referred to as the Canada-U.S. Tax Treaty, is exempt from Canadian withholding tax except for participating debt interest. For other countries, the rate of non-arm's-length interest may be reduced by an applicable tax treaty.

The 25 per cent withholding tax on dividends may also be reduced under an applicable tax treaty. For example, Article X(2) of the Canada-U.S. Tax Treaty provides for a withholding tax rate of 5 per cent on dividends paid or credited by a Canadian corporation to a corporation resident in the U.S. if the U.S. resident holds 10 per cent or more of the Canadian corporation's voting shares. Under the Canada-U.S. Tax Treaty, the withholding tax rate applicable to dividends is reduced to 15 per cent for all other cases.

In addition, Canada has eliminated the withholding tax on computer-software royalty payments under the Canada-U.S. Tax Treaty.

e. Tax Treaties

In addition to reducing or eliminating withholding-tax rates, most tax treaties with Canada generally provide that the business profits earned by non-residents from carrying on business in Canada are not subject to tax under the ITA, except to the extent that such profits are attributable to a permanent establishment of the non-resident in Canada. [Permanent establishments are discussed further in this section under "Taxation of Branch Operations (a Permanent Establishment) in Canada."]

f. Transfer Pricing in Non-arm's-length Transactions

The ITA generally taxes transactions between related parties based on the price and terms that would have applied between unrelated parties.

The ITA adopts the "arm's-length principle" to counteract the potential for abuse in transfer pricing. The transfer pricing rules relate to all types of non-arm's-length inter-company transactions involving property, services, intangibles and any cost-contribution arrangements such as research and development cost-sharing or management-fee cost allocations.

Canadian taxpayers and non-arm's-length non-residents are required to conduct their transactions on terms similar to those that would have applied had the parties been dealing at arm's length. Canadian taxpayers that transact with non-arm's-length non-residents are also required to prepare and retain certain documentation under the ITA. Failure to do so may result in significant penalties if the parties are ultimately held to have transacted on other than at-arm's-length terms. These rules apply to related persons and to parties who, as a matter of fact, do not deal with each other at arm's length.

g. General Filing and Reporting Requirements

Every corporation must file an income tax return within six months of the corporation's fiscal year-end, regardless of whether the corporation has realized a profit or the corporation's income is exempt from Canadian tax pursuant to the terms of a tax treaty. The ITA sets out penalties for failing to file or for providing incorrect or incomplete information on a return.

Neither the ITA nor any of the provincial income tax statutes currently permit the filing of consolidated returns by related corporations. Each corporation must file its own return and may not utilize any losses of related corporations to offset the income. In certain circumstances, however, including the winding up of a wholly owned subsidiary into its parent and the amalgamation of two or more corporations, the ITA may permit loss consolidation between related corporations. In the budget released by the federal government on March 4, 2010, the federal government committed to exploring the possibility of introducing consolidated group reporting or related-party loss-transfer rules into the Canadian tax system. Since this will be a major change, extensive review will likely be required before any change is made.

The ITA and other legislation require corporations making specified payments, including wages and other remuneration, to submit periodic information returns detailing such payments and to remit withholding tax on such payments. Canadian resident corporations and foreign corporations carrying on business in Canada are also subject to reporting requirements in respect of transactions with non-arm's-length non-residents.

h. General Anti-avoidance Rule

Section 245 of the ITA, the general anti-avoidance rule (GAAR), gives the CRA broad discretion to adjust taxes payable where an avoidance transaction resulting in a tax benefit has occurred.

The ITA defines a tax benefit as a reduction, avoidance or deferral of tax or other amount payable, or an increase in a refund of tax or other amounts. An avoidance transaction is a transaction or series of transactions that give rise to a tax benefit that may reasonably constitute a misuse or abuse of any provision of the ITA, the *Income Tax Regulations*, the *Income Tax Application Rules*, a tax treaty or any other enactment relevant to computing tax.

When such a misuse or abuse occurs, the CRA will determine the tax consequences to the taxpayer as is reasonable in the circumstances to deny the tax benefit that would have resulted.

i. Payroll Tax

Employers, including non-resident employers, are required to register with the CRA. They are also required to withhold and remit to the Receiver General for Canada withholding tax from salaries, wages and taxable benefits paid to employees (whether resident

or non-resident) for employment services performed in Canada. They must also pay and remit other amounts such as Canada Pension Plan contributions and *Employment Insurance Act* contributions.

Where a payee is a non-resident individual and exempt from Canadian tax pursuant to a treaty between Canada and the payee's country of residence, the payee may be able to obtain a waiver from income tax withholding from the CRA. Payers can be relieved of their obligation to withhold income taxes only if the payee can obtain such a waiver and present the CRA with a copy. Relief from the obligation to make Canada Pension Plan contributions may be available if social-service coverage continues in the individual's country of residence.

Additional withholding in respect of tax may be required for services or work performed in Québec.

j. Regulation 105 Withholding

The ITA requires a resident of Canada to withhold tax of 15 per cent on any fees, commissions or other amounts paid to non-residents in respect of services rendered in Canada (other than salary or wages paid to an officer or employee or a former officer or employee, which are subject to a different payroll tax as described above). This requirement applies even when the non-resident has no permanent establishment in Canada or is entitled to an exemption under a treaty for Canadian tax on income from performing services in Canada.

If the person performing the services is eligible for an exemption from Canadian income tax on its Canadian business income under a treaty, the person may recover the tax withheld (commonly referred to as "Regulation 105 tax") by filing a Canadian tax return. There is also a process whereby the non-resident can obtain a waiver of the requirement of the Canadian resident to withhold Regulation 105 tax in certain circumstances, but the waiver must be applied in respect of each contract with a Canadian resident and prior to any payment.

k. Scientific Research and Experimental Development

The ITA provides generous incentives through a system of tax deductions and credits to taxpayers for expenditures incurred for scientific research and experimental development (SR&ED) related to a business carried on in Canada by the taxpayer. In conjunction with similar tax incentives provided under various provincial laws, Canada is an attractive tax environment in which to engage in SR&ED.

3. Canadian Taxation of a Canadian Resident Subsidiary

a. Income Tax Liability

A subsidiary incorporated anywhere in Canada is considered to be resident in Canada and is subject to federal and provincial taxation in Canada on its worldwide income. Canada's corporate tax rates are relatively low and are proposed to be further reduced in the near future. Combined federal and provincial rates are currently between 26.5 and 32.5 per cent and are proposed to be between 25 and 27 per cent for the most populous provinces of British Columbia, Alberta, Ontario and Québec by 2012.

b. Property Income

Interest, rent, royalties and other passive income or investment income earned by Canadian resident corporations (other than CCPCs) are included in income and are taxed at the same rate. They are also subject to many of the same restrictions in their calculation as business income, which does not qualify for any rate reduction.

c. Capital Gains and Losses

Capital gains receive preferential treatment under the ITA. A capital gain is the amount by which the proceeds of disposition of a capital property exceed its adjusted cost base and reasonable costs of disposition. A capital loss is the amount by which the adjusted cost base of a capital property exceeds the proceeds of its disposition and reasonable costs of disposition.

The ITA currently provides that only 50 per cent of a capital gain (also referred to as a "taxable capital gain") is included in income. Fifty per cent of a capital loss (also referred to as an "allowable capital loss") is deductible, but generally only against taxable capital gains. The amount by which taxable capital gains exceed allowable capital losses incurred in a taxation year is included in the corporation's income and is subject to tax at the regular rates. Where allowable capital losses exceed taxable capital gains, the excess, or net capital loss, may be carried back three years and carried forward indefinitely, but may only be used to offset taxable capital gains of those other years.

d. Business Income

The ITA provides that a taxpayer's business income is the profit from that taxpayer's business for any given taxation year. However, the term "profit" is not defined by the ITA.

The common law provides that "profit" is to be determined in the normal manner of calculating the difference between receipts attributable to production and the expenses of earning those receipts. Generally, the only permissible deductions from income are those expenses that are incurred for the purpose of earning business income and, subject to certain express exceptions provided in the ITA, are not on account of capital. The ITA imposes a further requirement that expenses must be reasonable in the circumstances in order to be deductible.

A number of special rules apply. For example, certain business expenses, such as reserves or estimated expenses (other than those specifically allowed by the ITA), are not deductible, while others are subject to limitations.

e. Deductibility of Expenses

In order to be deductible, expenses must be incurred in the year for the purpose of gaining or producing income from business. Generally, only current expenses are deductible in computing taxable income. Capital expenditures may be deducted pursuant to the capital cost allowance (CCA) regime, which is discussed later in this section.

Accounting and tax treatment of expenses are not always the same. Expenses that are deductible for accounting purposes may be treated more or less generously for tax purposes or may be prohibited altogether.

i. Meals and Entertainment Expenses

Generally, only 50 per cent of food and entertainment expenses may be deducted under the ITA, notwithstanding the fact that they may have been incurred solely for bona fide business purposes.

ii. Interest

Generally, interest is deductible only to the extent that it was paid on a debt incurred for the purpose of earning income from business or property. A number of restrictions may apply. For example, the "thin capitalization" rules restrict the interest deduction that a corporation resident in Canada can claim on a debt owing to a "specified non-resident." Interest on such debt is deductible only to the extent that the debt does not exceed two times the equity contributed by such non-residents. Specific rules apply for the purpose of calculating the amount of debt or equity that was outstanding at a particular time.

iii. Loss Carry-overs

Losses realized from business operations are fully deductible in the year that they are incurred. These losses, to the extent that all or any portion of them remain unused and were incurred in or after 2006, may be carried back three years and forward 20 years. Where these losses arose before 2006 but after March 23, 2004, the carry-forward period is 10 years. Before March 23, 2004, the carry-forward period is seven years.

Capital losses may be used only to shelter capital gains and may be carried back three years and forward indefinitely. The ITA restricts the ability of a corporation to use loss carry-overs after control of the corporation

has been acquired. In addition, certain events such as amalgamations may result in short taxation years, which will accelerate the expiry of loss carry-overs.

f. Capital Cost Allowance (CCA)

The ITA explicitly disallows the deduction of capital expenditures other than those specifically permitted. Instead of claiming a deduction for depreciation, the ITA permits deduction of CCA. For this purpose, the *Income Tax Act* Regulations (the "Regulations") require the pooling of depreciable assets into various classes.

CCA may be claimed annually against the total undepreciated capital cost (UCC) of each class at the rate prescribed by the Regulations. CCA is generally claimed on a declining-balance basis and, in most cases, only half of the amount that is normally deductible can be claimed in the first year that an asset is acquired.

In addition, CCA may only be claimed on an asset when the asset is "available for use" for the purpose of earning income as that term is defined in the ITA. Detailed rules dictate when a particular property becomes "available for use." CCA is a discretionary deduction, thus the taxpayer is not required to claim it in a particular year.

When a depreciable property is sold, the proceeds of disposition are deducted from the UCC of the class. A portion of the resulting negative balance may be taxed as a recapture of depreciation. A resulting positive balance, where no assets remain in the class, may be deducted from income as a terminal loss. The disposition of depreciable property may also give rise to a capital gain.

g. Related-party Transactions

The "arm's-length principle" applies to related-party transactions. Where the disposition of property is made for less than fair market value (FMV), the ITA deems the vendor to have received proceeds equal to FMV. Similarly, property acquired at a cost greater than FMV is deemed acquired by the purchaser at a cost equal to FMV. These rules may result in double taxation since the resulting adjustment is one-sided.

h. Capital Tax

The ITA used to impose a tax on the taxable capital in excess of a certain amount employed in Canada on all taxable Canadian corporations and non-resident corporations with a permanent establishment in Canada. However, this tax, known as the large corporations tax, was eliminated for the years 2006 and on.

Financial institutions are still required to pay a capital tax of 1.25 per cent of their "taxable capital employed in Canada" in excess of their "capital deduction" for the year. For taxation years ending after June 30, 2006, the deduction is $1 billion.

Although most provinces at one time imposed a capital tax on the taxable paid-up capital of corporations with a permanent establishment in the province, such taxes have been eliminated in all but Nova Scotia, where it will be eliminated in 2012.

For corporations having corporate capital with a value below $10 million, the rate is 0.2 per cent, reducing to 0.1 per cent in July, with a $5-million deduction. For corporations having corporate capital with a value of $10 million and above, the rate is 0.1 per cent, reducing to 0.05 per cent in July.

i. Repatriation of Funds: Dividends

Under the ITA, a withholding tax will be payable on the gross amount of dividends paid or credited to a non-resident, subject to an applicable tax treaty. On the repatriation of funds by a Canadian subsidiary to its non-resident shareholder by way of a dividend, the ITA generally imposes withholding tax at a rate of 25 per cent. This rate may be reduced by a treaty. This tax is required to be deducted or withheld by the Canadian subsidiary on behalf of its shareholder.

j. Repatriation of Funds: Paid-up Capital

A Canadian subsidiary of a non-resident shareholder may distribute capital without triggering dividend withholding tax, even if it has undistributed earnings and profits, if the amount being distributed is less than the corporation's paid-up capital.

k. Non-arm's-length Transactions

Payments made by a Canadian subsidiary to its non-resident parent are subject to the "arm's-length principle" (as described earlier under "Transfer Pricing in Non-arm's-length Transactions"). Such payments are therefore deductible only to the extent that they do not exceed an amount that would otherwise have been reasonable if the parties had been dealing at arm's length.

l. Management, Rental and Royalty Payments

The ITA generally imposes a 25 per cent withholding-tax obligation in respect of management fees and rental and royalty payments, which is generally subject to reduction under Canada's tax treaties (as previously discussed under "Withholding Tax on Passive Income of Non-residents"). Under many of Canada's tax treaties, management fees charged by a non-resident parent to a Canadian subsidiary are treated as business profits and not subject to Canadian tax if the non-resident does not have a permanent establishment. The withholding tax does not apply in those circumstances.

m. Inter-corporate Loans

i. From Non-resident Parent to Canadian Subsidiary

As stated earlier, the "thin capitalization" rules in the ITA may disallow a deduction for interest payable by a Canadian subsidiary on debts owing to a "specified non-resident person" when such debts exceed the subsidiary's equity by a ratio of two to one.

Subject to an applicable tax treaty, a Canadian subsidiary must withhold tax on interest paid to non-arm's-length parties or on participating debt interest.

ii. From Canadian Subsidiary to Non-resident Parent

If a Canadian subsidiary lends money to its non-resident parent and the loan is not repaid within one year from the end of the subsidiary's taxation year during which the loan was made, the entire principal amount of the loan will be deemed to be a dividend paid to the parent, and withholding tax will be payable on the amount of the deemed dividend.

4. Taxation of Branch Operations (a Permanent Establishment) in Canada

Subject to a tax treaty between Canada and the non-resident's country of residence, a non-resident corporation that carries on business in Canada must pay Canadian income tax on income earned in Canada under the ITA. Generally, Canada's tax treaties provide that a corporation's business profits will only be subject to Canadian income tax to the extent that they are attributable to a Canadian permanent establishment.

Whether a Canadian permanent establishment exists depends on the facts. Generally, a permanent establishment is a fixed place of business through which the business of the non-resident is wholly or partly carried on. Tax treaties generally provide that a permanent establishment includes a place of management, a branch, an office, a factory or a workshop. As such, depending on the nature of its activities, a branch will generally constitute a permanent establishment in Canada.

However, a fixed place of business in Canada is not limited to those listed above. For example, the CRA considers computer equipment, such as a server that connects to the Internet, to be tangible property having a physical location that may constitute a place of business of a non-resident person, if it is at the disposal of the person (i.e., where it is owned or leased and used by the person). On the other hand, the mere use of a computer or server owned by a third party will not generally constitute a fixed place of business if the computer/server is not at that person's disposal. A non-resident corporation will usually not be considered to have a permanent establishment in Canada by reason of having sales representatives in Canada, provided these representatives do not have or habitually exercise authority to conclude contracts in the name of the non-resident.

Under many of Canada's tax treaties, a building site or construction or installation project constitutes a permanent establishment, but generally only if it lasts more

than 12 months. Under the Canada-U.S. Tax Treaty, if a U.S. enterprise is providing services in Canada and is not otherwise found to have a permanent establishment in Canada by virtue of the provisions of the Treaty, it will be deemed to be providing the services in Canada through a permanent establishment if:

- The services are provided in Canada for an aggregate of 183 days or more in any 12-month period; and
- The services are provided with respect to the same or a connected project for a customer who is either resident in Canada or who maintains a permanent establishment in Canada.

a. Branch Tax

In addition to Canadian federal and provincial income tax, a non-resident corporation carrying on business in Canada through a Canadian branch operation is subject to a branch tax. Under Part XIV of the ITA, the branch tax is 25 per cent of after-tax income that is not reinvested in Canada. Where the rate on dividends is reduced by treaty, as is usually the case, the branch-tax rate is generally reduced to the same rate.

The ITA generally provides that branch tax is levied on the after-tax Canadian earnings of the business carried on in Canada less any amounts that are reinvested in the Canadian business. A tax treaty may modify the method of calculating the earnings for branch-tax purposes. In addition, a tax treaty may exempt the first $500,000 of a non-resident corporation's income from branch tax.

The branch tax is intended to approximate the Canadian withholding tax that would have been payable on dividends paid by a Canadian-resident subsidiary to its non-resident parent. In the absence of a branch tax, a Canadian branch would be a more tax-efficient vehicle than a Canadian subsidiary because a subsidiary is subject to both tax on its business income and tax on dividends repatriated to the non-resident shareholder, whereas the branch would otherwise only be taxable on its business income.

However, the branch tax is more onerous than the withholding tax because it is payable in the year in which income is earned, regardless of whether profits are repatriated to the non-resident. By way of contrast, withholding tax is only payable when a dividend is paid and therefore can be postponed by accumulating assets in Canada.

A Canadian business may initially experience losses such that no Canadian tax would be payable until the business becomes profitable. During this period, consideration should be given to carrying on business in Canada by way of a branch rather than through a Canadian subsidiary in order to permit the deduction of Canadian current losses against the parent corporation's business profits.

A branch is not a legal entity, and the financial and tax accounting for branches may be more complex than for a Canadian subsidiary. For example, the determination of the non-resident's proportionate share of the parent corporation's overall general and administrative expenses could be problematic. Non-resident corporations wishing to carry on business in Canada through a branch face the potentially serious practical problem of preparing financial statements for the branch in a manner that will be acceptable to both the CRA and the tax authorities of its country of residence.

b. Books and Records

When a corporation carries on business through a Canadian branch, all of its books and accounting records with respect to its Canadian operations must be kept at its Canadian place of business or other designated place. They must also be made available for audit by the CRA (as previously discussed under "Carrying on Business in Canada").

c. Taxation of Non-resident Employees of a Branch

The taxation of employees of a branch depends on whether the employee is (or becomes) a Canadian resident. Although residency is generally determined in accordance with the common law, Canada's tax treaties contain tiebreaker rules for determining whether an individual is resident in Canada or another state. Generally, this rule provides that an individual is resident in the jurisdiction in which he or she has a permanent home available to him or her. If the individual has a home in both or neither places, then the next consideration is the individual's personal and economic ties. If these considerations are not determinative, certain treaties will then consider the individual's habitual abode, followed by his or her citizenship. Failing this, the respective revenue authorities must be called upon to settle the matter.

Employees who move to Canada would generally be taxed as Canadian residents on their worldwide income. Non-residents, on the other hand, are taxed only on their Canadian source income. For example, under the Canada-U.S. Tax Treaty, Canada will not tax a U.S. resident's employment income for a particular calendar year if, in general terms, either of the following conditions is met:

- Remuneration does not exceed $10,000 in respect of employment in Canada during the particular calendar year; or
- The employee is present in Canada for a period that does not exceed an aggregate of 183 days in that year, and the remuneration is not borne by the branch.

This exemption does not preclude the obligation of the employer, whether resident or non-resident, to withhold income tax or Canada Pension Plan contributions from the U.S. resident's remuneration for the services performed in Canada, unless a waiver is obtained from the CRA (as previously discussed under "Payroll Tax").

d. GST/HST

Non-resident corporations with a permanent establishment in Canada are deemed to be resident in Canada for GST/HST purposes and may be required to register for and collect GST/HST on all taxable supplies of property and services made through the permanent establishment. Special rules may require self-assessment for GST/HST on intangible property and services sourced from outside of Canada.

e. Unlimited Liability Companies

As previously noted, Canada does not permit the filing of consolidated returns in order to utilize related-party losses. However, for non-residents in certain jurisdictions such as the U.S., this concern may be addressed by the use of an unlimited liability company (ULC) established under the laws of the provinces of Nova Scotia, Alberta or British Columbia.

A ULC may be considered to be a flow-through or fiscally transparent entity for U.S. tax purposes. For Canadian purposes, however, the ULC is treated as a Canadian corporation. Certain benefits under the Canada-U.S. Tax Treaty are no longer available to ULCs. For more information on ULCs, see Section B, "Business Structures."

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