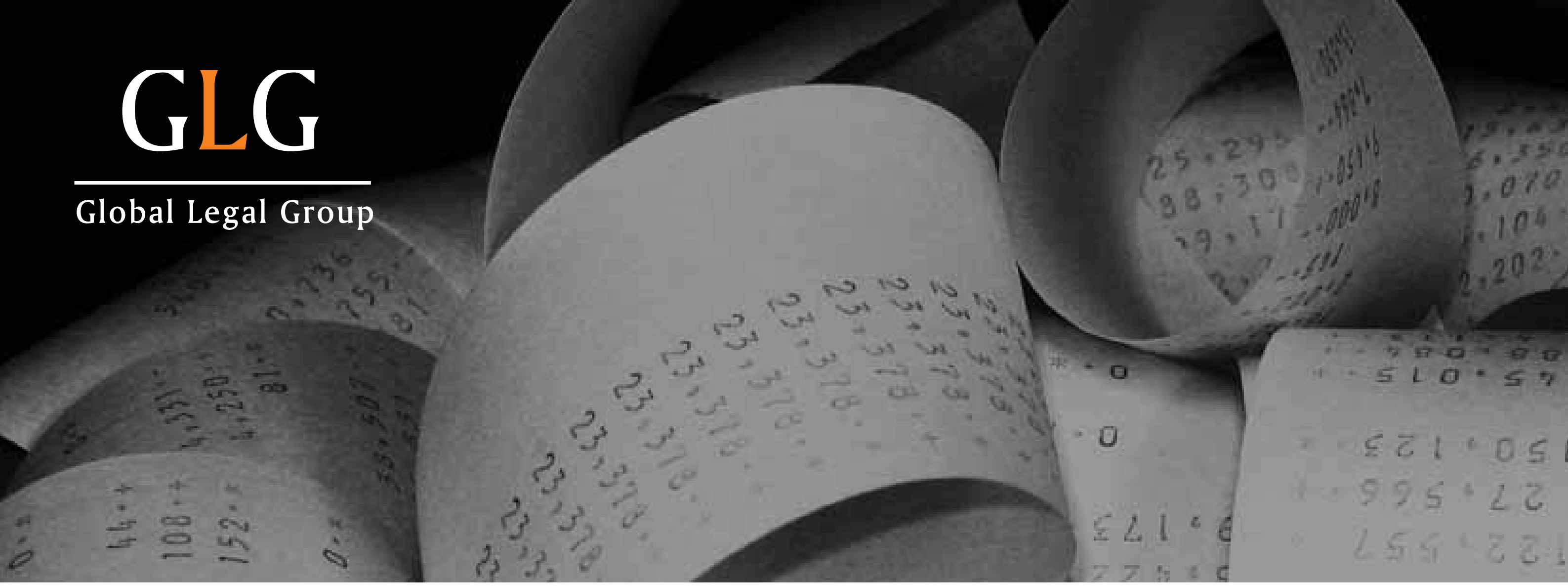

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The International Comparative Legal Guide to:
Corporate Tax 2012

A practical cross-border insight to corporate tax work

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Canada

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1 General: Treaties

1.1 How many income tax treaties are currently in force in Canada?

Canada currently has 89 treaties that are in force, 6 treaties are signed but not yet in force and 16 treaties that are either under negotiation or re-negotiation. In addition, Canada currently has 3 tax information exchange agreements that are in force; 12 that are signed but not yet in force and 14 under negotiation.

1.2 Do they generally follow the OECD or another model?

Canada's tax treaties generally follow the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

In order to come-into-force, a treaty must be incorporated into domestic law by way of a bill passed in Parliament.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Canada's tax treaty with the U.S. has a specific limitation of benefits rule that is derived from the limitation of benefits rule in the U.S. model treaty. Additionally, some of Canada's treaties have narrow limitation of benefits provisions, e.g., benefits are not available to certain types of entities.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

While treaties cannot be overridden by domestic legislation, the general anti-avoidance rule in the Income Tax Act can be applied to eliminate treaty benefits if a court concludes that a tax treaty has been abused.

2 Transaction Taxes

2.1 Are there any documentary taxes in Canada?

There are no documentary stamp taxes in Canada.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Canada has a 5% federal VAT, called the goods and services tax (GST). Many provinces have harmonised their commodity tax regime with the GST. In the "harmonised" provinces, an additional provincial tax is collected alongside the GST at rates, ranging between 7% and 10%. The combined tax is referred to as the "Harmonised Sales Tax". However, some provinces retain a transactional sales tax at between 5% and 10%. Quebec's sales tax mirrors the federal GST, but is imposed by separate provincial statute. The province of Alberta does not levy any type of VAT or sales tax.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

While the GST is a comprehensive tax on goods and services, like many countries it does not apply to all transactions. The legislation lists a variety of sectors where, for policy reasons, no tax is charged. For example, the transfer of shares or debt and the provision of many types of financial services are not subject to GST.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The GST is generally recoverable by all businesses. There are exceptional cases, however, particularly among the sectors where tax is not charged. For example, businesses engaged in the provision of financial services have limited recovery of the GST.

2.5 Are there any other transaction taxes?

Each province levies a variety of transaction taxes, the principal ones being imposed on alcohol, tobacco, and land transfers. In addition, some municipalities and cities levy a land transfer tax.

2.6 Are there any other indirect taxes of which we should be aware?

There are a number of other indirect taxes that are noteworthy. At the federal level, payroll taxes in the form of employment insurance premiums and pension plan contributions are paid by employers and employees. In addition, some provinces have additional payroll taxes (e.g., the Employer Health Tax in Ontario). The federal government also imposes indirect taxes on commodities such as fuel, alcohol and tobacco and certain forms of insurance.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Canada levies a 25% withholding tax on the gross amount of dividends paid by a Canadian-resident corporation to a non-resident shareholder. The 25% withholding tax may be reduced by treaty. Canada's treaties typically reduce the withholding tax rate on dividends to 15% where such dividends are paid to beneficial owners who are entitled to benefits under the relevant treaty and to 5% in the case of corporate shareholders that own more than 10% of the voting shares of the Canadian-resident corporation where such shareholder is the beneficial owner and is entitled to benefits under the relevant treaty.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Canada levies at 25% withholding tax on royalties paid by Canadian residents to non-residents. There are a number of domestic exemptions, the most significant of which is for royalties or similar payments in respect to copyright or for the production and reproduction of dramatic, musical and artistic works. Additionally, Canada's treaties generally reduce the withholding tax on royalties to 10% where such royalties are paid to beneficial owners who are entitled to benefits under the relevant treaty, and in some cases eliminate withholding tax entirely for royalties paid for the use of computer software.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Canada levies a 25% withholding tax on interest paid or credited to a non-resident. However, interest payments made to by a Canadian resident to an arm's length non-resident are exempt from withholding tax unless the interest is computed by reference to commodity price, cash flow, etc. (i.e., the interest is "participating interest"). In addition, non-arm length interest payments (that are not participating interest) are exempt from withholding tax under the Canada-U.S. tax treaty.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Canada permits the deduction of interest if the amount borrowed is used for the purpose of producing income or constitutes the unpaid purchase price of property used for the purpose of producing income. There are a number of limitations on interest deductibility, including thin-capitalisation rules which may limit the deduction of interest paid to specified non-residents (in broad terms, non-residents that hold 25% or more of the voting stock, or 25% or more of the fair market value of all of the issued and outstanding stock, of the Canadian-resident corporate borrower).

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The thin capitalisation rules limit interest deductibility on interest payments made to specified non-residents if the debt-to-equity ratio exceeds two to one. Any interest denied by the rule cannot be carried forward or otherwise applied.

The equity-side of the debt-equity formula is comprised of: (a) the company's retained earnings at the beginning of the year, determined on an unconsolidated basis; (b) the average of all amounts each of which is the company's contributed surplus in the beginning of a calendar month that ends in the year, counting only amounts that were contributed by specified non-residents; and (c) the average of the company's paid-up capital at the beginning of a calendar month that ends in the year, excluding the paid-up capital of shares that are not owned by specified non-resident shareholders.

The debt side of the formula is the average of all amounts, each of which is, in respect of a calendar month at that end of that year, the greatest total amount at any time in the month of the company's outstanding debts to specified non-residents.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The thin capitalisation rules do not apply to debt advanced by a third party that is guaranteed by a parent company.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no additional rules that specifically apply to the deduction of interest payable by a Canadian-resident company to a non-resident. However, there are a number of other rules that are applicable to certain taxpayers that may apply to limit interest deductions. For example, interest expense relating to the construction of a building is not deductible and instead is required to be capitalised as part of the cost of the building.

3.8 Does Canada have transfer pricing rules?

Canada has transfer pricing rules which include documentation rules and penalties that apply if an adjustment exceeds a *de minimis* threshold. The transfer pricing rules adopt the arm's length standard, and the OECD transfer pricing guidelines are considered relevant in assessing arm's length price, terms and conditions.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The federal corporate tax rate for 2011 is 16.5%, which will be reduced to 15% on January 1, 2012. In addition to the federal corporate tax rate, each province levies a corporate tax at rates that range from 10% to 16%.

4.2 When is that tax generally payable?

A corporation's federal tax liability must be paid within two months (and in limited circumstances three months), following the end of the corporation's taxation year. In addition, corporations are subject to instalment rules that, if not complied with, result in penalties.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base upon which the corporate tax is levied is determined in accordance with specific statutory rules. The starting point for the calculation is the company's profit, as determined under general commercial principals. After profit is determined, specific adjustment rules in the *Income Tax Act* for both income inclusion and expense deduction apply to determine income.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

A corporation's tax profit will often differ significantly from its financial statement income. For example, no "reserve" amounts are permitted unless specifically authorised in the *Income Tax Act*, and there are very few reserves so provided. Additionally, depreciation and depletion rates for assets and mineral, timber and oil and gas properties differ significantly from financial statement income. These are but a few of the examples of the differences between commercial accounts and tax accounts.

4.5 Are there any tax grouping rules? Do these allow for relief in Canada for losses of overseas subsidiaries?

Under current law there is no consolidation or tax grouping regime. Instead, in-group tax relief is effected by way of "loss consolidation" transactions, using interest expense or undeducted depreciation expenses. These transactions are well understood and are not considered abusive by the tax authorities. Canada is actively considering introducing a loss transfer regime so that taxpayers do not have to rely on the *ad hoc* system currently in place.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

A corporation's tax rate is the same regardless of whether profits are distributed or retained. Note that certain corporations pay an additional tax on portfolio and investment income, which is refundable when dividends are paid. These rules are not relevant to most non-resident investors.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Some provinces have a capital tax, which is a tax on the net "wealth" of a corporation determined on a balance sheet basis. The federal capital tax has been repealed.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are many local business taxes and miscellaneous taxes (e.g., oil and gas royalties and mining taxes). Each province must be examined on a case-by-case basis to determine if the activities would attract the tax.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Canada provides a base preference for capital gains. That is, one-half of a capital gain is included in income and is taxed at ordinary rates. Capital losses may only be used to offset capital gains, and may be carried back three years and forward indefinitely.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

As noted above, Canada provides a base, not a rate, preference for capital gains. Therefore, one-half of realised capital gains are included in income and taxed ordinary rates.

5.3 Is there a participation exemption?

Canada does not have a participation exemption for capital gains.

5.4 Is there any special relief for reinvestment?

There is no special relief for reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No stamp, capital or wealth duties are imposed on the formation of a subsidiary. As noted above, some provinces have retained a capital tax.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no such significant taxes.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch of a foreign company are determined in the same manner as a Canadian-resident company.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Canada levies a branch profit tax of 25% on branch profits that are considered withdrawn from Canada under a statutory formula. In this connection, amounts reinvested in Canada as determined by detailed statutory and regulatory rules may reduce the amount of branch profits that are considered withdrawn from Canada.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Under the Income Tax Act, the branch tax rate is generally reduced where the corporation is a resident of a country that has a tax treaty with Canada, which reduces withholding tax rates on dividends. The applicable rate is that which applies where a non-resident corporation owns all of the shares of a Canadian-resident company (this will often be 5%). In addition, some of Canada's tax treaties exempt the first $500,000 of a non-resident corporation's Canadian-source income from the branch tax base where such corporation qualifies for benefits under the relevant treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

There is no other tax that would be imposed a consequence of remitting profits by the branch of the head office.

7 Overseas Profits

7.1 Does Canada tax profits earned in overseas branches?

Canadian residents are liable to Canadian tax on their worldwide income. Consequently, a Canadian-resident company will be subject to Canadian tax on profits earned from overseas branches. The *Income Tax Act* allows a foreign tax credit for foreign taxes paid. In computing the credit there are two income "baskets"; business income and non-business income. In addition, the credit is computed on a country-by-country basis, so that credits for foreign tax paid to one country cannot be used to reduce Canadian tax on foreign-source income from another country.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

In effect, the *Income Tax Act* exempts dividends received by a Canadian resident from "foreign affiliates" if the dividends are derived from active business profits earned by a foreign affiliate that is resident in a country with which Canada has a tax treaty or tax information and exchange agreement and the profits are earned by the affiliate through a permanent establishment in such a country. The foreign affiliate rules are complex, and are linked with Canada's controlled foreign corporation rules (discussed below).

7.3 Does Canada have "controlled foreign company" rules and if so when do these apply?

Canadian resident taxpayers that own shares of a "controlled foreign affiliate" at the end of a taxation year of the affiliate ending in a taxation year of the taxpayer are required to include certain types passive income and capital gains ("foreign accrual property income") in computing the taxpayer's income for the year. Where the taxpayer is a Canadian-resident taxpayer, the foreign accrual property income rules work in concert with the foreign affiliate rules mentioned above.

8 Anti-avoidance

8.1 Does Canada have a general anti-avoidance rule?

Canada has had a statutory general anti-avoidance rule since 1988. There is now a substantial amount of jurisprudence considering the application of the rule.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

The province of Quebec requires reporting of certain types of tax avoidance transactions if certain conditions are met. In addition, the federal government in its March 4, 2010 Federal Budget released draft proposals to require the reporting of certain tax avoidance transactions. Although draft legislation to implement the draft proposals has been released, it is our understanding that the consultation process is not complete.

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Michael has a particular expertise in the taxation issues faced by mining companies, and regularly advises a number of Canadian and foreign-based multinational mining companies. Michael has experience structuring mining investment in Canada (including oil sands), the United States, Australia, Mexico, Scandinavia, and numerous countries in South and Central America, Africa and Central Asia.

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Michael is listed in Law Business Research's International *Who's Who of Corporate Tax Lawyers 2010*, International *Who's Who of Business Lawyers 2011* and its Canada Special Report *Who's Who Legal: Canada 2010*.

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