The MNE's Abridged Tax Guide to Canada

by Steve Suarez

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In this article, the author identifies elements of the Canadian tax system that can create major problems for multinational enterprises that include a Canadian resident corporation or have other connections with Canada.

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Multinational enterprises that include a Canadian resident corporation ("Canco") or have other connections with Canada will encounter various elements of the Canadian tax system over time. This article identifies several of those elements that can create significant exposure for those MNEs unless identified and planned for.

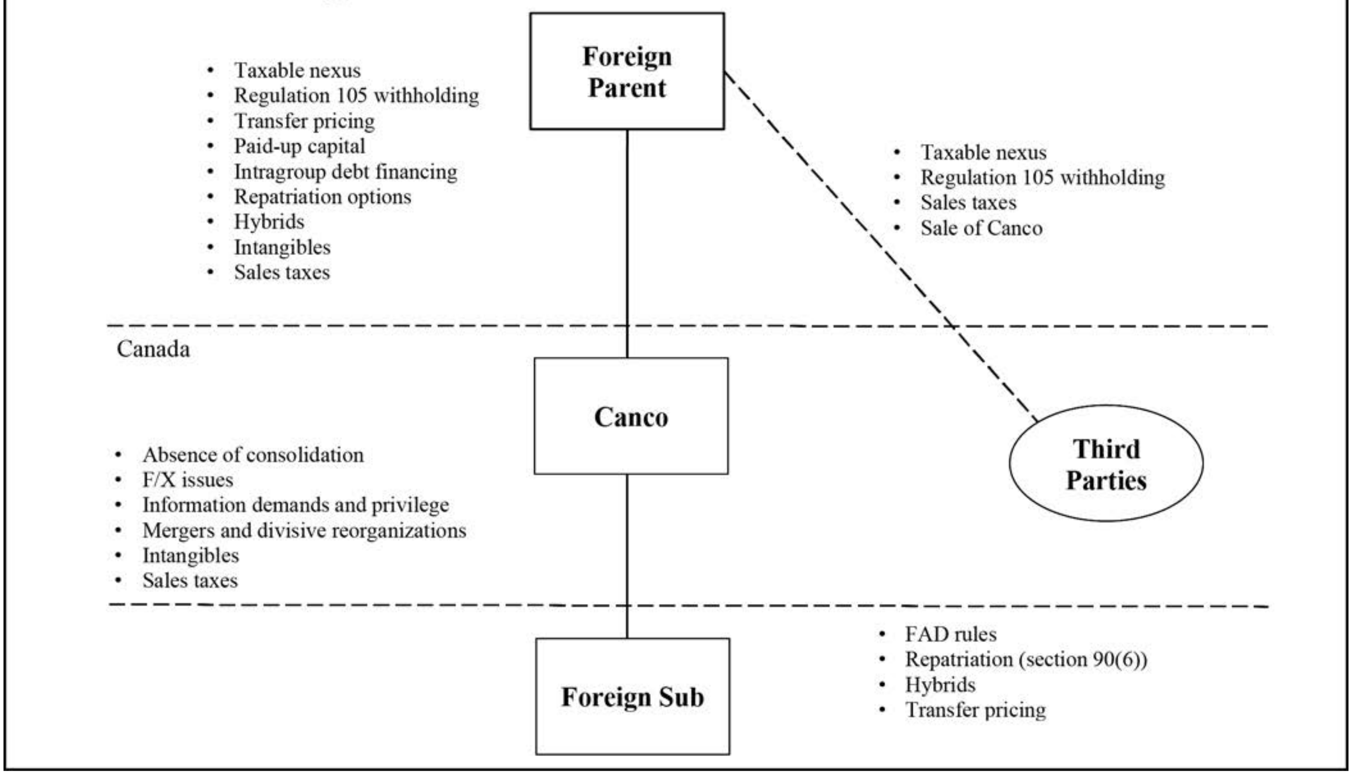
I. Taxable Nexus (Carrying On Business in Canada)

Nonresidents[1] with business connections to Canada must be careful about whether their activities rise to the level of carrying on business in Canada. That question frequently arises for an MNE when non-Canadian group members provide services to Canadian group members, deal directly with Canadian customers or suppliers, or send personnel to Canada for various reasons.

The concept of carrying on business in Canada is relevant to a nonresident's Canadian income tax

[1] A corporation is resident in Canada for Canadian tax purposes if its legal existence is derived from a Canadian corporate law statute or its central management and control (typically interpreted with regard to its board of directors) is in Canada. That domestic law result may be overridden by a tie-breaker rule in an applicable Canadian tax treaty when both Canada and another country assert a corporation to be a fiscal resident.

Figure 1. Overview of Canadian Tax Issues for MNEs



obligations in two ways.[2] First, when a nonresident corporation carries on business in Canada during a particular year, it must file a Canadian income tax return for the year (whether or not tax is owed). Second, a nonresident that carries on business in Canada will be subject to Canadian income tax on any related income, unless a tax treaty provides relief from Canadian taxation and the nonresident meets the conditions for claiming that relief. Canada has tax treaties with almost 100 countries, so in most cases the threshold for a nonresident corporation to have to file a Canadian tax return — that is, carrying on business in Canada — will be considerably lower than that for actually being taxable in Canada on business income — that is, having a permanent establishment in Canada.

If revenue-generating contracts are concluded (that is, a binding offer is accepted) in Canada, that is often considered enough to constitute carrying on business there. For that reason, Canadian tax advisers typically encourage nonresidents to ensure that (1) they do not execute any business contracts while physically present in Canada, and (2) their contracts with Canadian customers are structured such that the nonresident formally agrees after the customer — that is, in technical legal terms, the Canadian customer makes the offer, and the nonresident accepts it outside Canada.

The reverse is not true, however: A nonresident who ensures that all business contracts with Canadians are concluded outside Canada may yet be carrying on business in Canada if other activities occur there. Producing, growing, creating, packing, or improving any property in Canada is deemed to be carrying on business in Canada. Section 253 of the Income Tax Act also deems a nonresident who "solicits orders or offers anything for sale in Canada through an agent or servant" to be carrying on business in Canada. Thus, making a binding offer (whether or not accepted) from within Canada would constitute carrying on business in Canada.[3]

[2]Canada's federal goods and services tax uses a similar (but not identical) concept. *See* Section XV, *infra*.

[3]The in-Canada element of the deeming rule applies to the activity (soliciting orders or making offers), not the person at whom it is directed or the subject matter of the transaction. *See Maya Forestales SA v. The Queen*, 2005 TCC 66, at para. 34.

The concept of soliciting orders is a gray area. General awareness advertising or marketing in Canada clearly does not rise to that level.[4] If the term "orders" were given its ordinary commercial meaning — that is, binding offers to purchase specific products on specific terms — it may be that significant customer-specific marketing activities could be performed in Canada without being considered to amount to soliciting orders so as to be deemed carrying on business in Canada in and of itself.

Beyond those deeming rules, there is no bright-line test for what constitutes carrying on business in Canada. Simply selling goods or services to, or buying goods and services from, Canadians by itself is not enough. The determination in any particular case depends on the facts, in terms of the frequency, extent, and nature of the activities occurring *in Canada*. The most relevant indicia established in the case law include:

- whether the nonresident's business contracts are completed in Canada;
- the presence or absence in Canada of the nonresident's employees or agents;
- the place where goods are delivered (and legal ownership transfers) or services are provided;
- whether the nonresident has registered under commercial law to do business in Canada;
- whether the nonresident solicits business transactions from within Canada;
- whether the nonresident's bank account used for Canadian transactions is in Canada;
- whether the nonresident's name and business are listed in a Canadian directory;
- whether the nonresident has any office or other place of business in Canada; and
- whether any activities occurring in Canada are merely ancillary to the main business.[5]

It is essential to understand when "in-Canada" activities will be attributed to a nonresident. When the nonresident engages people to physically perform business functions in Canada, those activities will be attributed to the nonresident if those persons are the nonresident's own employees, or are agents who have the power to bind the nonresident in sales contracts.[6] Moreover, a nonresident engaging non-employees to perform business functions in Canada should ensure that the third party's status is not that of an agent. Instead, the role of the third party (whether or not dealing at arm's length with the nonresident) should be structured as an independent contractor that is providing specific agreed-on services to the nonresident in the course of the contractor's own business, not as an extension of the nonresident's business.

Other relevant considerations for nonresidents with a material Canadian presence include:

- *Employee Taxation/Employer Remittance*: For nonresidents who send employees to Canada from time to time, whether (1) those employees are themselves subject to Canadian income tax on a portion of their earnings by virtue of performing employment services in Canada, and (2) their employer has a corresponding Canadian withholding and remittance obligation.[7]
- *PE*: For nonresidents who are carrying on business in Canada and are fiscally resident in a country with a Canadian tax treaty, whether the nonresident has a PE in Canada, either by virtue of having a fixed place of business in Canada[8] or employees or agents in Canada who exercise authority

[4] *Sudden Valley Inc. v. Minister of National Revenue*, 75 DTC 263 (TRB), *aff'd* 76 DTC 6448 (FCA) ("In considering whether the Plaintiff was 'soliciting orders' in Canada, I do not agree that the words can be extended to include 'a mere invitation to treat.'. . . Soliciting or completing sales with Canadians from outside of Canada via the Internet based on a server located outside of Canada would also not constitute 'soliciting orders . . . in Canada.'"

[5] See CRA Docs. 2006-019443, 2001-0116133, and 2000-054455 for examples of the Canada Revenue Agency applying those criteria in its administrative positions.

[6] *See, e.g.*, *Pullman v. The Queen*, 83 DTC 5080 (FCTD). Thus, it is possible for a nonresident to be carrying on business in Canada without any of its own employees ever entering Canada.

[7] For further discussion, see Natasha Miklaucic, "Canadian Tax Considerations of Nonresidents Providing Services in Canada," *Tax Notes Int'l*, Mar. 9, 2015, p. 899.

[8] CRA auditors will frequently assert the presence of a Canadian PE if office space of a Canadian group member is formally set aside and made available to visiting employees of a nonresident group member. That issue must be carefully managed.

Table 1. Nonresidents Carrying On Business in Canada

Issue	Nonresidents in a Country With a Canadian Tax Treaty	Nonresidents in Country With No Canadian Tax Treaty
Income tax return required if carrying on business in Canada	Corporations*	Corporations*
Canadian taxation of income from carrying on business in Canada	No, if nonresident is both eligible for benefits under its home country's tax treaty with Canada, and not carrying on business through a PE in Canada**	Yes
Employees present in Canada: Canadian tax on employee remuneration	Yes, unless relief is provided to nonresident employee under tax treaty between Canada and nonresident employee's home country	Same as residents of tax treaty countries
Employees present in Canada: Nonresident employer obliged to withhold and remit Canadian tax on employee remuneration	Yes, unless nonresident employee is treaty-exempt and employer obtains exemption under Regulation 102 waiver or qualifying nonresident employer certification program***	Yes, unless nonresident employee is treaty-exempt and employer obtains Regulation 102 waiver

* No filing obligation for nonresident individuals unless disposing of (or realizing capital gains from) specific property or taxes owing.

** A PE is as defined in the relevant tax treaty, typically as either a fixed place of business or an employee who exercises authority to conclude contracts in the nonresident's name.

*** That requires that the treaty-exempt nonresident employee either works in Canada for less than 45 days in the calendar year that includes the time of the payment, or is present in Canada for less than 90 days in any 12-month period that includes the time of the payment.

to conclude contracts on the nonresident's behalf.[9]

Strategies frequently used to minimize the risk of in-Canada activities creating Canadian tax obligations or nexus for a nonresident include: (1) creating a Canco to perform the necessary in-Canada activities as an independent contractor under a fee-for-services contract; and (2) formally seconding the nonresident's visiting employees to a Canadian group member, so that the Canadian entity becomes the employer of the visiting employee while in Canada and assumes the related employment supervision and tax obligations.

II. Regulation 105 Withholding

Nonresidents of Canada frequently encounter unwelcome surprises with withholding obligations under Regulation 105. Regulation 105 applies whenever a person (Canadian or nonresident) pays a fee, commission, or other amount to a nonresident "in respect of" services rendered in Canada. When applicable, Regulation 105 requires the payer to withhold and remit 15 percent of the payment as a credit toward the nonresident's Canadian income tax liability (if any). If the amount withheld and remitted exceeds the nonresident's actual Canadian income tax liability as ultimately determined, the nonresident can file a tax return and claim a refund of the difference. A payer who fails to withhold and remit is liable for the 15 percent amount, plus interest and penalties, with no time limit for reassessment.

Essentially, the purpose of Regulation 105 withholding is to force the payer to remit funds to the Canada Revenue Agency and thereby require the nonresident to either file a Canadian income tax return or forgo the withheld amount. If the nonresident can satisfy the CRA in advance of the payment that Regulation 105 withholding would

[9]The Canada-U.S. tax treaty has an additional services PE article that may deem a U.S. resident to have a Canadian PE if the U.S. resident's employees perform services in Canada in excess of 183 days during any 12-month period.

exceed its Canadian income tax liability,[10] the CRA may issue a waiver relieving the payer from (or reducing) the obligation to withhold. The waiver process can be lengthy and cumbersome, however.

The breadth of Regulation 105 withholding is attributable to several factors: It applies to fees or commissions in respect of, not merely for, services rendered in Canada; it applies to both Canadian and nonresident payers; and most important, the recipient need not be the entity rendering, and the payer need not be the entity receiving, those services rendered in Canada.[11] That can produce highly anomalous and unfair results that go beyond the scope of the tax policy Regulation 105 is intended to address. For example, it is common for entities dealing with an MNE to contract directly with the foreign parent for services that include an in-Canada element, which are then provided by the foreign parent's Canadian subsidiary under a separate intragroup services agreement between the foreign parent and Canadian subsidiary. That logical arrangement unfortunately leads to hidden Regulation 105 withholding (and interest and penalties) even when the amounts for in-Canada services are fully taxed in Canada.

That was the case in *FMC Technologies Company v. The Queen*, 2009 FCA 217, *aff'g* 2008 FC 871, whose facts are illustrated in Figure 2. Customer Petro-Canada had a services contract with the foreign parent (FMCI) of the Canadian subsidiary (FMC) that would actually be providing the in-Canada services. Even though FMC invoiced the customer directly for the in-Canada services (and FMCI assigned its rights to those amounts to FMC), the only party with a legal right to payment for the in-Canada services from the customer was FMCI.

The CRA assessed Petro-Canada for 15 percent of the C $18.8 million invoiced to it by FMC (plus interest and penalties) on the basis that Petro-Canada was required to withhold under Regulation 105 because the legal payee for those amounts (FMCI) was a nonresident. That was so even though the payments were made for work actually performed by a Canadian resident (FMC) that had been taxed on them in Canada. The CRA said that because FMCI was the only party with whom Petro-Canada had an agreement to provide services, the payments made by Petro-Canada for the in-Canada services were constructively made to FMCI, even if received by FMC on FMCI's direction.

Petro-Canada (presumably indemnified by its counterparty FMCI) did not challenge the assessments in court. FMCI lacked the standing to claim a refund because it appeared not to have filed Canadian income tax returns, and the courts denied FMC the ability to recover the withheld amounts (even though they resulted in a windfall for the CRA[12]) because it was neither the taxpayer assessed nor the legal payee (having no direct legal rights against the customer).

To relieve Canadian customers of the burden of effecting Regulation 105 withholding, Canadian tax advisers often suggest having a Canadian subsidiary of the MNE provide all in-Canada services under a contract between the subsidiary and the customer, with fees for those services calculated separately and billed by (and paid directly to) the Canadian subsidiary.[13] Non-Canadian MNE group members can contract directly for any "outside Canada" services (which are not subject to Regulation 105 withholding). Structured that way, no Regulation 105 withholding will apply, because fees for the in-Canada services are being paid to a Canadian resident legally entitled to receive them, while the amount paid to the nonresident is not in respect of services rendered in Canada.

Regulation 105 withholding can arise in many unanticipated ways to produce unfair results, and attention must be paid to any agreement (either intragroup or with third parties) regarding services to be performed in Canada.

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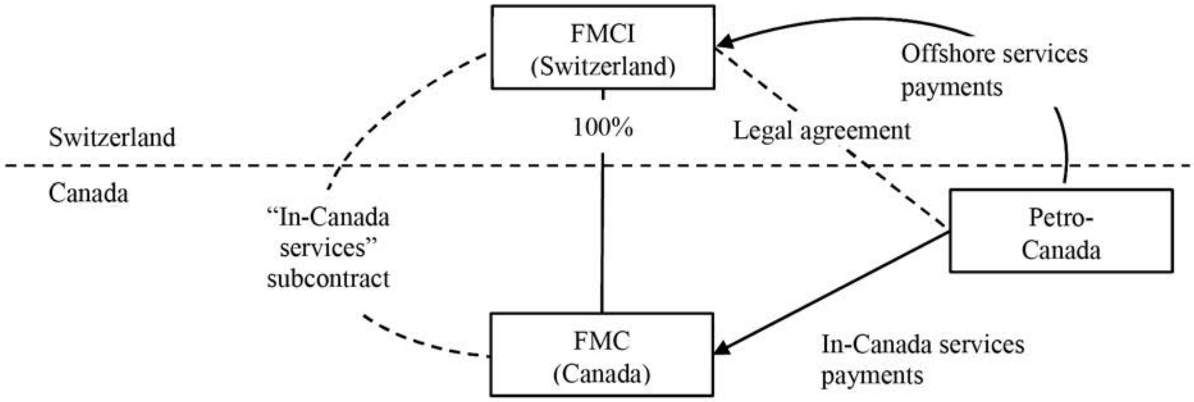
[10]For example, if the nonresident is both exempt under an applicable tax treaty and eligible to claim benefits under that treaty. The Canada-U.S. income tax convention includes a limitation on benefits article that imposes a higher standard than simply being resident in Canada or the United States to claim treaty benefits. *See* Steve Suarez, "Thoughts on the New LOB Clause in the Canada-U.S. Treaty," *Tax Notes Int'l*, Oct. 5, 2009, p. 39.

[11]Regulation 105 withholding does not apply to payments to reimburse actual expenses incurred by the recipient, because those reimbursements are not "fees, commissions or other amounts in respect of services rendered in Canada." *Weyerhaeuser Co. Ltd. v. The Queen*, 2006 TCC 65.

[12]Suarez and David Gaskell, "Withholding Decision Creates Windfall for Revenue Agency," *Tax Notes Int'l*, Aug. 24, 2009, p. 600.

[13]Unless the in-Canada portion of payments to a nonresident is clearly identifiable, the CRA will typically assess Regulation 105 withholding on the entire amount paid to a nonresident for services.

Figure 2. Regulation 105



III. Transfer Pricing

For MNEs with Canadian group members, transfer pricing is frequently the single most time-consuming (and often most important) Canadian income tax issue. Transfer pricing is very much a growing area of tax practice in Canada, because of the CRA's increased allocation of assets to transfer pricing audits, its aggressive application of Canada's transfer pricing rules, the highly judgmental nature of determining "correct" transfer prices, and the huge dollar value of transactions between Canadians and non-arm's-length nonresidents (NALNRs).

Canada's transfer pricing rules apply to transactions between a Canadian resident and a nonresident not dealing at arm's length with that resident (an NALNR). They ensure that the resident has not paid too much (or received too little) by testing those transactions against the arm's-length standard. Specifically, ITA section 247(2) requires identification of a particular transaction or series of transactions (the tested transactions) that both the Canadian taxpayer and an NALNR participate in. The general transfer pricing rule in section 247(2)(a) applies when the terms and conditions of the tested transactions between the actual participants differ from those that would have been made between arm's-length persons in the same circumstances.[14] If the general rule applies, the CRA is entitled to revise those terms and conditions — that is, prices — to whatever arm's-length parties would have agreed to.

The highly judgmental nature of determining what arm's-length persons in the same circumstances would have agreed to creates a range of potential transfer prices and different methods for determining them. In Canada, transfer pricing penalties may apply when the taxpayer's net transfer pricing adjustment for the year exceeds the lesser of C $5 million or 10 percent of its gross revenue for the year. The amount of the penalty is 10 percent of the net adjustment, which excludes adjustments for which the taxpayer made reasonable efforts to determine and use arm's-length prices and allocations. Because Canadian transfer pricing penalties are computed as percentages of transfer pricing adjustments rather than any resulting increases in actual taxes owed, they are relatively onerous.

In theory, a taxpayer subject to transfer pricing adjustments (however large) can avoid penalties if it can show it made reasonable efforts to determine and use arm's-length prices and allocations. Whether the taxpayer has made those efforts for any particular transaction is a question of fact. However, when the taxpayer fails to meet the statutory requirements in section 247(4) to prepare and provide the CRA with satisfactory contemporaneous documentation outlining the underlying analysis, it is deemed not to have made reasonable efforts. That puts taxpayers who fail to prepare satisfactory contemporaneous

[14] The more severe transfer pricing recharacterization rule in section 247(2)(b) applies when the tested transactions would not have been entered into between arm's-length persons at all — that is, they are commercially irrational — and can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

documentation at considerable risk (which is indeed the intention of the penalty).[15]

Whether or not penalties apply, an adverse transfer pricing adjustment will also typically result in secondary adjustments to reflect the finding that the resident has essentially conferred a benefit on the NALNR (by paying too much or receiving too little). Unless the CRA allows the NALNR to reimburse the transfer pricing adjustment to Canco, the benefit will be treated as a deemed dividend subject to Canadian dividend withholding tax (25 percent unless reduced under an applicable tax treaty).

While in general terms Canada follows the OECD's transfer pricing guidelines, in practice Canadian courts have placed much greater weight on the taxpayer's commercial law rights and obligations as established under the actual contracts and are less willing than the 2017 OECD guidelines to ignore those in favor of perceived economic substance. It is important for MNEs to appreciate the significant (and increasing) divergence between Canadian case law and the OECD's transfer pricing guidelines. The CRA's cancellation of Information Circular IC 87-2R (its primary administrative guidance on transfer pricing) in February[16] ostensibly because the circular no longer reflects the most current OECD transfer pricing guidelines suggests that the CRA is not accurately interpreting the case law and that transfer pricing disputes with taxpayers will become more frequent.

Transfer pricing audits in Canada are lengthy, time-consuming, and often contentious, frequently taking many years to complete. A taxpayer dissatisfied with the result can pursue an administrative review from CRA Appeals and litigate before the Tax Court of Canada.[17] A taxpayer whose relevant NALNR is resident in a country with a Canadian tax treaty can seek relief from the Canadian competent authority under the mutual agreement procedure in the relevant tax treaty. The dispute resolution options can be complex.[18]

IV. Paid-Up Capital

Paid-up capital (PUC) is the tax version of stated capital under corporate law and is an extremely important tax attribute for nonresidents that have significant share ownership in a Canco. Generally, when a corporation issues shares of a particular class, it adds the consideration it received for issuing those shares to the PUC of that class. The PUC of any share of a particular class equals the PUC of the entire class divided by the number of outstanding class shares. Subsequent issuances or redemptions of shares of that class will affect the PUC of each share, but the sale of an already issued share to another person does not affect PUC. Thus, for example, if A subscribes for 100 shares of Canco for $100 and B later subscribes for another 100 Canco shares of the same class for $500, the total PUC of $600 is apportioned evenly over each share of the class — that is, $3 per share, or $300 for A's 100 shares and $300 for B's 100 shares. If B later sells her 100 shares to C for $1,000, C's cost base in those shares will be $1,000 but their PUC will remain unchanged at $300, because no new shares were issued or existing shares redeemed.

When a Canadian corporation redeems or repurchases its own shares, it is deemed to have paid a dividend to the selling shareholder equal to the amount by which the redemption price exceeds the PUC of the redeemed or repurchased share. Thus, were C's 100 shares to be redeemed for their fair market value of $1,000, Canco would be deemed to have paid a dividend of $700 ($1,000 - $300 PUC) to C, even though C paid $1,000 for those shares and would have realized no dividend or gain had they been sold to a third party (other than Canco) for their $1,000 value. Because a nonresident shareholder of Canco can receive property from Canco as a tax-free return

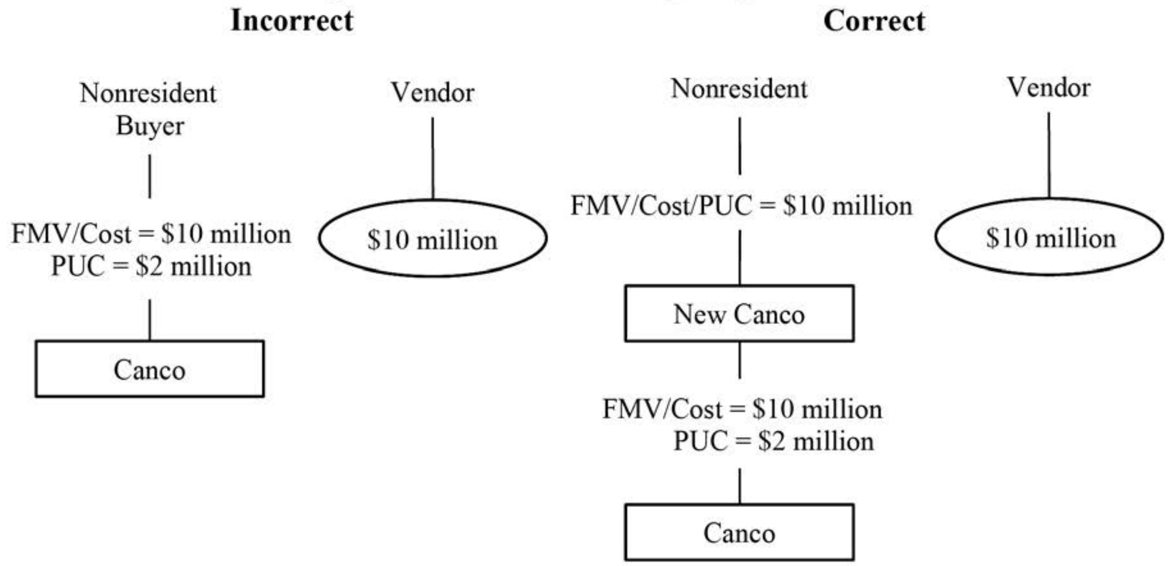
[15] *See* Suarez, "Transfer Pricing in Canada," *Tax Notes Int'l*, Dec. 2, 2019, p. 781 at 790.

[16] *See* CRA, "Notice to Tax Professionals: International Transfer Pricing Administrative Guidance Archived," PR 2020/02/26B Rev (Feb. 26, 2020).

[17] The most recent example is *Cameco Corp. v. The Queen*, 2018 TCC 195, in which the court reversed the CRA's reassessments. For analysis, see Suarez, "The *Cameco* Transfer Pricing Decision: A Victory for the Rule of Law and the Canadian Taxpayer," *Tax Notes Int'l*, Nov. 26, 2018, p. 877; and Nathan Boidman, "Cameco and Cash-Boxes," *Tax Notes Int'l*, Dec. 10, 2018, p. 1055. On June 26, 2020, the Federal Court of Appeal upheld the Tax Court's decision (2020 FCA 112).

[18] For a visual illustration of the various options, see Suarez, *supra* note 15, at 811.

Figure 3. Nonresident Acquiring a Canco



of capital (rather than a dividend) up to the amount of the PUC of the nonresident's shares, PUC represents the ability to extract value out of Canada without Canadian dividend withholding tax — a very valuable tax asset.

To ensure that a nonresident purchaser of an existing Canadian corporation obtains both cost basis and PUC equal to the purchase price paid, Canadian tax advisers typically encourage nonresident purchasers to create and fund a new Canadian corporation as the direct buyer (which is then merged with the Canadian target corporation immediately post-closing).[19] For example, a nonresident buyer of a Canadian corporation whose shares are worth $10 million but have only $2 million of PUC should not acquire those shares directly. Instead, a new Canadian corporation should be created and capitalized with $10 million to make the acquisition, so that the cross-border shares owned by the nonresident have full $10 million of PUC.

Maximizing cross-border PUC facilitates various planning opportunities and optimizes interest deductibility under Canada's thin capitalization rules for debt owed by Canadian subsidiaries to NALNRs (see Section V, *infra*).

V. Intragroup Debt Financing

Most MNEs with Canadian group members debt-finance their Canadian entities to some extent. Non-Canadian group members (rather than from arm's-length parties) often act as creditors. Canada's rules on interest deductibility and interest withholding tax must be considered in such cases.

A. Interest Deductibility

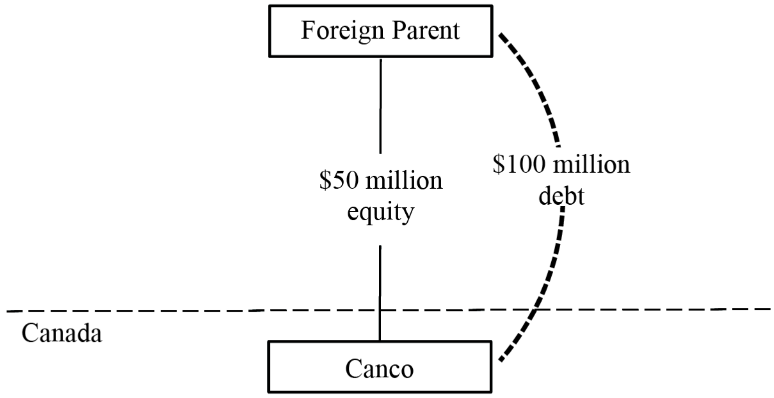
Interest expense is generally deductible only when linked to an income-earning purpose and of a reasonable amount. The case law has generally treated an arm's-length rate of interest as meeting the reasonableness standard.

Canada's thin capitalization rules restrict the amount of interest-deductible debt Canco[20] can incur in connection with debts owed to related nonresidents, limiting the potential for cross-border intragroup interest stripping. Essentially, those rules prevent Canco from deducting interest on outstanding debt owed to specified

[19] *See* Suarez and Kim Maguire, "Tax Issues on Acquiring a Canadian Business," *Tax Notes Int'l*, Aug. 31, 2015, p. 775 at 786.

[20] The thin capitalization rules apply not only to Cancos but also to Canadian resident trusts and to nonresident corporations and trusts that either carry on business in Canada or elect to be taxed as Canadian residents. Those rules also generally apply to partnerships in which any of those entities are members.

Figure 4. Basic Thin Capitalization Example



nonresidents[21] if that debt exceeds 150 percent of Canco's equity.

For example, a Canco that owes $100 million to its foreign parent and has only $50 million of equity for thin capitalization purposes will be able to deduct interest expense on only $75 million of that debt (see Figure 4). Interest on the remaining $25 million of debt will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend subject to 25 percent Canadian nonresident dividend withholding tax (potentially reduced under an applicable tax treaty) instead of as interest.

The 1.5-1 debt-to-equity ratio used in the thin capitalization rules requires annual computation of Canco's outstanding debts to specified nonresidents and equity. Canco's outstanding debt to specified nonresidents is determined by adding the maximum amount of that debt at any time in each calendar month that ends in the relevant tax year and dividing that amount by the number of those calendar months (to produce an average). That formula makes it disadvantageous to increase debt owed to specified nonresidents shortly before month-end, relative to waiting until the start of the next month if possible.

Canco's equity for a particular year is calculated as the sum of three amounts:

- Canco's unconsolidated retained earnings at the beginning of the year (an accounting concept);
- Canco's total of the start-of-month contributed surplus received from its specified nonresident shareholders[22] for each calendar month ending in the year, divided by the number of those calendar months; and
- the total of the start-of-month PUC of Canco shares owned by its specified nonresident shareholders for each calendar month ending in the year, divided by the number of those calendar months.

Thus, Canco's retained earnings for thin capitalization purposes are calculated only at the beginning of the tax year, in contrast to the other relevant amounts calculated as monthly averages during the year. The various computational nuances make it particularly important for Canco to monitor its debt and equity for thin cap purposes and to review its retained earnings before each year-end, so that any necessary adjustments can be made to stay within the 1.5-1 debt-to-equity limit for the next year — that is, reducing debt or increasing equity. In particular, actions that would reduce start-of-year retained earnings should be identified.

The 2019 election platform of the Liberal Party of Canada included a general proposal to restrict the deductibility of interest expense (irrespective of who the creditor is) to a specified percentage of the debtor's earnings. For corporations with net interest expenses of more than $250,000, the proposal would limit deductible interest expense

[21] A specified nonresident is defined here as a nonresident person who either owns at least 25 percent of Canco's shares (by votes or value, and including any shares held by non-arm's-length persons) or does not deal at arm's length with shareholders holding at least 25 percent of Canco's shares.

[22] That is, a shareholder holding at least 25 percent of Canco's shares who is a nonresident.

Figure 5. Canadian Interest Withholding Tax

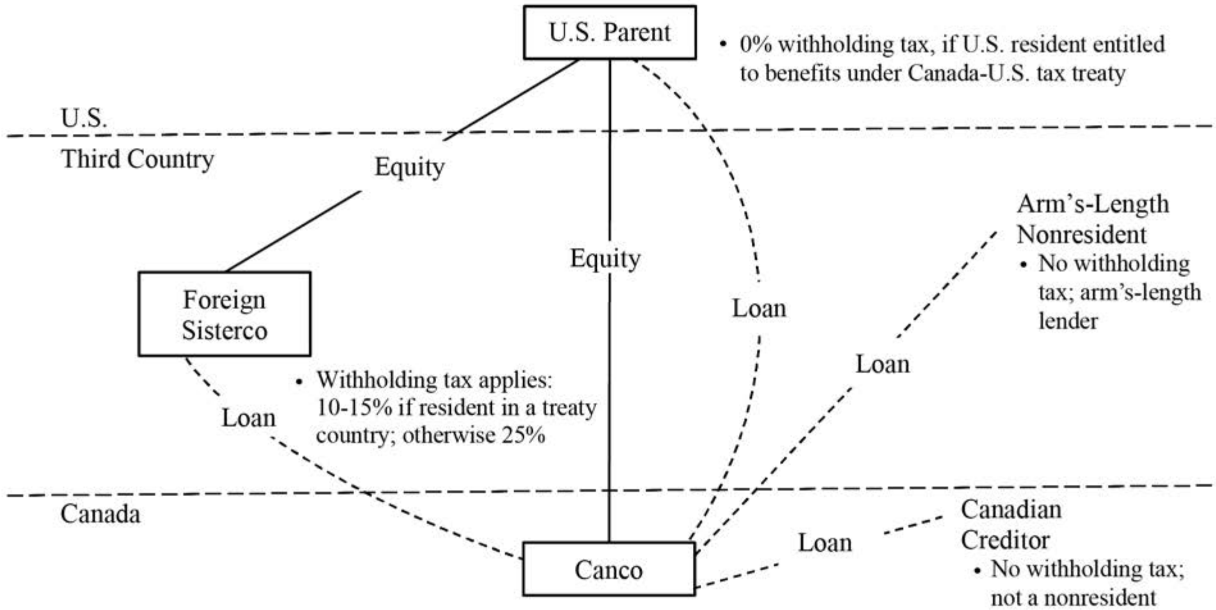
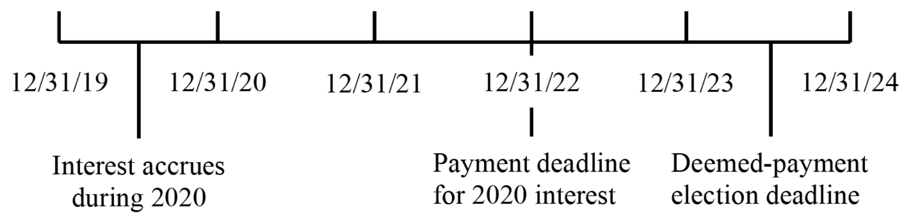


Figure 6. Accrued Non-Arm's-Length Interest and Section 78(1)



to no more than 30 percent of the debtor's earnings before interest, taxes, depreciation, and amortization. When the corporation is part of a multinational corporate group and its interest expense exceeds the 30 percent EBITDA threshold, interest deductibility would be allowed up to the worldwide group ratio of interest expense to EBITDA.

Very little additional information is available on the proposal, which has yet to be the subject of any announcement by the Liberal minority government formed after the October 2019 election or the Department of Finance.[23]

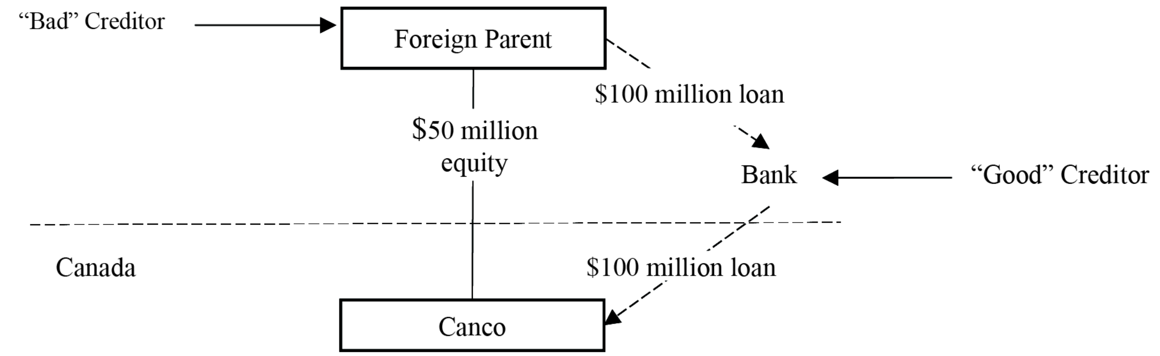
B. Interest Withholding Tax

Canadian domestic law imposes nonresident interest withholding tax only on interest paid to nonresidents who do not deal at arm's length with the debtor and participating interest. The relevant rate of Canadian withholding tax on interest paid to an NALNR will generally be 0 percent for U.S. residents entitled to benefits under the Canada-U.S. tax treaty, 10 percent or 15 percent for recipients resident in any other country with a Canadian tax treaty, and 25 percent for recipients resident in a country with no Canadian tax treaty (see Figure 5). That generally makes it advantageous for Canadian subsidiaries to borrow directly from arm's-length banks, rather than banks lending to a foreign MNE group member that then on-loans a portion of that external debt to the Canadian subsidiary.

There is a limit to how long expenses owed to a non-arm's-length person can remain unpaid

[23] Office of the Parliamentary Budget Officer, "Cost Estimate of Election Campaign Proposal" (Sept. 29, 2019).

Figure 7. Back-to-Back Loan Example



before the Canadian debtor's deduction is reversed (that prevents the debtor from claiming interest expense (and other) deductions on an accrual basis while indefinitely deferring payment of withholding tax, which applies on payment). An expense incurred by the taxpayer owing to a non-arm's-length person in one tax year must be paid by the end of the payer's second following tax year. If it remains unpaid by that time, the amount is added back into the payer's income in the immediately following tax year, effectively reversing any deduction previously taken (see Figure 6).

As an alternative to increasing the debtor's income, the parties can file a joint Form T2047 to deem the amount paid and loaned back to the taxpayer, which will avoid the income addback. However, the deemed payment of the expense will often trigger Canadian withholding tax when the non-arm's-length person is a nonresident. Form T2047 must be filed by the due date of the taxpayer's income tax return for the following year (mid-2023 for an expense incurred in 2020).

C. Back-to-Back Loan Rules

The thin capitalization and interest withholding tax rules are supported by back-to-back loan rules. Those rules may apply if a connection exists between (1) a debt Canco owes to a "good" creditor (for example, an unrelated bank) from a thin capitalization or interest withholding tax perspective, and (2) specific arrangements between that good creditor and a nonresident not dealing at arm's length with Canco. For example, if Canco's foreign parent made a loan to a third-party bank that in turn made a loan to Canco, the back-to-back rules would ignore the third-party bank and effectively deem the foreign parent to be Canco's creditor, causing the thin capitalization rules, and potentially higher Canadian interest withholding tax, to apply.

Unfortunately, the scope of the back-to-back rules is considerably broader than the simple example in Figure 7, and it is generally necessary to review any arrangements between Canco's creditor and non-Canadian members of the MNE group to ensure that those rules don't apply.[24] The presence of those rules has made determining the interest withholding tax and thin cap outcome of debt financing a Canadian subsidiary from within the MNE considerably more complex, even when no tax avoidance motive exists.

VI. Hybrids

Historically, Canada has not been particularly concerned with hybrid entities or structures. The traditional Canadian approach has been not to enact specific anti-hybrid rules, and to apply Canadian tax laws and entity classifications to the taxpayer's legal relationships as they exist and generally without regard to how foreign tax law views them. However, that position has shifted over the past 10-15 years, to the point that MNEs with hybrid arrangements involving Canadian group members need to exercise caution regarding entities or structures that are treated

[24] *See* Suarez, "Canada Releases Revised Back-to-Back Loan Rules," *Tax Notes Int'l*, Oct. 27, 2014, p. 357. Those rules have been expanded to include some royalty arrangements. *See* Michael Kandev, "Canada Expands Back-to-Back Regime: Examining the Character Substitution Rules," *Tax Notes Int'l*, June 19, 2017, p. 1087.

differently in Canada and another relevant country.[25]

A. Limited Liability Companies

U.S. limited liability companies that are disregarded for U.S. tax purposes have been a concern for some time, because of the CRA's position that those entities (which are viewed as corporations for Canadian tax purposes) are not U.S. residents for treaty purposes and so cannot claim treaty benefits. That question was litigated in *TD Securities (USA) LLC v. The Queen*, 2010 TCC 1127, with the Tax Court of Canada ruling in favor of the taxpayer. Specifically, it concluded that the context, object, and purpose of the Canada-U.S. tax treaty would not be achieved (and indeed would be frustrated) if treaty benefits could not be claimed on the LLC's Canadian-source income (which the United States had taxed in the hands of the LLC's U.S.-resident sole shareholder).[26]

In 2007 when Canada and the United States amended their tax treaty to include specific anti-hybrid rules, they added Article IV(6) to allow U.S. residents (only) to claim treaty benefits through an LLC that is disregarded for U.S. tax purposes.[27] That provision addresses situations in which the LLC's shareholder is a U.S. resident entitled to treaty benefits — that is, it meets at least one of the tests under the treaty's limitation on benefits article.[28] However, other U.S. residents and residents of third countries are well advised not to invest in Canada through disregarded LLCs, because the CRA maintains its position that an LLC that is transparent under U.S. tax laws is not a U.S. resident for treaty purposes.[29] LLCs owning shares of a Canadian unlimited liability company that is transparent for U.S. tax purposes should also be avoided.[30]

B. Unlimited Liability Corporations

Article IV(7)(b) of the Canada-U.S. tax treaty is a specific anti-hybrid rule that denies treaty benefits to U.S. residents receiving payments from Canadian resident entities that are transparent for U.S., but not Canadian, tax purposes — that is, hybrid characterization — if the U.S. tax treatment of the amount is different from what it would have been had that entity not been disregarded for U.S. tax purposes. That provision most frequently applies to Canadian unlimited liability corporations (ULCs), which are treated as regular corporations for Canadian tax purposes but can be transparent in the United States.

In its simplest form, a payment to a U.S. resident from a Canadian ULC that is transparent in the United States will frequently result in article IV(7)(b) applying to deny treaty benefits to the U.S. recipient. For example, a dividend paid by that kind of ULC to a U.S. resident will be subject to full 25 percent dividend withholding tax, because the U.S. tax treatment of the payment is different from what it would have been had the ULC not been disregarded for U.S. tax purposes.

The typical workaround in that situation has been to bifurcate the dividend into distinct steps (see Figure 8). First, the ULC increases the PUC of its shares without making a distribution — that is, a deemed dividend for Canadian tax purposes but ignored for U.S. purposes (irrespective of how the ULC is characterized in the United States) — so Canada allows the treaty-reduced dividend withholding tax rate to apply. The ULC then effects a distribution as a return of PUC, which does not attract Canadian dividend withholding tax. The CRA has ruled favorably on that two-step technique.[31]

[25] For discussion of Canada's periodic anti-hybrid initiatives over the past 10-15 years, see Boidman and Kandev, "BEPS Action Plan on Hybrids: A Canadian Perspective," *Tax Notes Int'l*, June 30, 2014, p. 1233.

[26] See Suarez, "Canadian LLC Ruling Overturns Longstanding CRA Policy," *Tax Notes Int'l*, Apr. 19, 2010, p. 199. The CRA reconciles its differing treatment of LLCs and U.S. S corporations in that regard on the basis that an S corporation is liable to U.S. tax under the residence article of the Canada-U.S. tax treaty (whereas an LLC is not, in its view), and an S corporation's shareholders must themselves be taxable in the United States. *See* CRA Doc. 9713120.

[27] Or through multiple entities like that. *See* CRA Doc. 2017-0736531I7.

[28] *See* Suarez, *supra* note 10.

[29] *See* Kristen A. Parillo, "Canada Will Litigate U.S. LLC Questions Under Fifth Protocol," *Tax Notes Int'l*, Oct. 4, 2010, p. 7.

[30] *See* CRA Doc. 2009-0345351C6.

[31] *See, e.g.*, CRA Docs. 2012-0467721R3 and 2011-0399121R3.

Figure 8. Dividends Paid by Disregarded ULC: Workaround

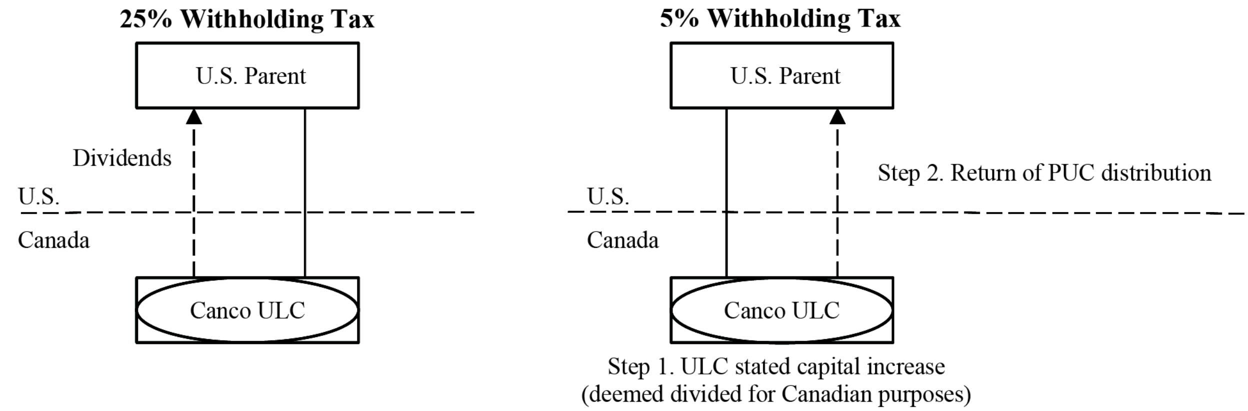
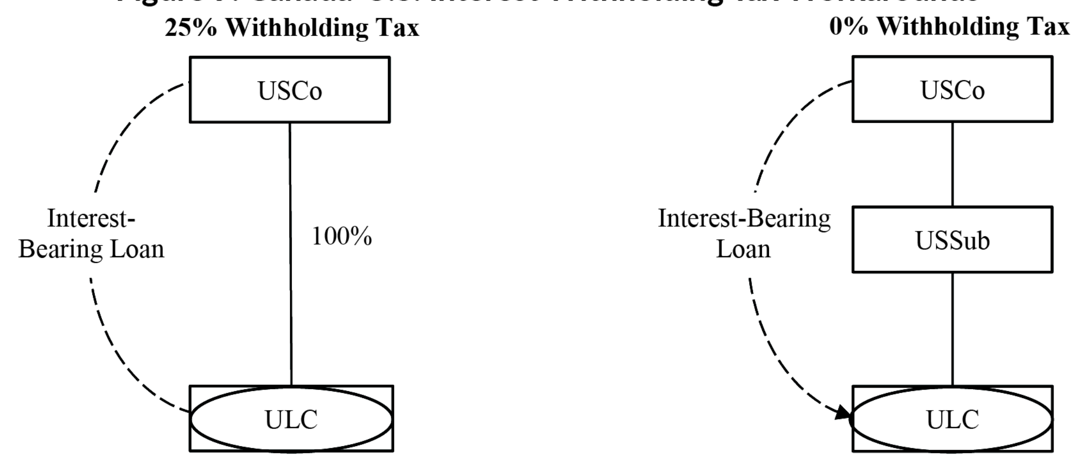


Figure 9. Canada-U.S. Interest Withholding Tax Workarounds



Similar workarounds have been developed for other payments, such as interest. A common strategy is to make a "grandparent" loan to the ULC from the parent of the ULC's own shareholder (see Figure 9). Other variations include a second ULC shareholder so that the ULC is treated as a U.S. partnership rather than being disregarded.[32] The CRA is aware of those techniques and has ruled favorably on them.[33]

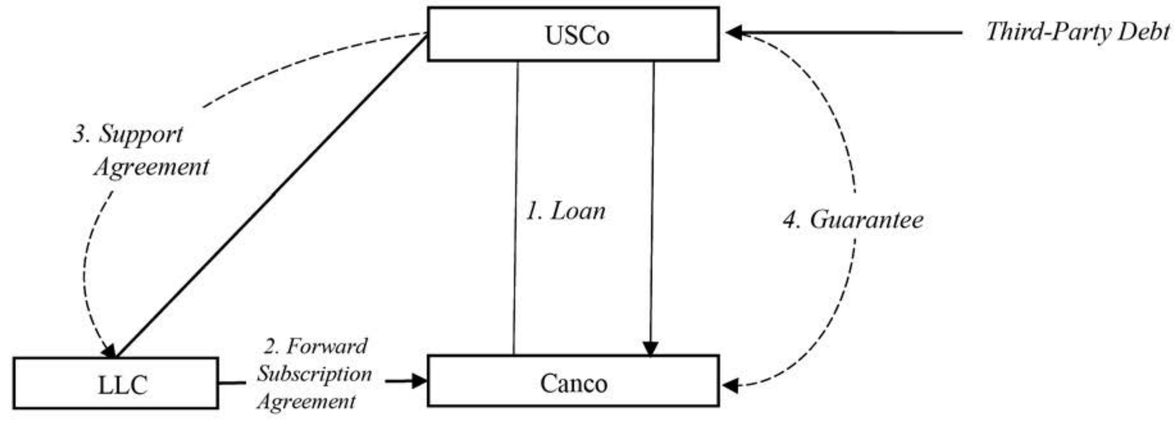
Most recently, the CRA has become creative in applying nontraditional rules to attack hybrids. For many years, a common U.S.-to-Canada inbound financing structure was a hybrid financing treated as debt in Canada but not for U.S. tax purposes. Under the structure, a Canadian subsidiary borrows funds from its U.S. parent while simultaneously entering into a forward subscription agreement with a U.S. sister entity whereby the sister subscribes for shares of the Canadian subsidiary whenever funds are needed to repay interest or principal on the debt to the U.S. parent. The U.S. sister entity typically obtains from the U.S. parent the funds required to meet its obligations under the forward subscription agreement. Structured properly, that arrangement results in deductible interest expense for the Canadian debtor and no interest income in the United States — that is, a hybrid mismatch (see Figure 10).

In a highly unusual notice to tax practitioners, the CRA in July 2019 announced that an audit of this structure had concluded on the basis that

[32] For discussion of Article IV(7)(b) and workarounds, see Matias Milet and Peter Repetto, "Canada-U.S. Tax Treaty Issues: Anti-Hybrid Rules, the GAAR, and the U.S. Dual Consolidated Loss Rules," *Tax Notes Int'l*, Sept. 19, 2011, p. 889.

[33] See, for example, CRA Doc. 2009-0318491I7, which discusses several examples and reviews in detail the CRA's views on what constitutes the same U.S. tax treatment under Article IV(7)(b).

Figure 10. U.S.-Canada Inbound Double-Dip



transfer pricing rules applied to recharacterize the debt and that transfer pricing penalties applied. The notice stated:

> It is the CRA's general view that such transactions are undertaken primarily to obtain a tax benefit and that they would not be undertaken by parties dealing at arm's length. When the CRA finds transactions similar to the example . . . the Transfer Pricing Review Committee will be consulted regarding the application of paragraphs 247(2)(b) and (d). Where these paragraphs apply, related transfer pricing penalties will generally apply on the basis that taxpayers engaging in this type of tax planning did not use reasonable efforts to use arm's length prices, terms and conditions in their transfer pricing.

It would be unsurprising to see further anti-hybrid developments in Canada.

VII. Foreign Affiliate Dumping Rules

The foreign affiliate dumping (FAD) rules strongly discourage a Canco from owning significant (10 percent or more) interests in foreign corporations, if it is itself controlled by a nonresident person (or group of NALNRs). Thus, those rules are aimed squarely at foreign-based MNEs with Canadian group members.

The FAD rules start from the premise that a Canco controlled by a foreign person generally should not have foreign subsidiaries and that situations like that need to be policed. Under Canada's rules on foreign subsidiaries of Canadian corporations, active business income earned by a foreign affiliate[34] of Canco is generally not subject to Canadian tax, either as it accrues or on repatriation to Canada.

The Department of Finance was concerned that foreign MNEs were causing their Canadian members to acquire interests in foreign affiliates that do not produce significant income taxes in Canada either to generate interest expense deductions in Canada that reduce Canco's Canadian corporate income tax — that is, if Canco issues debt to purchase the foreign affiliate's shares — or as a way of distributing surplus cash out of Canada without paying Canadian dividend withholding tax.[35]

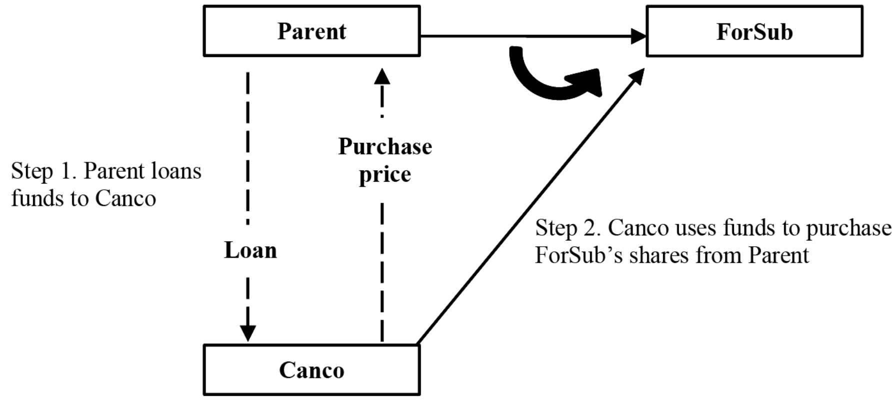
Under a classic FAD, the Canadian member of the multinational group acquires existing shares (often fixed-value preferred shares) of another non-Canadian group member (see Figure 11). Any cash paid by Canco is viewed as the distribution from Canada of an income-generating asset in exchange for assets (shares of a foreign affiliate) perceived to be unlikely to generate significant taxable income in Canada[36] without dividend withholding tax having been

[34] Generally, a corporation resident outside Canada will be a foreign affiliate of Canco if Canco directly or indirectly owns at least 1 percent of the foreign corporation's shares and Canco and all persons related to it collectively own at least 10 percent of the foreign corporation's shares directly or indirectly. Those and other elements of the Canadian foreign affiliate system are explained in Drew Morier and Raj Juneja, "Foreign Affiliates: An Updated Primer," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Canadian Tax Foundation Conference Report (2013).

[35] For example, by purchasing equity of non-Canadian members of the multinational group for cash.

[36] Canco remains subject to Canadian income tax on capital gains from a disposition of the shares of its foreign affiliates, as well as passive (and some Canadian-source) income earned by its foreign affiliates.

Figure 11. Foreign Affiliate Dumping



incurred (surplus stripping). The same concern exists if Canco pays in shares of itself or with debt, because the amount added to the PUC of those shares or the obligation to repay the debt principal on maturity represents an eventual distribution of cash or other valuable property without incurring dividend withholding tax.[37]

Unfortunately, the FAD rules extend far beyond that simple fact pattern, often with alarming results. They generally apply whenever a Canco controlled[38] by a nonresident person or group of NALNRs (Parent) makes an investment in a non-Canadian corporation (ForSub) that is (or becomes) a foreign affiliate of Canco. An investment includes subscribing for shares of, extending credit to, making a capital contribution in, or conferring a benefit on ForSub.[39]

There are a few exceptions to the FAD rules for specific investments:

- debt investments in ForSub that are either debts arising in the ordinary course of Canco's business (for example, trade payables) if settled within 180 days (other than as part of a series of loans and repayments), or debts that Canco and Parent have elected to be subject to the ITA section 17.1 interest imputation regime (see Section VIII, *infra*);
- some corporate reorganizations that do not result in a new investment in economic terms; and
- a complex and difficult-to-meet exception intended to allow Canco to make a "strategic acquisition of a business that is more closely connected to its business than to that of any non-resident member of the multinational group."[40]

When applicable, the FAD rules will either reduce the PUC of Canco's shares by the amount of the investment (which harms Canco in various ways), or deem Canco to have paid a dividend to the foreign parent (triggering Canadian dividend withholding tax). In effect, an investment made by Canco down the chain is treated as a distribution by Canco up to its foreign parent. Depending on the circumstances, the FAD rules may allow Canco to replace a deemed dividend otherwise occurring with a corresponding reduction in Canco's PUC, or to change the deemed payee of a deemed dividend to obtain a treaty-reduced rate of dividend withholding tax.[41] The FAD rules are complex, and advice should be obtained in any situation in which a Canadian group member of an MNE has (or may acquire) an equity interest in a non-Canadian entity.

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[37] Payment in debt also allows Canco to deduct the resulting interest expense against its other income (including Canadian-source income).

[38] For most Canadian tax purposes, control means de jure control — that is, ownership of shares sufficient to elect a majority of the corporation's board of directors and thereby direct the corporation's affairs and management.

[39] The FAD rules also apply to the acquisition of shares of a Canco that derives more than 75 percent of its value from foreign affiliates as an indirect investment in foreign affiliates.

[40] Department of Finance, Explanatory Notes to Section 212.3(16), Bill C-43, S.C. 2014, C. 39, S. 65(13) and (14).

[41] For discussion, see Suarez, "An Analysis of Canada's Latest International Tax Proposals," *Tax Notes Int'l*, Sept. 29, 2014, p. 1131.

Table 2. Summary of Repatriation Options From Canada

	Withholding Tax	Deductible to Canco	Effect on Canco Thin Capitalization	Other
Dividend	25%: treaty reduced as low as 5%	No	Retained earnings decrease reduces equity in following year	Corporate law limits on payment; consider 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%: treaty reduced as low as 10% (0% for qualifying U.S. residents); supported by B2B antiavoidance rule	Yes, subject to thin cap rules	Retained earnings 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 enough interest (ITA section 15(2)) or joint election into section 17.1 regime	No	None	Transfer pricing or benefit issue if interest too low; various base-erosion rules potentially applicable; consider interest deductibility if paid using borrowed money
Management Fee	25%: typically treaty exempt if provider has no Canadian PE	Yes	Retained earnings decrease reduces equity in following year	Transfer pricing and deductibility issues if above arm's-length amount; Regulation 105 withholding if services rendered in Canada
Royalty	25%, subject to some exceptions under domestic law and in specific tax treaties; supported by B2B antiavoidance rule	Yes	Retained earnings decrease reduces equity in following year	Transfer pricing and deductibility issues if above arm's-length amount

VIII. Repatriation Options

There are various potential alternatives for an MNE to consider when repatriating funds from Canada, each of which has different Canadian tax consequences (see Table 2).[42] The primary Canadian considerations tend to be whether withholding tax applies, whether Canco can deduct the payment, and the effect on Canco's equity in determining the amount of interest-deductible debt Canco can borrow from NALNRs under Canada's thin cap rules. In some cases, it will also be necessary to consider whether there are transfer pricing constraints on the amount of the payment, and whether interest would meet the general income-earning-purpose test for deductibility if Canco funds the payment using borrowed money.

A. Loans

Loans warrant particular mention, because several rules ensure that debts nonresidents owe

[42] Unlike U.S. earnings and profits rules, in Canada the tax character of a distribution by a Canadian corporation follows its legal form as either a dividend or a return of capital (PUC). There is no default to dividends simply because earnings exist.

to Cancos do not erode the Canadian tax base (see Table 3). Those rules often overlap. The starting point is ITA section 15(2), which targets debt involving a particular corporation and one of its shareholders. However, the provision is in fact much broader because the actual creditor need not be that particular corporation and the actual debtor need not be a shareholder of any corporation. It may apply when the creditor is the particular corporation or another corporation related to it, and the debtor (other than a Canadian resident corporation) is (or is someone not at arm's length with) a shareholder of that particular corporation.[43] The basic premise of that rule is that those kinds of loans are de facto shareholder distributions that should be treated as such and included in the debtor's income unless falling under limited exceptions:

- debt repaid by the end of the creditor's second tax year after the debt was incurred (if not part of a series of debts and repayments);
- debt between nonresidents of Canada, owed by certain employees of the creditor, owed to Canadian residents from their foreign affiliates,[44] or arising in the ordinary course of the creditor's business if repayment arrangements are made promptly; and
- debt the parties have elected to have ITA section 17.1 apply to instead.

When section 15(2) applies, the debt is simply included in the debtor's income. If the debtor is a nonresident, the debt is treated as a dividend paid by a Canco to the nonresident, so dividend withholding tax applies. A subsequent repayment of the debt may entitle the debtor to a corresponding deduction from income (or refund of withholding tax previously paid).

When a nonresident corporation controls a Canco to which it (or a related nonresident corporation) owes money and section 15(2) otherwise applies, it and Canco may jointly elect to cause section 17.1 to apply to the debt instead of section 15(2). The section 17.1 rule essentially treats the debt as a real loan rather than a disguised dividend and requires Canco to include no less than a minimum prescribed amount of interest (4.27 percent for the third quarter of 2020) in its income for the year.

A broader rule in section 17 applies to a debt owed by any nonresident person to a Canco, also requiring Canco to include no less than a minimum prescribed amount of interest in income. The scope of that provision is extended by an indirect loan rule that applies when a nonresident owes money to an intermediary that has in turn made a related loan or transfer of property to Canco. The section 17 rule does not apply to debts to which section 15(2) has applied to create unrefunded dividend withholding tax or to which section 17.1 applies, that are repaid within one year, or that are owed by arm's-length nonresidents that are ordinary course trade debts or that controlled foreign affiliates of Canco incurred in their active business.

Finally, section 90(6) applies when the creditor is a foreign affiliate of a Canadian resident instead of the Canadian resident itself, and the debtor is (or does not deal at arm's length with) that Canadian resident.[45] The section thus addresses both loans that replace what would otherwise be equity distributions from the foreign affiliate directly to the Canadian resident and de facto repatriations out from under Canada to nonresidents above the Canadian resident.

That rule includes the amount of the debt in the Canadian resident's income unless the debt is repaid within two years (if not part of a series of debts and repayments), section 15(2) applies to the debt, the debtor is a controlled foreign affiliate of the Canadian resident, or the debt arose in the ordinary course of the creditor's business if repayment arrangements are made promptly. To reflect that Canada's foreign affiliate rules allow a Canadian corporation to receive dividends from a foreign affiliate effectively free of Canadian tax if attributable to the affiliate's active business income, a Canco that suffers a section 90(6) income inclusion may claim an offsetting reserve if it could have received the amount directly as a foreign affiliate dividend without incurring Canadian tax. The reserve is added back to

[43] The section 15(2) rules are supported by detailed back-to-back antiavoidance provisions designed to prevent circumvention via the use of intermediaries.

[44] *See supra* note 34.

[45] *Id*. Section 90(6) does not apply if the debtor is also a foreign affiliate of, and controlled by, the Canadian resident.

Table 3. Amounts Owing by Nonresidents to Cancos (and Their Foreign Affiliates)

ITA	Creditor	Debtor	Principal Exceptions	Consequence	Other
Section 15(2)	Corporation	Person (other than a Canco) that is (or is connected to) a shareholder of either Creditor or a corporation related to Creditor	- Debt repaid before Creditor's second tax year-end - Debt to which section 17.1 applies - Debt between nonresidents - Debt owed by employees - Debt owed from foreign subsidiaries - Debt arising in ordinary course of Creditor's business	Amount of debt included in Debtor's income; if Debtor is nonresident, amount is deemed a dividend paid by Canco to Debtor, triggering dividend withholding tax; reversed on debt repayment	Regime supported by back-to-back debt antiavoidance rules
Section 17.1	Canadian resident corporation controlled by a nonresident corporation	Nonresident corporation that controls Creditor (or that deals non-arm's length with nonresident corporation that controls Creditor)	Elective regime that applies only when both (1) either section 15(2) or FAD rules* would otherwise apply; and (2) the parties jointly elect into section 17.1 regime instead	Creditor required to include at least a minimum prescribed amount of interest in income	Unavailable if tax treaty reduces effect of application
Section 17	Canadian resident corporation	Nonresident person	- Debt repaid within one year - Debt to which section 17.1 applies - Debt to which section 15(2) applies to create (unrefunded) dividend withholding tax - Ordinary-course trade debts owed by unrelated nonresidents - Debt owing by controlled foreign affiliates of Canco relating to an active business	Creditor required to include no less than a minimum prescribed amount of interest income	Regime supported by back-to-back and indirect loan antiavoidance rules

Table 3. Amounts Owing by Nonresidents to Cancos (and Their Foreign Affiliates) ***(Continued)***

ITA	Creditor	Debtor	Principal Exceptions	Consequence	Other
Section 90(6)	Foreign affiliate** of a Canadian resident	The Canadian resident or any person not dealing at arm's length with the Canadian resident (except some closely held foreign subsidiaries)	- Debt repaid within two years - Debt to which section 15(2) applies - Debt arising in ordinary course of Creditor's business	Amount of debt included in Canadian resident's income, less elective reserve for amounts that could have been paid to Canadian resident as tax-free dividend; deduction from income permitted on repayment of debt	Regime supported by back-to-back antiavoidance rule

* *See* Section VII, *supra*.

** A non-Canadian corporation in which the relevant Canadian has at least a 10 percent direct or indirect equity interest.

Canco's income the following year, with a new reserve claimable for that year if sufficient favorable tax attributes remain unused and available that would allow a tax-free foreign affiliate dividend.

B. Cash Pooling

Multinational group cash pooling arrangements are a frequent Canadian tax irritant for MNEs with Canadian members. Cash pooling can be physical (cash is actually swept from accounts in each country daily) or notional (the external group lender notionally nets positive and negative balances in each country, but doesn't actually move cash to net them out). There are no Canadian tax rules designed to accommodate cash pooling arrangements, meaning they are subject to the general rules described above for debts owed to Canadians by nonresidents and vice versa (in particular, section 15(2) and thin capitalization), often with unsatisfactory and somewhat arbitrary results.[46] For example, the Canada Bar Association-Chartered Professional Accountants Canada Joint Committee on Taxation has expressed serious concern with the application of the back-to-back rules to notional cash pooling arrangements with Canadian participants, even when undertaken entirely for commercial reasons.[47] MNEs with Canadian group members should obtain advice regarding the potential Canadian tax impact on their cash pooling arrangements.

IX. Foreign Exchange Issues

Transactions between Canadian and non-Canadian multinational members frequently create foreign exchange problems for one or both parties. In some cases, Canadian resident corporations can elect to compute all relevant amounts for Canadian tax purposes in a qualifying currency.[48] Otherwise, the general rule is that for Canadian tax purposes all relevant amounts must be computed in Canadian dollars, meaning that in most cases either Canco or its

[46] *See, e.g.*, Mark Brender, Marc Richardson Arnould, and Patrick Marley, "Cross-Border Cash-Pooling Arrangements Involving Canadian Subsidiaries: A Technical Minefield," *Tax Mgmt. Int'l J.* 345 (June 13, 2014). The CRA has stated that it has no discretion not to apply section 15(2) or other provisions that technically apply to cash pooling arrangements, and in general has not adopted accommodating administrative policies facilitating their use. CRA Docs. 2017-0692631I7 and 2015-0595621C6F.

[47] *See* committee submission to Department of Finance, at 10-11 (July 25, 2016). CRA Doc. 2015-0614241C6 states that "deposit balances of the nonresident pool participants would be considered 'intermediary debts' for the purposes of [the back-to-back rules], with the result that the back-to-back loan rules would be engaged" if their other preconditions were met.

[48] Section 261. The only qualifying currencies are U.S. or Australian dollars, euros, and U.K. pounds.

nonresident counterparty will have to bear some degree of foreign exchange risk.

At a high level, the principal foreign exchange issues arising for Canadian tax purposes are:

- *Characterization*: Foreign exchange gains and losses must be bifurcated between gains and losses on income account (100 percent included in or deducted from income) and those on capital account (only 50 percent of gains included in income; capital losses are deductible only against capital gains).
- *Recognition*: Foreign exchange gains and losses on income account can generally be recognized on either an accrual (year-end mark-to-market) basis or when actually settled, so long as the method selected provides an accurate picture of the taxpayer's profit and the taxpayer is consistent from year to year. Capital gains and losses are recognized only when realized — that is, on disposition of property or settlement of liability. [49]

Characterization disputes often arise on whether a transaction should be treated as a hedge so as to take its income or capital character from the item alleged to be the object of the hedge. The TCC overturned some of the most objectionable of the CRA's administrative policies on hedging in *George Weston Ltd. v. The Queen*, 2015 TCC 42. The Supreme Court of Canada validated that reasoning recently:

> As these cases demonstrate, the characterization of a derivative contract as a hedge turns on its purpose. The primary source for ascertaining a derivative contract's purpose is the extent of the linkage between the derivative contract and an underlying asset, liability, or transaction. The linkage analysis begins with the identification of an underlying asset, liability or transaction which exposes the taxpayer to a particular financial risk, and then requires consideration of the extent to which the derivative contract mitigates or neutralizes the identified risk. The more effective the derivative contract is at mitigating or neutralizing the identified risk and the more closely connected the derivative contract is to the item purportedly hedged, the stronger the inference that the purpose of the derivative contract was to hedge. However, as noted, perfect linkage is not required to conclude that the purpose of a derivative contract was to hedge.[50]

Special rules may apply in various circumstances, such as the denial or suspension of loss recognition (for example, on a disposition among related parties) or the deferral of gains (for example, on a qualifying transfer of property to a Canadian corporation in exchange for shares of that corporation).

A simple example of unforeseen foreign exchange results that may occur is in CRA Doc. 2010-0381061I7, in which Canco loaned $1 million to its foreign shareholder (Foreignco) when that amount was the equivalent of C $1.2 million. ITA section 15(2) applied to the loan, with the result that 25 percent Canadian dividend withholding tax (C $300,000) was paid. When Foreignco later repaid the entire $1 million loan when $1 million was worth only C $1.1 million, the CRA ruled that Foreignco was entitled to only C $275,000 of refunded dividend withholding tax, based on the current exchange rate.

X. Absence of Consolidation

Unlike many countries, Canada's tax system contains no consolidation or group filing rule: Each Canadian entity in a related group computes its own taxes and files its own return. As a result, planning is generally necessary to match income and losses in the Canadian group to prevent excess deductions in one entity and taxable income or gain in another.

When there is net income or gain in one Canadian entity and available tax shelter (for example, losses) in another, there are CRA-approved planning techniques to allow consolidation of income and losses among related

[49] For discussion, see Suarez and Byron Beswick, "Canadian Taxation of Foreign Exchange Gains and Losses," *Tax Notes Int'l*, Jan. 12, 2009, p. 157.

[50] *James MacDonald v. The Queen*, 2020 SCC 6, at para. 32.

Canadian entities. For example, a property with an accrued gain can be rolled over on a tax-deferred basis to a related Canadian entity that has available losses and can sell the property at FMV. Other loss consolidation techniques involve circular flows of interest (deductible to the borrower with income and taxable to the creditor with losses to absorb it) and tax-free intercorporate dividends.[51] The CRA accepts that kind of planning within administrative limits and frequently issues binding advance tax rulings on it.

XI. Information Demands and Privilege

The CRA has extensive powers to demand documents and information from taxpayers, which it has increasingly tested the limits of (particularly on cross-border matters). Examples that have resulted in litigation before the courts in recent years include:

- compelling a taxpayer to answer written questions on the contents of tax-sensitive discussions it had with its accountant;[52]
- seeking a compliance order forcing a Canadian subsidiary of an MNE to turn over its list of uncertain tax positions that had been prepared as part of the financial statement preparation process, which the CRA wanted to use as a roadmap for future audits;[53]
- compelling disclosure of a tax diligence report identifying a Canadian target corporation's potential tax exposures prepared for the purchaser by an accounting firm;[54]
- forcing an accounting firm to disclose confidential information on some of its unnamed clients, including identities and documentation of their participation in a tax structure;[55] and
- seeking a court order requiring the taxpayer to make 25 employees across the MNE available for oral interviews as part of a transfer pricing audit.[56]

There are relatively few practical limitations on the CRA's regulatory information-gathering powers:

- they may be used only to further a civil tax investigation — that is, verifying a tax liability — not a criminal prosecution, in compliance with Canada's Charter of Rights and Freedoms;
- any demand must be made in the context of a tax audit conducted in good faith as part of a genuine and serious inquiry into someone's tax liability, not as a fishing expedition;
- the information sought must be at least potentially relevant to taxes payable or information that should be in the taxpayer's books and records;
- recent caselaw provides that a taxpayer's obligation to assist CRA officials conducting a legitimate audit does not encompass what amounts to self-audit or performing core audit functions (the limits of that new doctrine are unclear);
- if the focus of the CRA's investigation is not the taxpayer from whom information is being sought but rather a group of unnamed persons (for example, all business customers of the taxpayer), the CRA must obtain prior authorization from a federal judge; and
- most important, the CRA cannot compel disclosure of documents and information protected from disclosure under lawyer-client privilege.

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[51] *See* Suarez, "Using Tax Losses Within a Canadian Group of Companies," *Tax Notes Int'l*, Apr. 2, 2012, p. 59. Subject to various limitations (most particularly on acquisitions of control), noncapital — that is, operating — losses from a particular year may be carried back up to three years and carried forward up to 20 years, while capital losses may be carried back up to three years and carried forward indefinitely.

[52] *See* Suarez, "Canada Revenue Agency Forces Taxpayer to Disclose Discussions With Accountant," *Tax Notes Int'l*, May 11, 2015, p. 553.

[53] The CRA was initially successful but lost on appeal. *See* Suarez, "Canadian Appeals Court Denies CRA Demand for Taxpayer's UTP List," *Tax Notes Int'l*, Apr. 24, 2017, p. 289; and Suarez, "Canada Revenue Agency Declares Open Season on Taxpayer Information," *Tax Notes Int'l*, July 13, 2015, p. 143.

[54] *See* Suarez, "Canadian Court Orders Disclosure of Accounting Firm Diligence Report in *Atlas Tube*," *Tax Notes Int'l*, Dec. 24, 2018, p. 1283. The case was appealed and later settled out of court.

[55] *Minister of National Revenue v. KPMG LLP*, 2016 FC 1322.

[56] *See* Suarez, "Canada Revenue Agency Revises Administrative Policy on Obtaining Taxpayer Information," *Tax Notes Int'l*, May 13, 2019, p. 613; and Suarez, "Canada Revenue Agency's Demand for Oral Interviews of Taxpayer's Employees Refused by Court," *Tax Notes Int'l*, Aug. 28, 2017, p. 901.

Table 4. Lawyer-Client Privilege in Canada

	Solicitor-Client Privilege	Litigation Privilege
Purpose	Allow candid discussion of legal rights and obligations (protects relationship).	Allow investigation and preparation of case for litigation (protects process).
Requirements	Communication/document: • made between lawyer and client; • intended to be confidential; and • made for the purpose of seeking or giving legal advice.	Communication/document: • made in the course of or in anticipation of litigation; and • made for the dominant purpose of that litigation.
Duration	Indefinite.	Until conclusion of litigation (including related litigation).
Third-Party Communications May Be Included	Only if third party is acting as agent of client or lawyer in obtaining or delivering lawyer's legal advice.	Yes, if otherwise meeting litigation privilege requirements.

In most cases, lawyer-client privilege is the only substantive defense practically available and effective in resisting CRA information demands. There are two main types in Canada: solicitor-client privilege and litigation privilege.

Solicitor-client privilege generally protects confidential communications between a lawyer and a client that directly relate to the seeking, formulating, or giving of legal advice. There are three essential elements to the creation of solicitor-client privilege (sometimes called "legal advice privilege") to protect a communication from disclosure:

- the communication must be 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 must be intended by the parties to be confidential; and
- the purpose of the communication must be the seeking or giving of legal advice (not other matters, such as business advice).

There is no U.S.-style concept of return preparer privilege or other privilege for accountants or other non-lawyers. The basic rule is that tax authorities can compel disclosure of communications between taxpayers and non-lawyers and the work product of non-lawyers. However, the jurisprudence has extended solicitor-client privilege when appropriate to cases in which a non-lawyer's input is used to facilitate the lawyer's delivery of legal advice to her client.

Litigation privilege is meant to assist the litigation process by creating a protected area to facilitate trial investigation and preparation. For litigation privilege to attach, a communication must be made or a document must be created during or in anticipation of litigation for the dominant purpose of preparing for that actual or reasonably anticipated litigation.

Lawyer-client privilege is significantly stronger in Canada than it is in most other countries (including the United States). Unlike in some European countries, in Canada legal advice provided by in-house lawyers who are employees of a taxpayer is every bit as eligible for lawyer-client privilege as is advice from external counsel. Unlike in the United States, in Canada the doctrine of limited waiver lets a taxpayer disclose privileged information to its audit firm for the limited purpose of allowing its external auditors to complete its financial statements without waiving privilege.

MNEs should prioritize the creation, maintenance, and assertion of lawyer-client privilege over the tax affairs of Canadian members whenever reasonably possible. It is particularly valuable in a tax-planning context, because it gives a taxpayer the ability to obtain a full and candid assessment of the strengths and weaknesses of different alternatives without fear of that advice ultimately being used against it. Sensitive matters should be structured to come within the scope of the privilege whenever possible and clearly identified as privileged. The potential for inadvertent waiver of privilege should be minimized by restricting circulation of privileged materials and clearly identifying situations in which disclosure is being made based on a limited waiver or common interest privilege. When non-lawyers (such as accountants) are part of the tax process, taxpayers should consider whether their work can potentially come under the lawyer-client relationship — that is, generated for use as input in the lawyer's advice, rather than non-lawyers expressing independent opinions on tax matters.

Canadian members of MNEs frequently receive CRA demands for documents or information not in their possession but rather located outside Canada. While the Canadian entity can be required to turn over only what it has (or has the legal right to obtain), one statutory provision for MNEs to be aware of is ITA section 231.6. That provision allows the CRA to issue to a Canadian resident a notice demanding any relevant tax information or document located outside Canada (foreign-based information or document, or FBID). The notice must describe the FBID sought; give a reasonable period of not less than 90 days to comply; and explain the consequences of failing to substantially comply, which is the inability to use *any* FBID described in the CRA's notice (including that provided to the CRA) in subsequent court proceedings. That sanction effectively prevents the taxpayer from choosing to disclose only FBID favorable to it, because the exclusion of *all* relevant FBID will make it difficult for the taxpayer to challenge in court a CRA reassessment involving the requested material (especially a transfer pricing case).

XII. Intangibles

Canadian members of MNEs frequently license or otherwise receive the benefit of intellectual property and other intangibles held outside Canada. Different forms of IP have different tax consequences in Canada, making it essential to draft licensing agreements precisely (for example, using the correct nomenclature to describe the IP rights in question) and separate a bundle of rights into their constituent parts so that they can be taxed (or not) separately.

A. Deductibility

In most cases a periodic license fee incurred by a Canadian group member will be deductible in computing its income under general principles. However, there are some limits on that rule. As noted, Canada's transfer pricing rules prevent a Canadian from deducting more than what an arm's-length person would reasonably agree to pay under the same circumstances.

The CRA is particularly aggressive in challenging IP transactions with foreign multinational group members. For example, for royalties for the use of know-how, the CRA frequently challenges whether that know-how exists at all, how much it contributes to the Canadian taxpayer's profits, and whether it could be otherwise replicated.[57] It is also common for the CRA to assert that the foreign licensor has benefited from the Canadian group member's marketing activities.

Acquisitions of rights that are essentially capital in nature (for example, acquiring ownership rather than a periodic right to use) may result in the payment being capitalized and deducted from income over time. Similarly, when expenses have been prepaid, the payer's deduction will be deferred until the year to which a particular amount relates. As noted, deductible expenses owing to non-arm's-length persons that remain unpaid after two tax years are added back to the payer's income (see Figure 6).

B. Withholding Tax

Canada imposes nonresident withholding tax on various forms of IP-related payments when made to a nonresident. Because the Canadian payer is jointly liable with the nonresident recipient (with no time limit for the CRA to assess the unwithheld amount plus interest and penalties for failing to withhold), any applicable Canadian withholding tax must be determined even if the foreign licensor is otherwise indifferent because of Canadian tax being fully creditable in its home country.

[57] *See* Suarez, *supra* note 15, at 800.

To determine whether nonresident withholding tax applies to a payment for IP under the ITA, three questions are considered:

- Is the payment a royalty or similar payment under general principles?
- Is the payment caught by a specific inclusion in any of sections 212(1)(d)(i)-(v)?[58]
- Is the payment excluded from tax under the exceptions in any of sections 212(1)(d)(vi)-(xii)? The principal exceptions are royalties or similar payments on or for a copyright of the production or reproduction of any literary, dramatic, musical, or artistic work, and payment made under a bona fide research and development cost-sharing agreement.[59]

If the amount is taxable under the ITA and the recipient is resident in a country with a Canadian tax treaty, the recipient should determine whether the treaty reduces or eliminates Canadian tax. Table 5 summarizes the domestic law and treaty analysis (with reference to the Canada-U.S. treaty).

The first step in the domestic-law analysis is to determine if a payment can be characterized as a royalty or similar payment, which Canadian courts have said is one made "for the use of property, rights or information whereby the payments for such use are contingent upon the extent or duration of use, profits or sales by the user."[60] That connection between the amount of the payment and the payer's use of or profits from the subject matter of the payment is essential to the nature of a royalty. For example, one court found that a lump sum payment to acquire distribution rights did not constitute a royalty or similar payment (despite being characterized as a royalty in the agreement) for lack of that connection:

> The payments were the payee's profits and were in no way related to the [Canadian payer's] profits nor were they related to the [Canadian payer's] gross sales of the units. Whether the [Canadian payer] sold all the units or none of them, whether it made profits or not, did not influence the amount of money paid. There was no element of contingency in the payments in question and an element of contingency is the essence of a royalty payment.[61]

It is also important to distinguish royalties from payments for services, which are not for the use of property,[62] and payments for the purchase (rather than use) of property.

If an amount is not a royalty or similar payment, it will still be taxed under the ITA if it falls within section 212(1)(d)(i)-(v) and does not fall under an exception in section 212(1)(d)(vi)-(xii). Those provisions greatly expand the scope of tax far beyond a traditional royalty. In particular, section 212(1)(d)(i) may apply to payments for the use of or right to use property whether or not they are in any way contingent on the payer's use of or benefit from the property's use. Moreover, section 212(1)(d)(iii) includes payments for some services (rather than the use of property) contingent on the payer's use or benefit, making the exclusion for services performed in connection with the sale of property or negotiation of contracts especially important. Section 212(1)(d)(v) is also a trap for the unwary, because it may result in withholding tax applying to the sale price of property when the proceeds are contingent on the production or use of any property in Canada.[63]

IP agreements often involve various rights without separately allocating specific payments for each. Those bundled agreements create the risk that the CRA will allocate the payment among the constituent elements so as to increase the value apportioned to those rights bearing the greatest tax liability, which may be difficult for the taxpayer to challenge. However, when the CRA

[58] Section 212(5) imposes nonresident withholding tax on a payment for a right in or to use a motion picture or television product used or reproduced in Canada if the amount relates to that use or reproduction. Moreover, section 212(1)(i) imposes withholding tax on payments to nonresidents for restrictive covenants, a term the CRA interprets liberally. *See Pangaea One Acquisition Holdings XII SARL v. The Queen*, 2020 FCA 21; and CRA Doc. 2014-0539631I7.

[59] *See Syspro Software Ltd. v. The Queen*, 2003 DTC 931 (TCC); and CRA Docs. 2013-0506191E5, 2012-0441091E5, and 2004-0086631E5. *See also* CRA Doc. 2011-0399581I7.

[60] *Hasbro Canada Inc. v. The Queen*, 98 DTC 2129, para. 22 (TCC). The CRA has accepted that the linkage between the payment and the payer's use of or profits from the underlying property is the essential nature of a royalty. *See, e.g.*, CRA Doc. 2007-0246981E5.

[61] *Grand Toys Ltd. v. M.N.R.*, 90 DTC 1059.

[62] Although services payments may still trigger withholding tax — for example, regulation 105 withholding for services rendered in Canada or a specific inclusion to nonresident withholding for IP in section 212(1)(d)(iii). *See Patricia & Daniel Blais O/A Satronics Satellites v. The Queen*, 2010 TCC 361, para. 22.

[63] *See* Section XIV.C, *infra*.

Table 5. Canadian Nonresident Withholding Tax on Intangibles

Type of Payment*	Excluded From Type of Payment	Canada-U.S. Treaty Treatment
Royalty or similar payment: defined in jurisprudence as a payment for the use of property, rights, or information contingent on payer's use or benefits	Lump-sum payments (whether or not paid in installments) unrelated to payer's use or benefit (*Farmparts*), particularly when there is no time limit on the payer's right of use (*Saint John Shipbuilding*) Purchasing (not sales) commissions (*Hasbro*) Payment for services (*Blais*) Payment for purchase of property (*Grand Toys*; CRA Doc. 2017-0701291I7; and CRA Doc. 2006-0179371I7)	Royalties include payments for the use of or the right to use any copyright of literary, artistic, or scientific work (Article XII(4)) Copyright royalties and similar payments for production or reproduction of literary, dramatic, musical, or artistic work (other than for movies or TV) not taxable in payer's country (Article XII(3)(a))** Exclusive distribution rights not royalties for treaty purposes (CRA Doc. 2017-0701291I7)
(d)(i): *use of or for the right to use* in Canada any property, invention, trade-name, patent, trademark, design, or model, plan, secret formula, process, or other thing whatever (including use of a merchandising concept or technique (*Farmparts*))	Payment for exclusive right to buy and resell property — that is, distributorship (*Farmparts*; CRA Doc. 2017-0701291I7)	Royalties include payments for use of or right to use any patent, tangible personal property, trademark, design, model, plan, secret formula, or process (Article XII(4)) Payments for the use of or right to use patents or computer software not taxable in payer's country (Article XII(3)(b) and (c))** Payment for exclusive distribution rights not royalties within treaty definition, and generally treaty exempt as business profits** (CRA Doc. 2017-0701291I7)
(d)(ii): *information* concerning industrial, commercial, or scientific experience when payment dependent in whole or part on use, benefit, production, sales, or profits (including "know-how" (*Hasbro*))	Payment for know-how that is skills in trade practices in a particular area of the world or general business acumen in handling day-to-day commercial transaction, or that is used in performing services for but not imparted to the payer (*Hasbro*)	Payments for the use of or right to use information concerning industrial, commercial, or scientific experience not taxable in payer's country (unless for rental or franchise agreement) (Article XII(3)(c));** CRA Doc. 2012-0457951E5) Article XII(3)(c) extends to royalties paid for the use of or right to use (1) know-how and (2) designs, models, plans, secret formulas, or processes (1995 technical explanation)
(d)(iii): *services* of industrial, commercial, or scientific character when payment dependent in whole or part on use, benefit, production, sales, or profits, *excluding* services in connection with selling property or negotiating contracts	Payment for services in connection with selling property or negotiating contracts (*Hasbro* (commissions to buying agents); CRA Doc. 2013-0495611E5 (warranty sales incentives); and CRA Doc. 2002-013082 (training commissions))	Services not included in royalties definition: generally treaty exempt as business profits** See CRA Doc. 2011-0416181E5 (fee for per-click online advertising); CRA Doc. 2011-0431871I7 (training programs); CRA Doc. 2007-0253321E5 (generally); and CRA Doc. 2005-0161381I7 (maintenance payments) for further examples of treaty-exempt services payments

Table 5. Canadian Nonresident Withholding Tax on Intangibles *(Continued)*

Type of Payment*	Excluded From Type of Payment	Canada-U.S. Treaty Treatment
(d)(iv): payments *not to use (or permit use)* of property in (d)(i) or information in (d)(ii)	Payments for option to purchase and for purchase price of property (CRA Doc. 2006-0179371I7)	Not included in royalties definition: generally treaty exempt as business profits** See also CRA Doc. 2017-0701291I7 and CRA Doc. 2004-0086631E5
(d)(v): that is dependent on the use of or production from property in Canada	Sale price of property structured as a reverse earn-out or on share sales described in IT-426R (CRA Doc. 2019-0824461C6 and CRA Doc. 2006-0196211C6)	Royalties defined to include gains from sale of intangibles if contingent on use or production Payment for use of customer list in Canada treaty exempt as being for commercial information (CRA Doc. 2013-0494251E5)

* Excluded from tax are (1) royalties or similar payments relating to a copyright in respect of the production/reproduction of literary, dramatic, musical, or artistic work, or (2) payments made under a bona-fide research & development cost-sharing agreement.

** Assuming payment is not connected to a source-country permanent establishment of the recipient.

Cases mentioned in this table:

The Queen v. Farmparts Distributing Ltd., 80 DTC 6157 (FCA);

The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd., 80 DTC 6272 (FCA);

Hasbro Canada Inc. v. The Queen, 98 DTC 2129 (TCC);

Patricia & Daniel Blais O/A Satronics Satellites v. Her Majesty the Queen, 2010 TCC 361; and

Grand Toys Ltd. v. MNR, 90 DTC 1059.

fails to allocate a bundled payment between taxable and nontaxable amounts, the courts have determined that no portion of the payment is taxable.[64]

Canada's nonresident withholding tax rules are supported by a complex and robust back-to-back antiavoidance regime, which in practice acts as a domestic anti-treaty-shopping rule. In general terms, those rules may apply to arrangements in which the Canadian licensee pays or credits an amount of a royalty or similar payment to a nonresident (the immediate licensor) if:

- when or after the Canadian license is executed, the immediate licensor (or person not dealing at arm's length with that licensor) has an obligation to pay an amount to another person (ultimate licensor) under another license that has causal connections with the Canadian license (for example, one is computed with reference to the other);
- had the Canadian licensee paid the ultimate licensor instead of the immediate licensor, greater Canadian royalty tax would have applied; and
- if the ultimate licensor deals at arm's length with the Canadian licensee, one of the main purposes of the other license was to reduce Canadian tax.

When applicable, those rules treat the Canadian licensee as having paid the royalty to the ultimate licensor. They are highly complex and should be considered whenever a treaty reduces Canadian withholding taxes on IP payments.[65]

[64] *See Hasbro Canada* ("It has been decided that, where a payment can reasonably be considered to be in part for something taxable and in part for something non-taxable, there is an onus on the Minister to specify which portion of the payment is subject to the taxing provision relied upon. If the Minister fails to make this allocation, the taxpayer will not be subject to tax under that particular provision."). *See also* CRA Doc. 2011-0431871I7.

[65] See Kandev, *supra* note 24.

XIII. Mergers and Divisive Reorganizations

Merging two or more Canadian corporations is relatively simple. Under the relevant corporate law on amalgamations, the resulting corporation automatically acquires all the property, and assumes all the liabilities, of each participating corporation. Unlike the U.S. concept of one participant being the survivor, under Canada corporate law, the amalgamated entity resulting from the merger (Amalco) is deemed a continuation of each of the predecessor entities.[66] If one participating corporation owns all the shares of the other, a simplified corporate law process applies to effect that merger (a vertical amalgamation).

From an income tax perspective, the amalgamation will be tax deferred to the participating entities — that is, no realization of gains and losses, with Amalco acquiring all property at carryover cost basis — so long as Amalco acquires all property and assumes all liabilities of each participating corporation (except securities of one participant held by another participant) and each shareholder of a participating corporation (other than another participating corporation) receives shares of Amalco. The amalgamation will trigger a deemed tax year-end for the participants,[67] and Amalco will be able to choose its first tax year-end to occur in the next 365 days. While Amalco is deemed a new corporation for tax purposes, it is further deemed to effectively inherit most tax attributes of its predecessors and can choose to keep one predecessor's tax registration number. Loss carryforwards of a participating corporation remain available for post-merger use by Amalco.[68] The PUC of Amalco's shares is generally limited to the PUC of the shares of the participating corporations.[69] A shareholder of a participating corporation holding those shares as capital property also enjoys rollover treatment so long as no consideration other than Amalco shares are received in exchange.

Divisive reorganizations are much more complicated. The separation of one Canco into two Cancos occurring outside the constraints of Canada's limited exceptions for tax-deferred divisive reorganizations will result in material tax payable unless Canco either is disposing of assets without significant accrued gains or has sufficient available tax shelter to absorb any gains that will be realized on a taxable disposition.

Canada's rules for tax-deferred divisive reorganizations are complex. They rely on a few basic concepts. First, property can generally be transferred to a Canadian corporation in exchange for its shares on a tax-deferred basis.[70] Second, one Canadian corporation can generally receive a dividend from another Canadian corporation tax free (via a 100 percent dividends-received deduction). Finally, on a redemption of Canco shares, the excess of the redemption proceeds over the PUC of the redeemed shares is deemed a dividend and reduces any capital gain otherwise realized on a disposition of those shares.

The rules in section 55 restricting the use of tax-free intercorporate dividends to reduce gains on shares allow two basic forms of permissible tax-deferred divisive reorganizations. Section 55(3)(a) offers tax-free treatment to intercorporate dividends received in the course of some related-party divisive reorganizations. Section 55(3)(b) provides for a "butterfly" divisive reorganization when the new Canco receives the same percentage of each type of the existing Canco's property,[71] each shareholder of the existing Canco receives shares of the new Canco in the same pro rata proportion as their shareholdings in the existing Canco, and specific prohibited

[66] It is possible to effect a U.S.-style survivor amalgamation via a court-supervised corporate law proceeding referred to as a "plan of arrangement."

[67] A short tax year-end has numerous consequences (in addition to accelerating the participants' return filing obligation), such as requiring a recomputation of various tax attributes (for example, equity for thin capitalization purposes), aging tax attributes measured in tax years (for example, noncapital loss carryforwards), and reducing the period permitted for paying various amounts (for example, shareholder loans under section 15(2) or accrued expenses owing to non-arm's-length persons under section 78(1)).

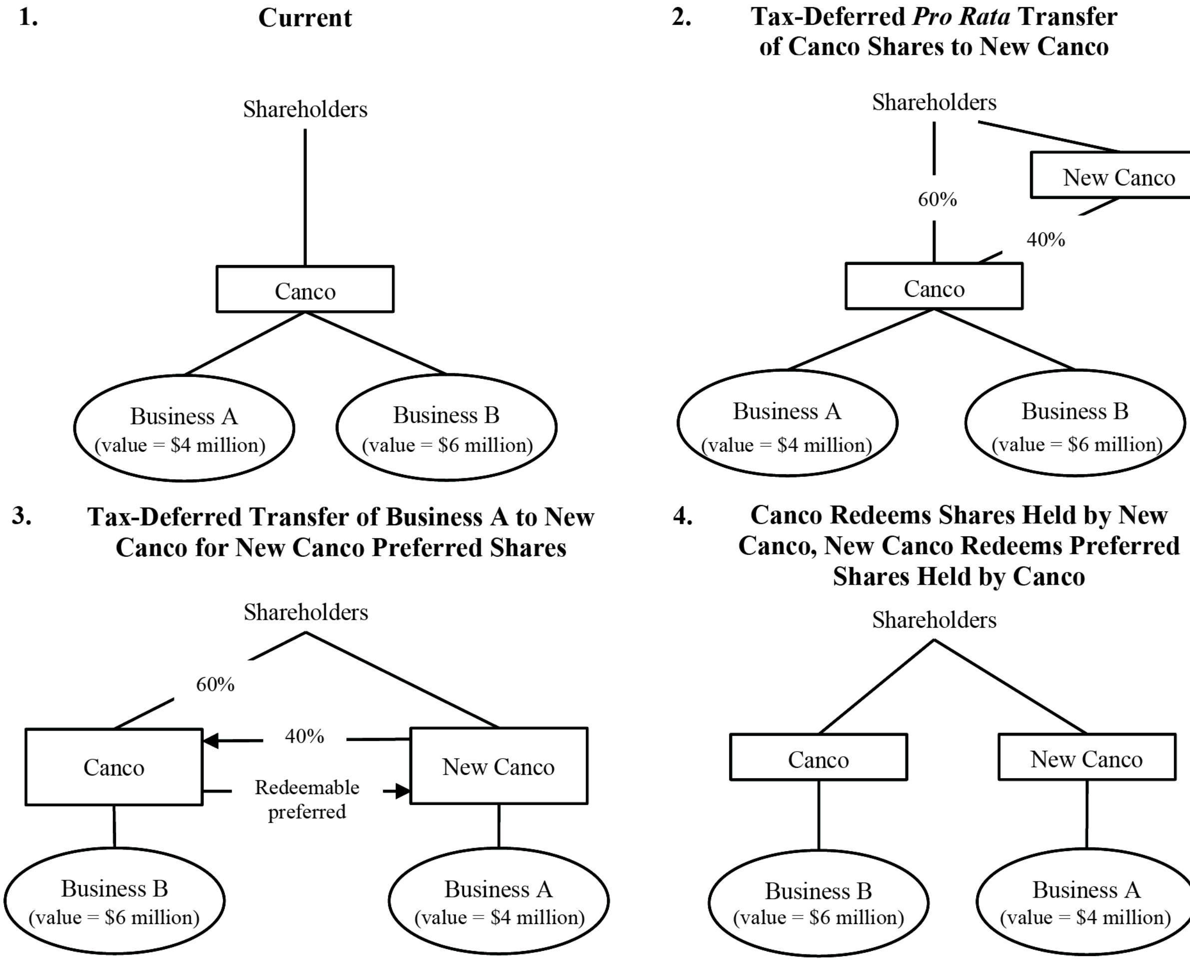
[68] *See* Suarez, *supra* note 51, at 60-61.

[69] Less the PUC of any shares owned by one participant in another (those shares are canceled without gain or loss).

[70] *See* Suarez and Maguire, *supra* note 19, at 781.

[71] The CRA's administrative rules categorize property as being cash/near-cash, business, or investment property. Canadian resident public companies are exempt from this requirement.

Figure 12. Simplified Tax-Deferred Divisive Reorganization



transactions do not occur as part of the same series of transactions.[72]

Figure 12 illustrates the steps involved in using those rules to effect a divisive reorganization of a Canco. It is easy to inadvertently taint a tax-deferred divisive reorganization, and care must be taken to ensure the proposed transactions stay within permissible constraints.

To effect a tax-deferred divisive reorganization of a Canco as part of a larger worldwide spinoff by a widely owned MNE, the Canadian portion of the spun-out business must represent less than 10 percent of the value of the top-tier foreign entity to be spun out to the MNE's shareholders. There are other subtle technical requirements for staying within Canada's strict rules on tax-deferred divisive reorganizations in those circumstances beyond those applicable to domestic demergers.

XIV. Sale of Canco

Canada taxes nonresidents on gains from the disposition of capital property that is taxable Canadian property, which essentially consists of land or natural resource rights in Canada (Canadian real property), shares of a corporation (or interests in a partnership or trust) that have derived more than 50 percent of their value from Canadian real property at any time in the

[72]The scope of prohibited transactions is broad, including an acquisition of control of either Canco, dispositions of the shares of either Canco by major shareholders, pre-reorganization acquisitions of Canco shares, and some acquisitions of property by either Canco.

Table 6. Canadian Tax on Capital Gains From Shares — Tax Treaties

Canada May Tax Share Sale Gains	Countries
All (no residual allocation of taxing rights to country of residence)	Argentina, Australia,[a] Brazil,[a] Cameroon, Chile, China,[a] Egypt, Guyana,[b] India, Japan, Jordan, New Zealand, Nigeria, Papua New Guinea, Trinidad and Tobago, Vietnam
Shares deriving their value primarily from Canadian real property	*Algeria*, Barbados, Colombia,[c, d, e, f] Gabon, Hong Kong, Indonesia,[d, e] *Ireland*, Israel, Korea,[d, e, f] Madagascar,[a, b] Poland, Portugal, Senegal, Serbia,[c] Taiwan,[b] Turkey,[g] United Arab Emirates, United States[b, d, e]
Shares deriving their value primarily from Canadian real property (excluding non-rental real property used in issuer company's business)	Armenia, *Austria*,[e] Azerbaijan,[c] *Belgium*,[d] *Bulgaria*,[d] *Croatia*, Czech Republic,[e] Denmark,[d] Ecuador,[b] *Estonia*,[d, e] *Germany*,[a, b, d, e] *Greece*,[e] *Hungary*,[d, e] *Iceland*, *Italy*, *Kazakhstan*,[e] *Kyrgyzstan*,[b, d, e] *Latvia*,[d, e] *Lithuania*,[d, e] *Luxembourg*, Mexico,[c, d, f] Moldova, Mongolia, Namibia,[a, b] *the Netherlands*,[a, d, e] Norway, Oman, Peru, Romania, Russia,[d, e] Slovakia, *Slovenia*, *South Africa*,[d, e] *Sweden*,[d, e] *Switzerland*,[a, b, d, e] *Tanzania*,[d, e] *Ukraine*,[d, e] *United Kingdom*,[e] *Uzbekistan*,[b, e] *Venezuela*[b]
Shares of company whose property consists primarily of Canadian real property	Bangladesh, Cyprus, Dominican Republic,[h] Finland,[c, i] France,[c, i] Ivory Coast, Jamaica,[h] Kenya, *Kuwait*,[i] Malaysia,[a, h] Malta,[i] Morocco,[h] Pakistan,[d, e, f, h] Philippines,[h] Singapore,[h] Spain,[i] Thailand, Tunisia, Zambia

Notes: Reprinted from Steve Suarez, "How the MLI Will Change Capital Gains Taxation in Canada," *Tax Notes Int'l*, May 11, 2020, p. 657.

Italics indicate exemption for exchange-listed shares.

Underlining indicates size of share ownership in issuer company relevant.

Canada's right to tax a resident of Zimbabwe on share gains is limited to shares of Canadian resident companies.

[a]Treaty under renegotiation or signed but not yet in force.

[b]Canada has not designated treaty as a covered tax agreement for MLI purposes.

[c]Rules refer to other interests in issuer company beyond shares.

[d]Fiscal residence of issuer company relevant.

[e]Rules for partnership interests differ from those for shares of companies.

[f]Canada may tax a resident of Colombia, Korea, Mexico, Pakistan, or Sri Lanka on gains from shares that are part of a substantial interest in a Canadian resident company irrespective of what they derive their value from.

[g]Canada may also tax gains realized within one year.

[h]No indirect ownership test.

[i]Excluding real property through which the issuer company carries on business.

preceding five years,[73] and property used in a business carried on in Canada.

The capital gains article of most of Canada's tax treaties further restricts Canada's right to tax nonresidents on capital gains on shares. Treaty relief ranges from none to taxation only of major shareholdings in Canadian resident corporations whose shares derive their value primarily from Canadian real property (excluding real property through which the corporation carries on its business) (see Table 6). For most Canadian tax treaties, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting will

[73]Other than through entities interests in which are themselves not taxable Canadian property. Shares listed on a designated stock exchange, as well as units of a mutual fund trust or shares of a mutual fund corporation, will constitute taxable Canadian property only if the holder (together with non-arm's-length persons) also owned at least 25 percent of any class of the issuer's shares or units at any time during the preceding five years. On disposition of a partnership interest, the normal rule including only 50 percent of any capital gain in income does not apply if the buyer is (directly or through a partnership or trust) tax exempt or a nonresident. Section 100(1).

affect capital gains taxation by adding a 365-day lookback rule when testing whether shares and other interests derive their value primarily from (or whether an entity's property consists primarily of) Canadian real property, and imposing a principal purpose test to limit entitlement to treaty benefits.[74]

A. Section 116 Withholding

A reporting and withholding regime applies when a nonresident disposes of most forms of taxable Canadian property and imposes a 25 percent (or 50 percent) withholding obligation on the purchaser as a prepayment of any taxes owed by the nonresident. That regime applies whether or not the nonresident has an actual gain on the sale, and in some cases whether or not treaty relief exempts the gain from Canadian tax. Section 116 withholding is often an unpleasant surprise for nonresident vendors, because purchasers will generally assume no risk by withholding and remitting a portion of the purchase price unless the property being disposed of is clearly not taxable Canadian property, or the nonresident obtains a pre-closing withholding waiver from the CRA (or indemnifies the purchaser).[75]

B. Restrictive Covenants

Nonresident sellers should also be aware of a broad rule imposing 25 percent withholding tax on payments made for restrictive covenants. Those rules were originally motivated by large payments for covenants not to compete with buyers, but extend far beyond that and require attention when sellers (or non-arm's-length persons) are providing undertakings or agreements beyond a simple share sale.[76] They are particularly adverse for nonresident sellers, because they can recharacterize capital gains that are often untaxed in Canada as payments subject to withholding taxes.

C. Earn-Outs

The other principal trap for nonresident vendors is the Canadian tax treatment of earn-outs. Often some or all of the purchase price from a sale of shares or a business is computed based on post-closing profits or revenues. That type of arrangement (an earn-out) can help bridge valuation differences between the parties but must be approached carefully from a Canadian tax perspective for sellers. That is because ITA section 12(1)(g) provides that payments based on the use of or production from property, including as an installment of the sale price, are treated as income, not capital gains, to the recipient. That recharacterization is adverse for a nonresident seller of Canco shares, because 25 percent nonresident withholding tax applies to amounts included in a nonresident's income under section 12(1)(g), whereas nonresidents are typically exempt from Canadian capital gains tax unless selling Canadian real property or Canco shares deriving their value primarily from Canadian real property (as noted above).[77] Nonresident sellers are thus motivated to structure transactions so as not to fall under section 12(1)(g) (which does not affect the tax position of the buyer; recharacterization is one-sided).

There are two basic options for keeping the economics of an earn-out while avoiding the adverse tax treatment under section 12(1)(g). A reverse earn-out is frequently used to avoid the application of section 12(1)(g). Essentially, if a property's purchase price is expressed as a maximum considered to be the property's FMV at the time of sale, subject to reductions if reasonable conditions regarding future earnings are not met, section 12(1)(g) will not apply.[78] Instead, both the seller's proceeds and buyer's cost basis will be treated as the maximum amount owing, subject to

[74] *See* Suarez, "How the MLI Will Change Capital Gains Taxation in Canada," *Tax Notes Int'l*, May 11, 2020, p. 657.

[75] *See* Suarez and Marie-Eve Gosselin, "Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property," *Tax Notes Int'l*, Apr. 9, 2012, p. 175.

[76] *See* Suarez and Maguire, *supra* note 19, at 796. That provision was recently applied to a nonresident seller who received a separate payment from another shareholder for entering into a share purchase agreement with a buyer. *See* Kandev and James Trougakos, "Obscure Canadian Withholding Tax Rule a Trap for the Unwary," *Tax Notes Int'l*, Mar. 9, 2020, p. 1091.

[77] Even if the nonresident is taxable in Canada on the gain, maintaining capital gains treatment is still beneficial because only 50 percent of capital gains are included in income, and available capital losses can be used only against capital gains.

[78] *See, e.g.*, *Pacific Pine Co. Ltd. v. Revenue*, 61 DTC 95 (TAB). The CRA has expressed acceptance of reverse earn-outs in Interpretation Bulletin IT-462, including on dispositions of property other than shares (e.g., CRA Doc. 2011-0423771E5) and has issued favorable advance tax rulings on them (e.g., CRA Doc. 2009-0337651R3).

appropriate adjustment in post-sale tax years if the relevant conditions are not met and the sale price is reduced. Those post-closing adjustments to the buyer's cost basis can be troublesome if the buyer sells target shares before the completion of the adjustment period.

The CRA also has a helpful administrative policy on shares (not other property) sold subject to an earn-out, which allows the seller to use the cost recovery method to report the sale proceeds and avoid section 12(1)(g). Under that regime, as amounts of the sale price become determinable, the seller reduces its cost basis in the shares. Thus, no capital gain is realized until the amount of the sale price that can be calculated with certainty and to which the seller has an absolute (although not necessarily immediate) right exceeds the seller's cost base. The policy applies if the following conditions are met:

- the seller deals at arm's length with the buyer;
- the earn-out feature relates to underlying goodwill whose value cannot reasonably be expected to be agreed on by the parties at the date of sale;
- the last contingent amount under the earn-out becomes payable within five years of the end of the target tax year that includes the date of sale; and
- the seller submits a formal request to use the cost recovery method with its year-of-sale tax return.[79]

The availability of those two options for avoiding the adverse tax treatment created by earn-outs (along with the fact that it generally costs the buyer little or nothing to accommodate the seller in using them) means that in most cases earn-outs are a trap for the unwary rather than an insurmountable obstacle.

XV. Sales Taxes

Nonresidents with Canadian customers, suppliers, or subsidiaries are likely to engage Canada's federal sales tax (the goods and services tax) at some point in their activities.

Ontario and all four Atlantic provinces have combined their provincial sales tax with the federal GST to create a harmonized sales tax applicable in those five provinces and administered by the CRA. Quebec has also effectively harmonized its sales tax with the GST, but the GST and the provincial sales tax are formally separate (levied simultaneously on the same things, but at different rates), and the combined tax is administered by Quebec tax authorities rather than the CRA.

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 GST. In particular, no input tax credits (ITCs) are provided to avoid cascading taxes through the supply chain — that is, each purchaser is treated as the final consumer — although some exemptions apply (for example, goods purchased for resale). Alberta and the three Northern territories do not levy sales taxes.

Nonresidents typically engage the Canadian sales tax system when they sell into Canada (including to Canadian sister or subsidiary entities) or make purchases from Canadian suppliers.[80] The definition of a nonresident under the Excise Tax Act is similar to that for income tax purposes, in that a corporation that is governed by and existing under a Canadian corporate law statute is deemed a Canadian resident, and a corporation whose central management and control is in Canada is also a Canadian resident.[81] As noted below, however, for GST and HST purposes, a nonresident is deemed a Canadian

[79] *See* CRA Interpretation Bulletin IT-426R. While that document refers to Canadian resident sellers, the CRA has since stated that nonresident sellers who would otherwise be eligible to use the cost recovery method will generally not be subject to the nonresident withholding tax equivalent of section 12(1)(g). *See* CRA Docs. 2019-0824461C6 and 2006-0196211C6. The CRA also takes the positions that: (1) the cost recovery method may be used on the sale of shares of a holding company whose only assets are shares of another corporation (CRA Doc. 2019-0824531C6); (2) once a seller has chosen to use a different method to calculate its proceeds of disposition, it may not thereafter change its mind and file amended tax returns applying the cost recovery method (CRA Doc. 2014-0529221E5); and (3) the capital gains reserve for deferred sale proceeds cannot be claimed on an earn-out or reverse earn-out (CRA Doc. 2013-0505391E5).

[80] For further discussion, see Camille Kam, "Nonresidents and Canada's VAT System," *Tax Notes Int'l*, Aug. 20, 2012, p. 771.

[81] That would generally be determined based on where the corporation's directors, managers, and shareholders reside and hold meetings, and where the corporation carries on its principal business activities and keeps its records.

Table 7. Federal and Provincial/Territorial Sales Tax Rates (2020)

Provinces and Territories	GST	Provincial Tax	HST
British Columbia	5%	7% PST	N/A
Alberta, Nunavut, Yukon, and Northwest Territories	5%	N/A	N/A
Saskatchewan	5%	6% PST	N/A
Manitoba	5%	6% RST	N/A
Ontario	N/A	N/A	13% HST
Quebec	5%	9.975% QST	N/A
New Brunswick, PEI, Nova Scotia, and Newfoundland	N/A	N/A	15% HST

resident for (but only for) the activities it carries on through any of its Canadian PEs.

A. Carrying On Business in Canada

Whether a nonresident is carrying on business in Canada is relevant to whether the nonresident is required to register as a supplier. The test is similar to that for income tax, although the GST version more broadly defines the term "business" and does not include the section 253 ITA deeming rule. The CRA considers the following criteria in determining whether a nonresident is carrying on business in Canada:

- where agents or employees of the nonresident are located;
- the place of delivery;
- the place of payment;
- where purchases are made or assets are acquired;
- the place from which transactions are solicited;
- the location of assets or inventory;
- where the business contracts are made;
- the location of a bank account;
- where the nonresident's name and business are listed in a directory;
- the location of a branch or office;
- where the service is performed; and
- the place of manufacture or production.[82]

B. PE in Canada

As noted, a nonresident that conducts activities through a PE in Canada is deemed a Canadian resident only for its activities carried on through that Canadian PE. That deemed Canadian residence affects a nonresident in several ways:

- by creating an obligation to register — that is, charge, collect, and remit GST — on taxable supplies it makes;
- by affecting whether those taxable supplies are considered to occur in Canada so as to incur GST;
- by potentially causing GST to apply to supplies of goods and services the nonresident acquires through the Canadian PE (which are normally zero rated when acquired by a nonresident for export); and
- by potentially requiring the nonresident to self-assess GST on the taxable importation of property and services acquired for consumption, use, or supply through the Canadian PE.

For GST purposes, a Canadian PE is a fixed place of business of the nonresident through which the nonresident makes supplies. The CRA considers a person to have a fixed place of business when (1) physical space is at the disposal of that person, (2) that exhibits a certain degree of continuity and permanence, (3) over which the person possesses control, and (4) through which the person's business activities occur with a degree of regularity.[83] A nonresident is also

[82] CRA, "Carrying On Business in Canada," GST/HST Policy Statement P-051R2 (updated 2005) ("a non-resident person must have a significant presence in Canada to be considered to be carrying on business in Canada"). The relevance of any particular criterion depends on the facts about and nature of the business.

[83] *See* CRA, "Meaning of Permanent Establishment in Subsection 123(1) of the Excise Tax Act (the Act)," GST/HST Policy Statement P-208R (updated 2005), which includes various examples.

deemed to have a PE at a fixed place of business of another person (other than a broker, general commission agent, or other independent agent acting in the ordinary course of business) who is acting in Canada on behalf of the nonresident and through whom the nonresident makes supplies in the ordinary course of business.[84]

A nonresident must make supplies through a fixed place of business for a PE to exist. The CRA has stated that to meet that test, the activities carried on at the fixed place of business must be an essential and significant part of the nonresident's overall business, and not exclusively of a preparatory or auxiliary nature. In its view, the presence of any of the following factors is usually enough to indicate that supplies are being made through a fixed place of business:

- there is authority at the fixed place to enter into contracts or accept purchase orders for the provision of supplies to other persons, and that authority is regularly exercised;
- the tangible personal property that is being supplied is physically manufactured or produced at the fixed place;
- if the supply is a service, the service is performed at the fixed place; or
- the maintenance of equipment supplied by the nonresident is performed at the fixed place (for example, an authorized factory repair outlet).

A combination of other secondary factors could also suffice to conclude that the nonresident is making supplies through the fixed place of business so as to create a PE.[85]

C. GST Registration

While the GST is a tax on buyers, vendors that are registered with the CRA for GST purposes are obligated to collect and remit the tax to the CRA and may claim ITCs for GST they pay. Anyone making a taxable supply in Canada in the course of a commercial activity in Canada they engage in is required to be registered, except a nonresident who is not carrying on business in Canada and some small suppliers.[86] Various place of supply rules govern where supplies are considered to have been made, which includes factors such as where goods are delivered, where services are performed, and where intangibles may be used.[87] That effectively means that:

- a nonresident with a Canadian PE through which it makes taxable supplies is required to register, because it is deemed a Canadian resident for the PE's activities;
- a nonresident that is making taxable supplies in Canada but whose activities do not rise to the level of carrying on business in Canada is not required to register; and
- a nonresident that is carrying on business in Canada but without a PE there must review the place of supply rules to determine if the taxable supplies it makes are considered to occur in Canada so as to obligate it to register.

A nonresident may voluntarily register to be eligible to claim ITCs for GST paid in various circumstances.

D. GST on Importation of Goods and Services

When a nonresident sells *goods* into Canada, in most cases the importer of record is required to pay 5 percent GST (or the federal portion of the HST) on importation. However, generally only the de facto importer (the person causing the goods to be imported — typically the owner) may be considered to have imported the goods for consumption, use, or supply in the course of its commercial activities so as to be able to claim an offsetting ITC (assuming it is GST registered). GST being paid on importation without an offsetting ITC being claimable is a complex area of frequent concern (particularly when the importer of record is not the de facto importer), despite several rules intended to provide relief in some circumstances.[88]

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[84] The CRA views the following as indicia of an agent being dependent: It is subject to the comprehensive control of the nonresident, it does not bear any entrepreneurial risk of loss, it makes supplies in the nonresident's name, and it does not act as an agent for any other person. *See id.*

[85] *Id.*

[86] A small supplier is a person whose worldwide taxable supplies (including those of associates) are no more than $30,000 in any single quarter and in the last four consecutive quarters.

[87] *See* CRA, "Place of Supply," GST/HST Memorandum 3.3 (Apr. 2000).

[88] For example, provisions addressing flow-through ITCs and constructive importers. *See* CRA, "Input Tax Credit Entitlement for Tax on Imported Goods," GST/HST Policy Statement P-125R (June 2007).

Table 8. GST/HST Overview for Nonresidents

Issue	General Rule	Special Rules
Classification as a nonresident (corporations)	• Based on location of corporation's central management and control • Deemed Canadian resident if governed by Canadian corporate law statute	Nonresident deemed a Canadian resident for activities carried on (supplies made) through a Canadian PE*
Mandatory GST/HST registration as a supplier (collect and remit tax)	• Required if nonresident makes taxable supplies through a Canadian PE* • Not required if nonresident is not carrying on business in Canada**	Required if nonresident makes taxable supplies *in Canada* (determined under place of supply rules) in the course of carrying on business in Canada**
Pay GST on importation of goods	• Importer of record liable to pay federal GST • *De facto* importer (generally property owner) entitled to claim offsetting input tax credit	• Unregistered nonresident importer not entitled to claim input tax credit • Various relieving rules to alleviate mismatches in who pays GST and who can claim offsetting input tax credit
Pay GST/HST on purchases of goods and services in Canada	Purchases for export out of Canada: • primary collection responsibility lies with Canadian seller • exports generally zero-rated (no tax on purchaser; supplier can still claim input tax credits on GST/HST it pays) • many services and intangibles also zero-rated	Purchases for use or resale in Canada: • unregistered nonresident is liable to pay GST/HST unless drop shipment rules apply • nonresident acquiring taxable supplies through a Canadian PE generally must pay GST/HST

* A Canadian permanent establishment is (1) a fixed place of business of the nonresident or its dependent agent, (2) through which the nonresident makes supplies (activities of the Canadian PE must be an "essential and significant part" of the overall business, and not exclusively of a preparatory or auxiliary nature).

** This is defined to include any activity engaged in on a regular or continuous basis that involves the supply of property by way of lease, license, or similar arrangement; determined on the basis of various factors described (with examples) in CRA, "Carrying On Business in Canada," GST/HST Policy Statement P-051R2 (updated 2005), which states that "a significant presence in Canada" is required.

When a GST-registered nonresident supplies *services or intangibles* into Canada (including to a Canadian multinational group member), the nonresident charges GST in the normal manner on services performed in Canada and intangibles to be used in Canada, and GST-registered customers using them in their commercial activities can claim ITCs as usual. For an unregistered nonresident supplier, no GST is charged, and customers importing those services or intangibles for consumption, use, or supply of at least 90 percent in a commercial activity need not pay GST.

E. GST on Purchases in Canada

As a general rule, taxable supplies that are made for consumption or use outside Canada are zero-rated — for example, if a nonresident purchases goods that are delivered or made available to it outside Canada. The same result usually applies if the nonresident takes possession of goods in Canada and then exports them as soon as is reasonably possible consistent with normal business practices for use outside Canada. A nonresident that pays GST on goods acquired for use primarily outside Canada and exported within 60 days may claim a rebate.

Services performed entirely outside Canada are not subject to GST, while many services performed in Canada for a nonresident (particularly an unregistered nonresident) are zero-rated.[89] Supplies of intangible personal

[89] A lengthy list of zero-rated items is set out in Schedule VI, Part V of the Excise Tax Act.

property made to unregistered nonresidents are generally zero-rated, subject to exceptions (for example, intangibles that may be used only in Canada).

If an unregistered nonresident acquires goods (or specific services) in Canada for direct delivery by the vendor to a GST-registered Canadian customer on the nonresident's behalf (for example, a purchase and resale by the nonresident), the drop shipment rules may relieve the nonresident from paying or charging GST otherwise exigible on what is essentially a Canada-to-Canada sale. If the nonresident is reselling to an unregistered Canadian customer, a GST-registered vendor is required to charge GST to the nonresident.

XVI. Conclusion

Having a Canadian subsidiary or other presence in Canada creates many potential Canadian tax pitfalls for an MNE. Most of those are manageable so long as the MNE is aware of them and willing to take appropriate steps to plan around them. ■