U.S. Perspectives from Canada's Law Firm

Top 10 Canadian tax issues for U.S. companies with Canadian subsidiaries

For U.S companies with direct or indirect Canadian subsidiaries, knowledge of the Canadian tax system is an important part of managing financial operations. In our experience, some of the most important Canadian tax issues relevant to a U.S. company that has a Canadian subsidiary include the following:

1. Taxable Nexus to Canada
2. Regulation 105 Withholding
3. Transfer Pricing
4. Paid-up Capital
5. Intra-Group Debt Financing
6. Hybrid Entities
7. Foreign Affiliate Dumping (FAD) Rules
8. Repatriation Options
9. Lawyer-Client Privilege
10. Sales Taxes

This legal primer provides an overview of the above 10 issues.

Note: This discussion assumes that the relevant U.S. parent company (USCo) is (1) a U.S. resident for U.S. tax purposes and (2) eligible under the Canada-U.S. tax treaty (the Treaty) to claim reductions in Canadian taxation provided for under the Treaty (Treaty benefits).[1]

1 For a more detailed discussion of these and other relevant issues, see Steve Suarez, "The MNE's Abridged Tax Guide to Canada," *Tax Notes International*, July 13, 2020, p. 171

1. What constitutes a taxable Nexus to Canada?

A USCo with business connections to Canada must be careful about whether its activities rise to the level of "carrying on business in Canada." This issue frequently occurs for a USCo that deals directly with Canadian customers or suppliers, provides services to a Canadian subsidiary (Canco), or sends personnel to Canada for various reasons. A USCo that "carries on business in Canada" for tax purposes is required to file a Canadian tax return and depending on the circumstances, may also be liable for Canadian taxes. The presence of a USCo's employees in Canada for work reasons could also cause those employees to be subject to Canadian income tax on part of their compensation, as well as potentially create Canadian tax withholding and remittance obligations for their U.S. employer. U.S. companies with Canadian business activities should be aware of what constitutes "carrying on business in Canada" and the typical strategies for minimizing these risks (note: a similar issue exists for the obligation to collect and remit Canadian sales tax).

2. What is regulation 105 withholding?

A 15 per cent withholding and remittance obligation (Regulation 105 withholding) applies whenever a person (Canadian or non-resident) pays a fee, commission, or other amount to a non-resident in respect of services rendered *in Canada*. Where applicable, Regulation 105 requires the payer to withhold 15 per cent of the payment and remit that amount to the Canada Revenue Agency (the CRA, Canada's equivalent of the IRS) as a prepayment of the non-resident's Canadian income tax liability (if any). If the amount withheld and remitted exceeds the non-resident's actual Canadian income tax liability as ultimately determined, it could file a Canadian tax return and claim a refund of the difference. A payer who fails to withhold and remit is liable for the 15 per cent amount, plus interest and penalties, with no time limit for re-assessment.

Regulation 105 withholding applies in simple fact patterns, such as a USCo sending employees to Canada to perform services for customers or a Canco. It can also apply in non-obvious circumstances. For example, a USCo that contracts directly with customers to provide services that include an "in Canada" element will trigger Regulation 105, even if another entity (e.g., Canco) actually performs the "in Canada" services, because the customer pays USCo in respect of services to be performed in Canada. This is so even if USCo is exempt from Canadian tax under the Treaty and even if someone else (such as a Canco) is being taxed on the "in Canada" services income. U.S. companies with Canadian business dealings that involve services being rendered in Canada need to be mindful of Regulation 105 withholding.

3. What are the characteristics of Canada's transfer pricing regime?

Canada's transfer pricing rules, like analogous rules in other countries, attempt to ensure a Canco has not paid too much (or received too little) in transactions between the Canco and a non-resident of Canada not dealing at arm's length with that Canco (a non-arm's-length non-resident or NALNR). If the terms and conditions of such transactions differ from those that would have been made between arm's-length persons in the same circumstances, the CRA is entitled to revise pricing to whatever arm's-length parties would have agreed to. Such adjustments typically increase Canco's taxes owing (plus interest and penalties) as well as trigger Canadian withholding tax (plus interest and penalties) on the amount the Canadian overpaid or undercharged. The CRA aggressively enforces Canada's transfer pricing rules, and USCos must be able to demonstrate that intra-group transactions involving related Cancos occur on arm's-length terms.

4. What is paid-up capital?

Paid-up capital (PUC) is the Canadian tax version of "stated capital" under corporate law and is an extremely important tax attribute for non-residents that have significant share ownership in a Canco. First, a Canco can choose to effect an equity distribution as a dividend (which creates dividend withholding tax) or a return of capital (which does not, to the extent of PUC), unlike in the U.S. where corporate distributions are deemed to be dividends to the extent of earnings and profits. Thus, PUC represents a pipeline of tax-free distributions out of Canada. Moreover, each dollar of PUC allows Canco to deduct interest expense on $1.50 of debt it owes to non-arm's-length non-residents under Canada's thin capitalization rules (see 5. below).

When a Canco issues shares of a particular class, it adds the consideration it received for issuing those shares to the stated capital for corporate purposes (and thereby to the PUC for tax purposes) of that class of shares. The PUC of each share of a particular class is the same, i.e., total PUC of the class divided by the number of issued shares. Since buying an existing share from the current holder does not affect the PUC of those shares, a USCo buying a Canadian target will usually create and fund a new Canadian corporation (creating full-PUC shares) and have that Canco purchase and merge with the Canadian target in order to maximize the PUC of the resulting Canadian entity.

5. Thin capitalization rules, intra-group debt financing & debt to equity ratios

Canada's "thin capitalization" rules prevent a Canco from deducting interest on debt owed to non-arm's-length non-residents to the extent that such debt exceeds 150 per cent of Canco's "equity." Interest on such excess debt is disallowed as a deduction to Canco, and treated as a dividend (as opposed to interest) for Canadian withholding tax purposes. This is typically undesirable because USCos are usually entitled to a complete exemption from Canadian interest withholding tax.

There are various computational nuances to how Canco's "equity" is computed. Essentially, for any given taxation year, Canco's equity is the sum of its start-of-year unconsolidated retained earnings, and the monthly average of the PUC and contributed surplus of shares owned by related non-residents. It is very important for Cancos owned by U.S. residents to stay onside the 1.5:1 debt/equity ratio to avoid paying non-deductible interest that also bears dividend withholding tax.

6. How does Canada tax hybrid entities?

Special Treaty rules apply to entities are "look-through" entities for tax purposes in one country and taxable entities in the other. The most common examples of these are U.S. limited liability companies (LLCs) and Canadian unlimited liability companies (ULCs) that are disregarded for U.S. tax purposes (both are considered corporations for Canadian tax purposes).

LLCs cannot be created under Canadian and provincial laws and Canada does not consider LLCs eligible to claim the benefit of tax reductions under the Treaty. That said, a special rule in the Treaty allows qualifying U.S. residents (but not residents of other countries) to claim Treaty benefits "through" the LLC. As a result, residents of third countries should not invest in Canada through a U.S. LLC.

U.S. residents that receive a payment (e.g., interest, dividends, royalties) from a ULC that is disregarded for U.S. tax purposes will be denied Treaty benefits if the U.S. tax treatment of that payment is different than what it would have been had the ULC been treated as a regular corporation for U.S. tax purposes. There are workarounds available in many cases, but the key is to be aware of the issue to know that a work-around is needed. Payments by a ULC to an LLC are also denied Treaty benefits.

7. What are the foreign affiliate dumping rules?

Canada's tax system for Canadian companies with foreign subsidiaries is relatively favourable: generally, a Canadian parent company receives a dividend from one of its foreign subsidiaries free of Canadian tax to the extent the dividend is attributable to the foreign subsidiary's "active business income." However, if the Canadian parent company is itself controlled by a non-resident (or group of related non-residents), i.e., it is a Canadian subsidiary of a USCo, a further set of adverse rules apply known as the "Foreign Affiliate Dumping Rules", or "FAD rules". The FAD rules effectively penalize foreign companies with a Canco that itself owns shares of another non-Canadian corporation, on the basis that this constitutes a misuse of Canada's favourable rules for foreign subsidiaries. USCos should generally avoid having their Cancos acquire shares in non-Canadian entities. For the same reason, careful planning is needed if a USCo is acquiring a Canco that has foreign subsidiaries.

8. What are the most efficient repatriation options?

When a USCo wants to repatriate cash from a Canco, the primary Canadian considerations tend to be:

- Whether withholding tax is applicable;
- Whether the payment is deductible to Canco; and
- The effect on Canco's "equity" for purposes of determining the amount of interest-deductible debt Canco can borrow from non-arm's-length non-residents under Canada's thin capitalization rules (see 5., above).

Table 1. Summary of repatriation options from Canada to U.S.

	Withholding Tax	Deductible to Canco	Effect on Canco Thin Capitalization	Other
Dividend	25 per cent rate Treaty-reduced to 5 per cent (if 10 per cent+ Canco ownership) or 15 per cent	No	Retained earnings (R/E) decrease reduces equity in following year	Corporate law limits on payment; review interest deductibility if paid using borrowed money
PUC Return	None, to the extent of Canco PUC	No	PUC decrease reduces equity in current year	Corporate law limits on payment; consider interest deductibility if paid using borrowed money; no U.S.-style E&P rule
Interest	25 per cent rate Treaty-reduced to 0 per cent unless "participating interest"	Yes, subject to thin cap rules	R/E decrease reduces equity in following year	Deductibility requires debt be incurred for income-earning purpose; transfer pricing and deductibility issue if rate exceeds arm's-length rate
Loan	None if repaid within permissible time limit and Canco is paid sufficiently high rate of interest	No	None	Transfer pricing or benefit issue if interest too low; variety of base erosion rules potentially applicable; review interest deductibility if paid using borrowed money
Management Fee	Usually Treaty-exempt if provider has no Canadian permanent establishment	Yes	R/E decrease reduces equity in following year	Transfer pricing and deductibility issues if more than arm's-length amount; Reg. 105 withholding if services rendered in Canada
Royalty	25 per cent rate reduced to 10 per cent or fully eliminated under the Treaty	Yes	R/E decrease reduces equity in following year	Transfer pricing and deductibility issues if in excess of arm's-length standard

9. How does lawyer-client Privilege protect Canadian tax planning?

The CRA has extensive powers to demand documents and information from taxpayers, which it uses aggressively (particularly on cross-border matters). In many cases, lawyer-client privilege is the only practical limitation on the scope those CRA powers. Unlike the U.S., in Canada no privilege exists for non-lawyers such as accountants working on tax matters.

Outside of a litigation context (where a separate form of legal privilege applies), "solicitor-client privilege" (sometimes called "legal advice privilege") protects communications and work product from disclosure if three conditions are met:

- The communication is between a lawyer and a client with whom the lawyer has a professional relationship — that is, the lawyer must be acting for the client;
- The communication is intended by the parties to be confidential; and
- The purpose of the communication is the seeking or giving of legal advice (not other matters, such as business advice).

Lawyer-client privilege in Canada is more robust than in most countries (including the U.S.): Canadian courts view it as a cornerstone of the legal system. For example, unlike the U.S., disclosing privileged information to a company's auditors for the purpose of preparing its financial statements is not a waiver of privilege. Because there is no statutory obligation to give tax authorities a list of uncertain tax positions (as in the U.S.), preparing sensitive tax analysis within the scope of lawyer-client privilege is especially valuable. USCos with Canadian subsidiaries or operations should seek to establish and maintain lawyer-client privilege over sensitive tax communications and analysis wherever possible.

10. What About Sales Taxes?

Canada has a 5 per cent federal sales tax (the GST) applicable to most sales of goods and services. Some exceptions exist, such as basic groceries and most financial transactions. The Canadian provinces from Ontario and eastward have merged their sales tax into the GST, creating a combined federal/provincial

harmonized sales tax (HST) in those provinces.[2] Tax is paid at each stage of the production and distribution chain as goods and services are purchased ("taxable supplies"), and double taxation is prevented via refunds (input tax credits or ITCs) given to qualifying businesses for the GST/HST they pay on their inputs. The ultimate burden is borne by final consumers who pay the tax and are not entitled to claim ITCs.

The Western provinces of Manitoba, Saskatchewan and British Columbia each levy a provincial sales tax on goods and a limited range of services that is distinctly different from the federal GST. In particular, no ITCs are provided to avoid cascading taxes through the supply chain (i.e., each purchaser is treated as the final consumer), although some exemptions apply (e.g., goods purchased for resale). Alberta and the three northern territories do not levy sales taxes at all.

The primary Canadian sales tax issues for U.S. companies are typically the following:

- Are they required to register as a vendor and collect and remit sales tax on sales into Canada;
- Are they required to pay GST on goods imported into Canada; and
- Are they required to pay sales tax on purchases from Canada?

Conclusion

When U.S. businesses expand into Canada organically or via acquisitions, a number of tax considerations commonly drive decision-making and can have an appreciable impact on the bottom line of U.S. parents and their Canadian subsidiaries. The foregoing pointers provide useful background information for U.S. counsel.

2 Quebec has also effectively harmonized its sales tax with the federal GST, but the federal GST and provincial Quebec Sales tax ("QST") are formally separate taxes (levied simultaneously on the same things, but at different rates), and both taxes are administered by Quebec tax authorities rather than the CRA

Calgary
Centennial Place, East Tower
520 3rd Ave S W, Suite 1900
Calgary, AB, Canada T2P 0R3
T 403.232.9500 | F 403.266.1395

Montréal
1000 De La Gauchetière St W, Suite 900
Montréal, QC, Canada H3B 5H4
T 514.879.1212 | F 514.954.1905

Ottawa
World Exchange Plaza
100 Queen St, Suite 1300
Ottawa, ON, Canada K1P 1J9
T 613.237.5160 | F 613.230.8842 (Legal)
F 613.787.3558 (IP) | ipinfo@blg.com (IP)

Toronto
Bay Adelaide Centre, East Tower
22 Adelaide St W, Suite 3400
Toronto, ON, Canada M5H 4E3
T 416.367.6000 | F 416.367.6749

Vancouver
1200 Waterfront Centre
200 Burrard St, P.O. Box 48600
Vancouver, BC, Canada V7X 1T2
T 604.687.5744 | F 604.687.1415

blg.com

Author

Steve Suarez
T 416.367.6702
SSuarez@blg.com

The information contained herein is of a general nature and is not intended to constitute legal advice, a complete statement of the law, or an opinion on any subject. No one should act upon it or refrain from acting without a thorough examination of the law after the facts of a specific situation are considered. You are urged to consult your legal adviser in cases of specific questions or concerns. BLG does not warrant or guarantee the accuracy, currency or completeness of this publication. No part of this publication may be reproduced without prior written permission of Borden Ladner Gervais LLP. If this publication was sent to you by BLG and you do not wish to receive further publications from BLG, you may ask to remove your contact information from our mailing lists by emailing **unsubscribe@blg.com** or manage your subscription preferences at **blg.com/en/MyPreferences**. If you feel you have received this message in error please contact **communications@blg.com**. BLG's privacy policy for publications may be found at **BLG.com/en/privacy**.

© 2020 Borden Ladner Gervais LLP. Borden Ladner Gervais is an Ontario Limited Liability Partnership.

Printed in Canada. BD9748–08–20