

INVESTING IN CANADA: SOME BASICS

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The second largest nation in the world in land mass but with a population of just over 30 million, Canada has throughout its existence utilized foreign capital to assist in exploiting its natural resources. Initially, most of this investment came from the United Kingdom, reflecting Canada's position as a former colony. Eventually, however, direct investment from the United States came to predominate. In 2009, United States residents had direct investment (stocks) in Canada worth Can \$1,288,287 million, representing 52.5 percent of all foreign investments in Canada.¹ The next largest investors were the United Kingdom with Can \$63,469 million, the Netherlands with Can \$46,529 million, Switzerland with Can \$21,191 million, France with Can \$18,218 million, Germany with Can \$13,892 million, Japan with Can \$13,122 million and Luxembourg with Can \$9,856 million.² Of special note is the People's Republic of China with had negligible investment in Canada before 1990 but which had grown to Can\$8,8549 million by 2009. The Chinese are particularly interested in investment in Canada's resource sector.

In actual trade, the relationship between Canada, the United States and the European Union is even more pronounced. While China has made inroads into all markets, Canada and the United States remain each other's largest markets. In 2009 the United States exported US \$171,695.2 million into Canada representing 19.37 percent of all exports (by comparison, second place China represented 12.20 percent).³ From the obverse perspective, this number represented 51.16 percent of Canada's imports in 2009.⁴ By

¹ International Affairs, Canada, http://www.international.gc.ca/economist-economiste/assets/pdfs/FDJ-stocks-Inward_by_Country-ENG.pdf

² Ibid. The presence of the Netherlands, Switzerland and Luxembourg on the list is no doubt reflective of their popularity in international tax structures. Nonetheless the European Union taken as a whole is the second largest direct investor in Canada. Canada is the European Union's first largest source of foreign direct investment (<http://www.international.gc.ca/commerce/fact-infors/eu-2008-ue.aspx>)

³ Industry Canada, http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php?hfFileNm=&naArea=9999&lang=30&searchType=All&toFromCountry=CDN¤cy=PC&hSelectedCodes=&period=5&timePeriod=5|Complete+Years&periodString=&productBreakDown=Complete+Years&reportType=TE&productType=HS6&areaCodeStrg=9999|DET&runReport_x=32&javaChart_x=&runGraph_x=&outputType=RPT&chartType=columnApp&grouped=#tag

⁴ Industry Canada, http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php?hfFileNm=&naArea=9997&lang=30&searchType=All&toFromCountry=US¤cy=PC&hSelectedCodes=&period=5&timePeriod=5|Complete+Years&periodString=&productBreakDown=Complete+Years&reportType=TE&productType=HS6&areaCodeStrg=9997|DET&runReport_x=28&javaChart_x=&runGraph_x=&outputType=RPT&chartType=columnApp&grouped=#tag

comparison, in the same period, Europe as a whole represented 14.44 percent of all Canadian imports with China amounting to 10.86 percent.⁵

From an export perspective, Canada's exports to the United States of US \$236,273,937, 974⁶ in 2009 represented 75.01 percent⁷ of all exports. Exports to Europe were next representing 9.14 percent⁸ of all Canadian exports. While Canada remains the United States' largest trading partner, it does now import more from China with China in 2009 providing 19.03 percent of total imports and Canada 14.44 percent.⁹

In the years 1998 to 2007 (cumulative at year-end) foreign direct investment in Canada increased from Can \$219.4 billion to Can \$500.9 billion¹⁰ Of major countries, only German investment declined during the period, attributable primarily to German manufacturing concerns being taken over by United States interests.¹¹

The stability of the Canadian economy is one explanation of the continued and universal interest in investment in Canada. Another explanation may lay in the elimination of Canadian withholding tax on interest payments to arm's length parties in most instances.¹² The latest Canadian budget has also proposed to eliminate the need for previous onerous filing requirements on the disposition of certain Canadian property.¹³

⁵ Ibid.

⁶ Industry Canada, http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php#tag

⁷ Industry Canada,

http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php?hfFileNm=&naArea=9999&lang=30&searchType=All&toFromCountry=CDN¤cy=PC&hSelectedCodes=&period=5&timePeriod=5|Complete+Years&periodString=&productBreakDown=Complete+Years&reportType=TI&productType=HS6&areaCodeStrg=9999|DET&runReport_x=32&javaChart_x=&runGraph_x=&outputType=RPT&chartType=columnApp&grouped=#tag

⁸ Ibid.

⁹ Industry Canada,

http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php?hfFileNm=&naArea=9999&lang=30&searchType=All&toFromCountry=CDN¤cy=US&hSelectedCodes=&period=5&timePeriod=5|Complete+Years&periodString=&productBreakDown=Complete+Years&reportType=TB&productType=HS6&areaCodeStrg=9999|DET&runReport_x=33&javaChart_x=&runGraph_x=&outputType=RPT&chartType=columnApp&grouped=#tag

¹⁰ Invest in Ontario, http://www.investinontario.com/siteselector/bcin_500.asp

¹¹ Statistics Canada, The Daily, "Foreign Control in the Canadian Economy", March 8, 2010, <http://www.statcan.gc.ca/daily-quotidien/100308/dq100308a-eng.htm>

¹² Section 212(1)(b) of the *Income Tax Act* (Canada), R.S.C. 1985 (5th Supp) as amended (the "Tax Act") was amended in 2007 to essentially exclude arm's length interest (except participating interests) from Canadian withholding tax

¹³ Section 116 of the Tax Act requires the reporting of and the taxation of dispositions of "taxable Canadian property". The March 4, 2010 federal budget (Canada, Department of Finance, 2010 Budget, Notice of Ways and Means Motion to Amend the Income Tax Act and Income Tax Regulation, March 4, 2010, resolution no. 38 (the "Proposals")) proposes that a share of an unlisted corporation is generally taxable Canadian property only if, at any time within the preceding sixty months, more than fifty percent of its fair market value was derived directly or

Essentially, the Proposals result in Canada no longer taxing non-residents who dispose of shares of Canadian private companies, other than companies owning Canadian real property, resource property or timber resource property.

These changes are particularly beneficial for portfolio investors either directly or through investment funds.¹⁴

The tax treatment of a non-resident person¹⁵ investing on a portfolio basis in Canada is relatively straightforward. As noted above, arm's length interest generally is not subject to withholding tax. Under the Tax Act dividends are subject to a withholding rate of 25 percent¹⁶ -- this rate is reduced to 15 percent under most of Canada's tax treaties.¹⁷ Under some of Canada's treaties, this withholding is further reduced to 5 percent where the recipient is a corporation and has a significant interest in the payer company.¹⁸

As discussed above, dispositions of other than taxable Canadian property under the Proposals are neither reportable nor taxable in Canada.¹⁹ If the disposition is taxable, the non-resident's gain is calculated in accordance with the Tax Act generally as being the amount by which the proceeds of disposition of the

indirectly from Canadian real (immoveable) property, Canadian resource properties, timber resource properties, or related options. Shares of a listed corporation under the proposals will only be considered taxable Canadian property if, at any time within the preceding sixty months, at least twenty-five percent of any class were owned by the taxpayer or non-arm's length persons, and more than fifty percent of the shares' fair market value was received directly or indirectly from Canadian real (immoveable) property, Canadian resource properties, time resource properties or options. Capital interests in or trust or units of a unit trust are also excluded from taxable Canadian property if their value was not derived from Canadian real property, Canadian resource property, or timber resource property for the previous sixty months

¹⁴ For a recent in depth discussion see Melody Chin, "Taxation on Non-Resident Investors in Canadian Investment Funds", in "International Tax Planning", (2010) Vol. 59, no. 1 *Canadian Tax Journal* 117-143

¹⁵ As defined under section 248(1) of the Tax Act, other than trusts, which are discussed below, flow through entities such as partnerships, and disregarded entities for Canadian tax purposes.

¹⁶ Section 212(2) of the Tax Act.

¹⁷ See, for example, Article X(2)(b) of The Convention Between Canada and the United States of America with Respect to TDICs on Income and on Capital, signed at Washington, DC, on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (the "Canada-US Tax Treaty"). Section 10(6) of the *Income Tax Application Rules*, R.S.C. 1985, c.2 (5th Supp), as amended, automatically applies to reduce the 25 percent rate to the application treaty rate.

¹⁸ For example, Article X(2)(a) reduces the withholding rate to 5 percent where the recipient is a corporation holding at least 10 percent of the voting stock of the company paying the dividends.

¹⁹ Premised on the passage of the Bill implementing the Proposals (Notice of Ways and Means Motion Re: Certain 2010 Budget Provisions and other Tax Measures – March 22, 2010 as Tabled in Bill C-9) the Canada Revenue Agency (the "CRA") is administering the Tax Act on the basis that the Proposals are drawn. These items were already excluded from taxation for residents of many countries as "treaty-protected property" as defined in subsection 248(1) of the Tax Act by the operation of subsections 116(6.1) and 116(5.02) of the Tax Act. The Proposals extends this treatment to the residents of all countries.

sale, less any reasonable costs of disposition, exceed the non-resident's adjusted cost base in the property.²⁰ If the property is capital property in the hands of the non-resident, one half of the gain will be included in income²¹; otherwise, the full gain is taxable. The applicable tax rate will then be applied.

For a non-resident corporation, the applicable federal corporate rate in 2010 is 28 percent.²² For a non-resident individual, graduated rates apply with the highest rate in 2010 being 42.92 percent for income for Canadian income tax purposes in excess of Can\$127,021.²³ Section 116 of the Tax Act imposes an obligation on the purchaser from a non-resident of taxable Canada property other than excluded property²⁴ for the amount of tax that the non-resident would otherwise be liable for under section 116 but has failed to remit.²⁵ For this reason, a purchaser acquiring property from non-residents will be very cautious and will call on the non-resident -- even with the new relaxed definition of taxable Canadian property in accordance with the Proposals -- to comply with section 116. There are only two ways that a purchaser can ensure that it does not become liable under section 116. The preferred method is to for the vendor to obtain a clearance certificate from the CRA in advance of the transaction.²⁶ If the clearance certificate is not obtained, the purchaser is required to remit 25 percent of the proceeds of disposition on account of the non-resident's Canadian income tax liability, which the non-resident can only recover in whole or in part by filing a Canadian income tax return. A non-resident investor subject to section 116 compliance may be required to file a Canadian income tax return in any event unless²⁷ (1) no tax was payable by the non-resident under Part I of the Tax Act for the year; (2) the non-resident had no tax liability under the Tax Act in respect of previous years; and (3) all taxable Canadian property disposed of was either excluded property²⁸ or a clearance certificate had been obtained in regard to each transaction. It should be noted that prior to 2009, non-residents subject to section 116 compliance were required to notify CRA of a disposition of taxable Canadian property and file a Canadian tax return whether or not the gain was a treaty-exempt property. The 2008 federal Canadian budget, however, introduced an

²⁰ Subsection 40(1) of the Tax Act.

²¹ Subsection 38(a) of the Tax Act.

²² Subsections 123(1) and 123.4(2) of the Tax Act.

²³ Subsection 117(2) and 120(1) of the Tax Act.

²⁴ "Excluded Property" is essentially "treaty-exempt property."

²⁵ Subsection 116(5) of the Tax Act.

²⁶ In accordance with subsection 116(1) of the Tax Act. If the non-resident does not obtain a clearance certificate the non-resident is still under an obligation to report dispositions of taxable Canada property, other than excluded property, within 10 days of a disposition of the property, proceeds of disposition and adjusted cost base.

²⁷ See subsection 150(5) of the Tax Act definition of "excluded disposition" for the purpose of filing Canadian income tax returns.

²⁸ As defined in section 116(6) of the Tax Act.

exemption for treaty-exempt property so that the filing of a return is not necessary if the property so qualifies unless otherwise required

An in-depth discussion of the taxation of personal trusts is beyond the scope of this paper. In any event personal trusts are normally not utilized for non-resident investment in Canada because of the presence of Part XII.2 of the Tax Act. This provision imposes on a trust other than a mutual fund trust²⁹, tax at a rate of 36 percent on its “designated income” consisting of gains from the disposition of taxable Canadian property and business income, to a “designated beneficiary” – which includes a non-resident: While trusts are a taxable entity in Canada they only pay tax on income not distributed by the trust. Given that *inter vivos* trusts are taxed in Canada at the highest personal graduated rate³⁰ such retention is unlikely. Most trust income is subject to withholding at a rate of 25 percent.³¹ This rate is reduced by many of Canada’s tax treaties – for example, to 15 percent in the case of the Canada-U.S. Tax Treaty.³² It should be noted that with the exception of a specified investment flow-through trust,³³ income loses its character when funnelled through a trust. Thus, if the trust earns interest income which otherwise would not be subject to withholding tax when paid to the non-resident such as interest or, would be subject to lower withholding tax rates as in the case of some dividends, receipt by the trust and flowing out to beneficiaries subjects the payment to withholding tax as trust income. Obviously, if at all possible, a non-resident should not hold any interest-bearing security or dividend producing equity in many cases, through a Canadian resident trust. The exception for dividends is the SIFT. Classification of a trust as a SIFT allows dividends received by a SIFT to retain their character as dividend income when paid out by the SIFT to a non-resident beneficiary.³⁴ This characterization is important under some of Canada’s tax

²⁹ A mutual fund trust is defined in subsection 132(6) of the Tax Act as having the following attributes: (a) it was a unit trust resident in Canada, (b) its only undertaking was (i) the investing of its funds in property (other than real property or an interest in real property), (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property (or interest in real property) that is capital property of the trust, or (iii) any combination of the activities described in subparagraphs 132(6)(b)(i) and 132(6)(b)(ii), and (c) it complied with prescribed conditions relating to the number of its unit holders, dispersal of ownership of its units and public trading of its units.

³⁰ As noted earlier 42.92 percent in 2010.

³¹ Pursuant to subsection 212(1)(c) of the Tax Act. As noted earlier, paragraph 38(a) of the Tax Act provides that only one-half of a capital gain is a taxable capital gain so the effective withholding on a capital gain is 12.5 percent.

³² Articles XXII(2). It should be noted that this provision contains a provision not found in any of Canada’s other treaties providing for an exemption from Canadian withholding tax of amounts earned by the trust outside of Canada.

³³ A specified investment flow-through trust (“SIFT”) is defined in section 122.1(1) of the Tax Act as a Canadian trust the investments of which are listed or traded or listed on a stock exchange or other public and which holds “non-portfolio property”. “Non-portfolio property” is also defined in section 122.1(1) and includes significant direct or indirect security interests (10 percent directly or 50 percent indirectly), significant holding (greater than 50 percent of all holdings) in Canadian real, immovable or resource property or property used to carry on a business in Canada.

³⁴ Subsection 104(16) of the Tax Act.

treaties. For example, under the Canada-U.S. Tax Treaty, the definition of dividends has been amended to contemplate the payer of the dividend to the non-resident not necessarily being a corporation — it is the characterization of the *payment* as a dividend by the source state that is relevant.³⁵ Characterization as a dividend is relevant for entities exempt from withholding on dividend but not trust income. For example, under the Canada-U.S. Tax Treaty, certain tax-exempt entities such as charities and pension funds are exempt from withholding on interest and dividends – there is no exemption for trust income.³⁶

Mutual fund trusts are subject to a special tax under Part XIII.2 of the Tax Act. The intent of this provision is to tax the otherwise non-taxable portion of capital gains distributions and returns of capital distributions made to non-resident beneficiaries³⁷ from a Canadian property mutual fund investment.³⁸ Meant to capture dispositions of taxable Canadian property that would otherwise be subject to tax if the investment was held directly, the tax is a withholding tax exigible on the payer trust at a rate of 15 percent. It is recoverable to the extent that the non-resident suffers a loss on the disposition of its mutual fund units.³⁹ The disposition of units of the trust will only engender Canadian income tax liability if the units can be characterized as taxable Canadian property.

A corporation is taxed as a single entity in Canada.⁴⁰ Except for dividends received from other Canadian corporation which are deductible from income⁴¹, income earned by the corporation is taxed in it. In addition, when dividends are received by a private⁴² or subject corporation⁴³ they are subject to Part IV

³⁵ Article X(3) of the Canada-U.S. Tax Treaty.

³⁶ Article XXI of the Canada-U.S. Tax Treaty.

³⁷ Defined as “assessable distributions” in section 218.3(1) of the Tax Act.

³⁸ Defined in section 218.3(1) of the Tax Act as follows: “Canadian property mutual fund investment” means a share of the capital stock of a mutual fund corporation, or a unit of a mutual fund trust, if (a) the share or unit is listed on a designated stock exchange; and (b) more than 50 percent of the fair market value of the share or unit is attributable to one or more properties each of which is real property in Canada, a Canadian resource property or a timber resource property.

³⁹ In accordance with section 218.3(6) of the Tax Act, the loss can be covered back three years and forward indefinitely. The non-resident should file Form T12623, Part III.2 Tax Return for the Non-Resident’s Investments in Canadian Mutual Funds” to establish the amount so that it may be claimed in a subsequent year.

⁴⁰ This is true even for an unlimited liability company (“ULC”), which can now be incorporated under the laws of Nova Scotia, Alberta and British Columbia and which may be regarded as fiscally transparent in foreign jurisdictions. This entity will be discussed in greater detail below.

⁴¹ Section 112(1) of the Tax Act.

⁴² Section 89(1) of the Tax Act defines a “private corporation” to include a corporation that is not a public corporation or controlled by a public corporation. A “public corporation” is defined in section 89(1) as follows: “public corporation” at any particular time means (a) a corporation that is resident in Canada at the particular time if at that time a class of shares of the capital stock of the corporation is listed on a designated stock exchange in Canada, (b) a corporation (other than a prescribed labour-sponsored venture capital corporation) that is resident in Canada at the particular time if at any time after June 18, 1971 and (i) before the particular time, it elected in prescribed manner to be a public corporation, and at the time of the election it complied with prescribed conditions

tax which is recovered when taxable dividends are paid to its shareholders. This capture of income and inability to flow-through characterization of income to shareholders makes the corporate structure unattractive for many foreign investors. A mutual fund corporation⁴⁴, however, can be used to help obviate this result. The mutual fund corporation will most likely be subject to Part IV tax on dividends received by it.⁴⁵ While a mutual fund corporation is subject to normal corporate tax rates⁴⁶ on all other income⁴⁷, it can recover taxes paid on realized capital gain through the mechanism of the capital gains

relating to the number of its shareholders, the dispersal of ownership of its shares and the public trading of its shares, or

(ii) before the day that is 30 days before the day that includes the particular time it was, by notice in writing to the corporation, designated by the Minister to be a public corporation and at the time it was so designated it complied with the conditions referred to in subparagraph (i), unless after the election or designation, as the case may be, was made and before the particular time, it ceased to be a public corporation because of an election or designation under paragraph (c), or (c) a corporation (other than a prescribed labour-sponsored venture capital corporation) that is resident in Canada at the particular time if, at any time after June 18, 1971 and before the particular time it was a public corporation, unless after the time it last became a public corporation and (i) before the particular time, it elected in prescribed manner not to be a public corporation, and at the time it so elected it complied with prescribed conditions relating to the number of its shareholders, the dispersal of ownership of its shares and the public trading of its shares, or

(ii) before the day that is 30 days before the day that includes the particular time, it was, by notice in writing to the corporation, designated by the Minister not to be a public corporation and at the time it was so designated it complied with the conditions referred to in subparagraph (i), and where a corporation has, on or before its filing-due date for its first taxation year, become a public corporation, it is, if it so elects in its return of income for the year, deemed to have been a public corporation from the beginning of the year until the time when it so became a public corporation;

⁴³ 186(3) defines a “subject corporation” to include a corporation that is controlled by an individual or a group of individuals.

⁴⁴ A “mutual fund corporation” is defined in section 131(8) as follows: (8) Subject to subsection 131(8.1), a corporation is, for the purposes of this section, a mutual fund corporation at any time in a taxation year if, at that time, it was a prescribed labour-sponsored venture capital corporation or (a) it was a Canadian corporation that was a public corporation; (b) its only undertaking was (i) the investing of its funds in property (other than real property or an interest in real property), (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property (or interest in real property) that is capital property of the corporation, or (iii) any combination of the activities described in subparagraphs 131(8)(b)(i) and 131(8)(b)(ii), and (c) the issued shares of the capital stock of the corporation included shares (i) having conditions attached thereto that included conditions requiring the corporation to accept, at the demand of the holder thereof and at prices determined and payable in accordance with the conditions, the surrender of the shares, or fractions or parts thereof, that are fully paid, or (ii) qualified in accordance with prescribed conditions relating to the redemption of the shares, and the fair market value of such of the issued shares of its capital stock as had conditions attached thereto that included such conditions or as were so qualified, as the case may be, was not less than 95 percent of the fair market value of all of the issued shares of the capital stock of the corporation (such fair market values being determined without regard to any voting rights attaching to shares of the capital stock of the corporation).

⁴⁵ A mutual fund corporation is deemed to be a private corporation for the purposes of Part IV of the Tax Act by section 131(5) except if it is an “investment corporation” throughout the year as defined in 130(3) of the Tax Act – very few mutual fund corporation so qualify, of course, Part IV tax is recoverable when it pays dividends to its shareholders.

⁴⁶ The federal tax rate for a mutual fund corporation is 28 percent in 2010.

⁴⁷ For example, interest and foreign income.

refund⁴⁸ or through the payment of capital gains dividends. A disposition of shares of a mutual fund corporation will only result in tax liability to a non-resident shareholder if the shares are taxable Canadian property.

A partnership is the only true Canadian flow-through entity. Partners are subject to taxation on their share of partnership income and losses, without regard to whether or not such amounts are distributed. A partnership calculates its income for Canadian income tax purposes as if it was a taxpayer and provides its partners with their share of profits and losses. A non-resident partner must file a Canadian tax return if the partnership carries on business in Canada or disposes of taxable Canadian property. While partnerships are not subject to regular withholding under the Tax Act⁴⁹ they are subject to a special withholding on amounts paid or credited to it. Given that a partnership is not as recognized as a resident under any tax treaty (not being subject to tax in any jurisdiction), a partnership cannot theoretically obtain the benefit of any tax treaty so that full 25 percent withholding applies in most instances. The recent revisions to the Canada-U.S. Tax Treaty provide for the looking through of “fiscally transparent” entities⁵⁰ such as partnerships and thus allows eligible U.S. partners to claim the benefit of lower rates under the treaty. Administratively, CRA has previously allowed partners of a partnership to claim the benefits of treaty protection.⁵¹ It is assumed that this administrative concession will continue under other treaties. Where the treaty protection or administrative concessions apply, the partnership will be ignored as an entity and the partners will be considered to have received all income directly. This means, for example that, in general, there will be no withholding on interest received by the partnership and distributed to partners and dividends will subject to regular withholding rules and treaty protection.

The partners of a partnership are considered to carry on any business carried on by the Partnership in Canada.⁵² The partners must file Canadian tax returns reporting their proportionate share of business income earned in Canada through the partnership. However, most Canadian tax treaties will provide relief from Canadian taxation if the partner is not considered to have a permanent establishment in

⁴⁸ As set out in section 131(2) of the Tax Act. This provision allows the mutual fund corporation to retain all or part of its capital gains when there are redemptions of shares of the corporation.

⁴⁹ Paragraph 212(13.1)(b) of the Tax Act provides for withholding on amounts paid to a partnership that is not a Canadian partnership (defined in sections 248(1) and 102(1) of the Tax Act) – being any partnerships (even one created in accordance with Canadian law) where at least one partner is non-resident of Canada.

⁵⁰ Article IV(6) of the Canada-U.S. Tax Treaty.

⁵¹ See, for example, the following CRA documents: 9231095 dated February 18, 1993 and 2004-00742441E5 dated July 19, 2005.

⁵² Paragraph 96(1)(c) of the Tax Act.

Canada.⁵³ Once more the disposition of a partnership interest or property of the partnership will only be taxable in Canada if it is taxable Canadian property.

Business investment in Canada, as in the rest of the world, has evolved over the past decades. While the standard dual corporate approach of a foreign parent with a Canadian subsidiary still can be optimal in many situations,⁵⁴ financing and other considerations may mandate more sophisticated structures. In particular, the use of “fiscally transparent” entities has become increasingly popular.

The simplest way for a foreign corporation to carry on business in Canada is directly through a branch.⁵⁵ In such an instance, the branch operation is subject to branch tax in addition to its regular tax liability in Canada.⁵⁶ The intent of the provision is to impose the equivalent the withholding tax that would exist if the branch were a separate corporation and paying a dividend to its parent. It is therefore not surprising that the statutory rate is 25 percent and that it is reduced to the level of a dividend under most of Canada’s tax treaties.⁵⁷ In fact, the Canada-U.S. Tax Treaty gives the branch even more benefit by exempting the first Can\$500,000 thousand of income of the branch from branch tax. Therefore, in particular, with U.S. parents, operation through a branch could be attractive in start-up situations depending on financing and liability concerns and the status of the parent corporation in its own jurisdiction.⁵⁸

The structure that had become very popular for investment in Canada prior to the amendments to the Fifth Protocol was the use of a Canadian unlimited liability company.⁵⁹ This popularity stems from the fact

⁵³ See, for example, Articles V and VII of the Canada-U.S. Tax Treaty. This should be the case with most investment funds. A treaty-protected tax return in accordance with sections 162(2.1) or (7) of the Tax Act should be filed in any event.

⁵⁴ Income is calculated and tax paid on the income of the Canadian subsidiary in accordance with the provisions of the Tax Act. Excess profits are repatriated subject to the statutory withholding rate of 25 percent or in accordance with the relevant treaty rate. For example, for a Canadian subsidiary of a U.S. parent, the withholding rate would be 5 percent in accordance with Article X(2)(a) of the Canada-U.S. Treaty).

⁵⁵ For the purposes of this paper it is assumed that the foreign entity is carrying on business in Canada through a permanent establishment such that there is no treaty protection for the Canadian source income.

⁵⁶ Section 219(1) of the Tax Act.

⁵⁷ For example, in accordance with Articles X16 of the Canada-U.S. Tax Treaty, the rate is reduced to 5 percent. Section 219.2 of the Tax act provides for the application of the relevant tax treaty dividend limitation rate.

⁵⁸ Particularly if the parent is a U.S. entity that is fiscally transparent under the Canada-U.S. Tax Treaty.

⁵⁹ For a thorough analysis see Matthew Peters and Elizabeth A. Peters, “Implications of Restructuring a Canadian Unlimited Liability Company – Fallout from the Fifth Protocol” in “Corporate Tax Planning” (2009), Vol 57, no. 1 *Canadian Tax Journal*, 171-192 and Corrado Carderli, “The Fifth Protocol to the Canada-U.S. Income Tax Convention, Provision relating to Hybrid Entities, Services Businesses, and Pension Plans, *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Tax Conference (Toronto, Canada Tax Foundation, 2009) , 26:1-26:31. As noted above, unlimited liability companies can be created under the law of the provinces of Nova Scotia, Alberta and British Columbia. The Fifth Protocol has introduced many new nuances into the Canada –U.S. Tax Treaty including a limitation of benefits and other issues which are beyond the scope of this paper. Other articles dealing with the

that they generally qualify for U.S. “check the box” treatment.⁶⁰ The structure was popular in that it provided the flexibility of continuing the U.S. tax benefit of deriving income through a fiscally transparent entity with the advantages of using an entity respectful for Canadian tax purposes. The Fifth Protocol has generally eliminated the advantages of this structure. The Canada-U.S. Tax Treaty has been amended by the addition of new rules in regard to fiscally transparent entities.⁶¹ In accordance with Article IV(7)(b) Canada can now impose unreduced withholding⁶² on payments to the U.S. parent because treatment of their receipt in the United States differs from the treatment if the entity were not transparent. This results because in accordance with the Article (1) a resident of the United States has received an amount paid by a resident of Canada; (2) the Canadian resident ULC is fiscally transparent for U.S. tax purposes; and (3) the ULC being fiscally transparent results in different tax treatment in the United States than with the ULC was not fiscally transparent.

It was the apparent intent of these new provisions to address and forestall the use of the hybrid structure to generate interest deductions in both Canada and the United States on the same borrowing. The extension to dividends may have been inadvertent but both nations have confirmed its application.⁶³ Assuming no amendment to the Canada-U.S. Tax Treaty existing structures have to be reformulated and new structures designed differently. Various alternatives are available for an existing structure which must be analyzed based on the factual situation in each case. They range from maintaining the status quo to winding –up the ULC to changing the status of the ULC to not be fiscally transparent. Another approach is to interpose a corporation from a foreign jurisdiction that has a favourable tax treaty with both countries. Any such restructuring would have to take into account the flow-through, limitation of benefits provisions and derivative benefits provisions now contained in the Canada-U.S. Tax Treaty and always of great importance when dealing with a Canadian taxpayer, the Canadian general anti-avoidance rule⁶⁴. Go forward structures could consider the use of a fiscally transparent entity (for example, in Luxembourg) to

topic include Michael Colborne and Shawn D. Porter, “The Limitation of Benefits Article in the Fifth Protocol to the Canada-U.S. Tax Communication,” *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Tax Conference (Toronto: Canada Tax Foundation, 2009), 25:1-25:75.

⁶⁰ Pursuant to the Treas.: reg section 301.7701-1 of Internal Revenue Code of 1986, as amended. It should be noted that while it is certain that Nova Scotia companies qualify and Alberta and British Columbia companies should qualify, there is no clear guidance from Treasury on the status of Alberta and British Columbia ULCs.

⁶¹ Article IV(7).

⁶² Generally 25 percent.

⁶³ See Lisa M. Nadal, “Joint Technical Explanation to Canada-U.S. Protocol Soon” (2008) Vol. 50, no. 6 *Tax Notes International* 448-49 and Lisa M. Nadal, “More Generic Treaty Guidance Likely in Next Business Plan, Official Says” (2008), Vol. 50, no. 7, *Tax Notes International*, 555-56. See also Technical Interpretation 2009 – 0345351C6, dated February 11, 2010.

⁶⁴ Subsection 245 of the Tax Act.

hold a Canadian ULC.⁶⁵ The structure could effectively implement the effect of the structure as previously existed prior to the introduction of Article IV(7)(b) of the Canada-U.S. Tax Treaty. U.S. and Canadian anti-avoidance rules as well as the new limitations on the Canada –U.S. Tax Treaty would have to be analyzed in planning to implement such a structure.

⁶⁵ See the analysis of the structure in Brad Gordica and Sara McCracken, “Canada-US Protocol: Top Five Issues for Cross-Border Businesses”, *2009 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2009), 91 1-56, 25.