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KEEPING IN TOUCH

HIGHLIGHTS

In this issue of *Keeping in Touch* we provide an overview of the Canadian taxation system and the taxes that a non-resident enterprise is likely to encounter in the course of conducting business in the Province of Ontario.

Canada has a modern industrial and service economy and, in common with other developed countries, has a complex tax system the intricacies of which must be successfully navigated if a business is to avoid an otherwise unnecessary tax burden. Despite the complexities, the principal attributes of the tax system will be familiar to most people and found to be similar to those of other advanced economies.

TAXATION IN ONTARIO, CANADA

Income Taxes

The most important type of tax imposed in Canada is the income tax which is applicable to the world wide income of residents of Canada and to income earned in or receive from Canada by non-residents of Canada.

Income taxes are imposed by both the Canadian federal government and by each of the provinces and territories, and are imposed on net income earned from business and property after deducting from gross revenues the costs reasonably incurred for the purpose of earning the income. Although income tax payable by individuals is imposed at graduated rates, income tax payable by corporations is generally imposed at a single rate, in all cases subject to various exceptions and exemptions.

Currently the effective federal corporate income tax rate is 33.12% of taxable income subject to a 10% reduction for income earned in a province or territory to allow for provincial or territorial income taxes resulting in a net federal income tax rate of 22.12%. The rates at which provincial income taxes are impose on corporations vary somewhat from province to province. In Ontario, the basic corporate income tax rate is 14% resulting in a combined federal and Ontario provincial corporate income tax rate of 36.12%. Income from manufacturing and processing qualifies for a reduction of 2% in the Ontario corporate income tax rate which results in a combined Federal and Ontario provincial tax rate of 34.12%.

The Federal government administers the collection of income tax imposed on individuals by all provinces other than Quebec so that individuals outside Quebec have only one annual income tax return to be filed. Most provinces administer their own corporate income taxes so most corporations file at least two income tax returns each year.

Consumption Taxes

The Canadian federal government imposes a value added tax which is called the goods and services tax (the "GST") and most of the provinces impose a retail sales tax. Unlike the GST, the provincial retail sales taxes are not value added taxes and generally are applied only at the final or retail sale level. Licencing arrangements permit commercial inputs to be acquired without payment of the tax. Three of the Atlantic provinces (Nova Scotia, New Brunswick, and Newfoundland and Labrador) have combined their retail sale taxes with the GST and the resulting combined value added tax in those provinces is referred to as the Harmonized Sales Tax (the "HST").

The GST is imposed at the rate of 6% of the acquisition cost of most property and services, including imports, and the HST is imposed at the rate of 14% which is allocated 6% to the federal government and 8% to the province. As value added taxes, both the GST and the HST permit input tax credits to be claimed as the means by which the taxes paid by businesses on commercial inputs are refunded.

Capital Taxes

Capital taxes are also imposed by the federal government and several of the provinces on the capital employed by corporations operating in Canada. In most cases there are substantial thresholds below which the taxes are not applicable and the trend has been away from the imposition of such taxes with rates being reduced over time and in many cases phased out. The federal capital tax, which is called the large corporations tax, is presently payable at the rate of 0.125% on capital in excess of $50 million. It is being phased out and is scheduled to be eliminated in 2008. The Ontario capital tax is presently payable at the rate of 0.3% on capital in excess of $10 million. The base exemption for the Ontario

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capital tax is being increased in stages to $15 million in 2008 and the rate is being reduced in stages and is scheduled to be fully phased out in 2012.

Other Taxes

Other taxes imposed at the federal and provincial levels include federal custom duties and provincial payroll taxes, and various excise taxes and duties imposed at both levels. Ontario imposes a payroll tax called the Employer's Health Tax which is at the rate of 1.95% on the amount by which a business payroll exceeds $400,000.

Non-residents of Canada

Income taxes are payable in Canada by non-residents of Canada in respect of net income earned in Canada from a business carried on in Canada. Generally, where the non-resident is a national of a country that has a tax treaty with Canada, the business must be carried on through a permanent establishment located in Canada for the income from the business to be taxable as such in Canada.

In addition to the taxation of net business income earned in Canada through a permanent establishment, Canada also imposes withholding taxes on the gross amount of a number of income payments made from Canada. The withholding taxes are imposed at the rate of 25% of the gross amount paid, are subject to reduction by tax treaties, and are applicable to such payments as dividends paid by Canadian resident corporations, interest paid on loans made to residents of Canada, and royalties paid in respect of the use, or the right to the use, in Canada of intellectual and other types of property owned by the non-resident recipient of the royalty payments.

Canadian subsidiaries

Whether and to what extent any of the foregoing taxes may impact on a resident of another country that conducts business in or with Canada will be determined by the structure adopted for the business and the impact of any tax treaty with Canada entered into by the country of residence.

Where the foreign enterprise chooses to have a subsidiary corporation established in Canada to carry on a Canadian business, the subsidiary corporation will be resident in Canada for tax purposes and be fully subject to both federal and provincial income taxes imposed on all income earned by it. Also, where the foreign parent corporation supplies equipment or other inputs to the Canadian subsidiary, the tax related considerations arising from the imports into Canada will include the customs duties and GST payable on the value of the imports supplied to the subsidiary and the withholding taxes imposed on any royalties paid by the subsidiary for property used by the subsidiary which belongs to the parent corporation.

Transfer Pricing

When assigning values for cross border sales between related entities, transfer pricing rules must be carefully taken into account. Such rules are designed to ensure that the prices assigned to the imports or exports are established at more or less arm's length values so that taxes payable in Canada are not artificially reduced, either through the reduction of customs duties and GST by understating the values on which such taxes are calculated, or the reduction of income tax by overstating the cost of inputs which are deductible as business expenses for income tax purposes or by understating the value of goods or services supplied by the Canadian entity.

Royalties

In the case of the payment of royalties, tax treaties usually limit the applicable withholding tax to 10% of the gross amount of the royalties paid. Additionally, tax treaties often exempt from withholding tax the royalties paid in respect of the use of, or the right to use, certain types of property which typically include computer software, patents, or information concerning industrial, commercial or scientific experience which does not relate to a rental or franchise agreement. Accordingly, royalties payable in respect of know-how transferred by a parent corporation to its subsidiary in Canada will often not be subject to the deduction of Canadian withholding tax.

Interest

Where the parent corporation is funding the Canadian subsidiary by interest bearing loans, tax treaties usually limit the rate of the withholding tax to be deducted from the interest on the loans to 10% of the interest paid. However, also to be taken into account is the thin capitalization rule which limits the amount of interest that may be deducted as a business expense by the Canadian subsidiary in computing taxable income to the interest payable on loans due to the non-resident parent corporation which do not exceed 2 times the equity share capital invested in the subsidiary by the parent corporation. Additionally, where as a result of the relationship between the parent and subsidiary corporations the applicable interest rate exceeds what would be agreed in the absence of the relationship, tax treaties usually exclude the excess interest from the limitation on the withholding tax rate so that the excess interest would be subject to withholding tax at the full 25% rate.

Dividends

Where the earnings of the subsidiary corporation are distributed to the parent corporation by the payment of dividends, tax treaties often reduce the withholding tax rate to 5% of the dividends paid. This rate is usually applicable where the ownership interest of the foreign corporation exceeds specified thresholds, such as at least 25% of the capital or at least 10% of the voting power of the Canadian subsidiary corporation. Where that is not the case, tax treaties will typically provide for a 15% withholding tax rate on dividends.

Canadian Branch

Should the foreign enterprise choose not to establish a subsidiary corporation in Canada to carry on its Canadian business, but elects to carry on the Canadian business directly through a branch operation, different considerations apply. Of primary importance are the provisions of the applicable tax treaty which in most cases will provide that the profits reasonably attributable to the Canadian branch will be taxable

in Canada only if the Canadian business is carried on through a permanent establishment in Canada. A permanent establishment is generally a fixed place of business and can consist of a place of management, an office or a workshop, and can also include a building site or construction project which lasts more than 12 months.

Where the profits of the Canadian branch are taxable in Canada, the amount of income reasonably attributable to the branch may not be readily apparent. There are a number of possible approaches to the allocation of income. An apportionment of income between the Canadian and foreign operations of the non-resident enterprise can be based on where costs are incurred, or income can be attributed to the Canadian branch based on notional commissions on sales by the branch where the equipment sold is manufactured outside Canada, or an apportionment of profit can be based on notional sales to the Canadian branch by the non-resident enterprise at fair market value.

Branch Tax

Upon the income of the Canadian branch being established, it is subject to Canadian income tax calculated on the same basis as the income of an incorporated subsidiary. However, the income of the branch is also subject to the imposition of an additional tax which is commonly known as the "Branch Tax" the purpose of which is to ensure that tax paid in Canada by a branch operation is more or less equal to the tax that would be payable in Canada if a subsidiary corporation had been established in Canada to carry on the Canadian operation.

The Branch Tax is designed to replace the withholding tax that would be payable in respect of profits repatriated by a Canadian subsidiary to its parent corporation by the payment of dividends. To achieve this result, the Branch Tax is imposed at the same rate as the withholding tax under the applicable tax treaty applied to dividends paid by a wholly owned subsidiary to its parent corporation. The tax is calculated on the net income attributable to the Canadian branch after allowing certain additional deductions which include federal and provincial income taxes paid in Canada and amounts which are reinvested in Canadian property. Additionally, under many tax treaties a specified based amount of income, often $500,000.00, is exempted from the Branch Tax.

Co-Ventures

Should the foreign enterprise decide to establish its Canadian business in conjunction with a Canadian enterprise under a partnership or joint venture arrangement, it could participate in the combined business either directly by establishing a Canadian branch or indirectly through a subsidiary corporation established for that purpose, and the method chosen will determine which of the foregoing tax considerations apply.

Where the combined Canadian business is organized as a partnership carried on in Canada, the computation of the income of the business takes place at the partnership level, and each partner is attributed its appropriate proportionate share of partnership income or losses. Under many tax treaties, where a foreign enterprise participates through a Canadian branch, the partnership operation would be considered a permanent establishment through which the Canadian business of the foreign enterprise is carried on, and its income as a partner would be taxed in the same manner as the income of a branch operation that was not participating in a partnership. Likewise, the tax rules applicable to the partnership income of a Canadian subsidiary corporation would be the same as those that would be applicable to the income of a Canadian subsidiary corporation carrying on its own separate business.

Although there is no strict legal definition of a joint venture, if the combined Canadian operation is not being conducted through a partnership arrangement with the Canadian participant, each participant in the joint venture would normally account separately for its share of the business, and the foreign participant, irrespective of whether it was a Canadian incorporated subsidiary or a branch operation of the foreign enterprise, would compute its profits and losses separately taking into account only its own revenues and expenses. Once again, its taxable income would be subject to the same tax rules as would be applicable to it as either a Canadian incorporated subsidiary or as a branch operation in respect of its income from its participation in the joint venture business as if that income was from a separately operated business. How revenues and expenses of the business would be shared among the joint venture participants would be dependent upon the terms of the joint venture agreement entered into by them.

Imports

A foreign enterprise that does not propose either to establish a Canadian corporation to carry on a business in Canada or to carry on business directly through a branch operation in Canada, but proposes only to sell its products or services in Canada, would not be subject to the imposition of Canadian income tax on the profits generated from such sales so long as, for the purposes of the applicable tax treaty, a fixed place of business is not established in Canada which would constitute a permanent establishment from or in which a business is operated.

In the case of a foreign enterprise selling its products into Canada, both customs duties and GST would be payable at the time of importation into Canada. Additionally, provincial sales tax would also be payable upon the products entering Canada.

Where the foreign enterprise is supplying services to the Canadian recipients, whether or not GST is payable in respect of the services will depend on the status of the Canadian recipient, but the non-resident enterprise would not be required to ensure that any applicable GST is paid. If the recipient is acquiring the services solely in the course of a commercial activity in respect of which it would be entitled to claim full input tax credits, GST will not be payable by the recipient on the acquisition of the services. Where GST is payable by the recipient in respect of the services acquired, it is required to self-assess and the GST is not collected by the foreign enterprise.

In the case of the licencing of equipment or intellectual property, the royalties payable to the foreign enterprise will be subject to withholding tax which under the

applicable tax treaty, as stated above, will usually be limited to 10% of the gross amount of the royalties paid except in the case of computer software, patents and know how which are often exempted from withholding tax.

CONCLUSION

It will be apparent from the foregoing that the tax considerations to be taken into account when establishing business dealings in or with Canada are many, and detailed analysis of the proposed structure would be necessary in order to determine which tax rules will be applicable. Both during the planning stages of any proposed Canadian business operation or investment, and during the on-going implementation of the business or investment, it will be important for the foreign enterprise to consult knowledgeable tax advisors in order to ensure that full compliance with applicable rules is achieved and avoidable taxes are not unnecessary incurred.

We welcome inquiries concerning any matters of interest to our readers. Please contact us for further information on the topics in this issue.

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