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*by Peter Cumyn**

IN APPROACHING THIS topic from the Canadian perspective what I propose to do is to emphasize recent developments in this area. This is a vast area and I will have to simplify it to a considerable extent.

Initially, I would like to enumerate the areas of taxation with which you should be concerned if you are considering a direct investment in Canada by a United States corporation. Under the Canadian Constitution, the provinces have the power to levy direct taxation within the provinces, *i.e.*, income taxes. They also have succeeded, notwithstanding the definition of direct taxes, to levy sales taxes at the retail level, and I will mention these briefly as I go through this enumeration. However, the principal tax with which you are concerned is obviously the federal income tax. Canada taxes capital gains in Canada to the extent of one-half of the gain and has been doing so since 1972. That portion of the gain which accrues prior to 1972 is generally excludable from the taxable amount, which has led to some fairly complex provisions in the corporate surplus area. However, basically, there is no separate tax in Canada on capital gains. It is part and parcel of the income tax system. If a gain is realised (this applies to non-residents as well as to residents), unless the gain is not taxable, one-half of the gain is includable in income and subjected to tax at ordinary rates. The basic charge under the Income Tax Act of Canada is based on residence. All Canadian resident corporations, individuals and trusts are subject to tax on their worldwide income. Canada has no notion of territoriality. Non-residents are taxable on certain types of income arising in Canada; taxation is not based on citizenship as it is in the United States, nor is domicile relevant for Canadian income tax purposes.

The federal government also levies a sales and an excise tax on certain luxury items, when goods are imported into Canada or when goods are being sold at the wholesale level the federal sales tax is generally applicable, the usual tax rate being twelve percent. The federal government also levies customs and dumping duties. With regard to dumping duties, the following is an update on the situation concerning steel imports into Canada.

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* Of Stikeman, Elliott, Tamaki, Mercier & Robb, Montreal. These remarks were made at the Canada-United States Law Institute's Transnational Taxation Conference, held April 21, 1978, at the Case Western Reserve University School of Law, Cleveland.

During 1977, Revenue Canada, which administers the Antidumping Act, discovered dumping of various steel products into Canada—not by United States companies—but by Japanese, British, French, Belgian, Luxemburgian and South African companies. (The Belgians were eventually exonerated.) An investigation was commenced, resulting in a preliminary finding of dumping, and dumping duties were eventually charged in many instances. As a result of this investigation the government decided to set up a special agency to monitor steel imports into Canada. This agency analyzes imports and makes recommendations where necessary. Dumping duties are now being levied on much of the steel that used to be imported. If imports of steel have dropped, it is presumably because of the duty, which is basically in an amount equal to the difference between the fair market value of the steel in its country of origin and the price at which it is being imported into Canada. However, an exception was created for steel imported into certain extreme provinces of Canada, *i.e.*, British Columbia, Alberta and Newfoundland. This was due to the fact that Sault Ste. Marie region was the only Canadian source for the steel in question, wide flange beams, and transportation costs were very high. There was a remission order permitting the import of wide flange steel beams without dumping duty, if destined for one of the above three provinces or the Yukon Territory. This order was valid until June 29, 1978, but was not extended past this expiration date.

The provinces levy logging and mining taxes, they also levy a retail sales tax. The Spring Canadian Budget financed a reduction in provincial sales taxes in order to spur the Canadian economy. It worked fairly well, although it resulted in controversy with Quebec. The provincial retail sales tax was temporarily dropped by two points thanks to this federal subsidy, and a further thanks should be extended to the provinces concerned. There were certain special arrangements made in particular provinces. For instance, Alberta does not levy a retail sales tax, therefore there was no reduction. In the Atlantic Provinces, the total amount was paid by the federal government because of the economic position of those provinces. In Quebec, the reduction was selective and was basically on clothing, furniture and other goods manufactured in the province.

Land transfer taxes are levied in Quebec and Ontario. There are many exemptions, but this is something to be taken into consideration nonetheless.

Finally, there are two other areas to be borne in mind, the Foreign Investment Review Act and the Anti-Inflation Programme.

The Foreign Investment Review Agency (FIRA) was established in Ottawa. Whenever a non-resident, or indeed a Canadian company which has a significant non-resident ownership, directly or indirectly acquires an existing business or starts a new business in Canada, FIRA approval must first be obtained. Although procedures are simplified for small transactions, they are still essentially subject to FIRA approval. It is often merely an administrative exercise, since as a practical matter, very few transactions are not approved, but in obtaining approval one is sometimes led to make certain concessions. For example, one of the functions of FIRA is to extract from the corporation involved undertakings that FIRA considers beneficial to the Canadian economy, such as the creation of new jobs or research in Canada.

However, there is a "grandfather clause" in the Foreign Investment Review Act in favour of businesses which already had a presence in Canada, for example employing salesmen in Canada, before the Act was implemented. If it can be determined that there was sufficient activity taking place in Canada at the time the Act was passed, thereby bringing the company concerned under that grandfather clause, a "letter of no action" can be obtained from the FIRA confirming that the incorporation of a Canadian subsidiary or some extension of the existing business is not subject to review by FIRA.

The other area to be considered apart from the Foreign Investment Review Act is the Anti-Inflation Programme which was introduced in 1975. The Anti-Inflation Act effectively froze prices, wages and dividends of companies under its control. The dividend freeze was removed in October 1978, and price and wage controls are currently being phased out.

With regard to tax administration in Canada, the Income Tax Act is administered, as are the customs, sales and excise taxes, by Revenue Canada. However, the Income Tax Act is administered by a separate and more sophisticated part of Revenue Canada. It is to Ottawa that one goes if one is seeking a binding advance ruling or a technical interpretation; on the operations side (audit, review, etc.), one deals with district offices located across the country.

Rulings from Revenue Canada have no sanction in the law. Therefore, they are not binding on the government in any way. As a practical matter however, they can be relied upon. In order to obtain a ruling, all of the facts and the identity of all the parties concerned have to be revealed. However, a ruling is never binding upon the parties requesting it; there are no provisions in the Act forcing the parties to carry out the actions described in a ruling. A ruling is often sought as an "insurance policy" on a large transaction, or where there are difficulties of interpretation, or where provisions of the Act do not interrelate. Basically, I am very much in favour of the rulings procedures in Canada, and I believe that they work very well. On the other hand, in order to maintain the anonymity of a client and to nonetheless obtain a reading of the law in a given matter, an interpretation can be requested from the Legislation Branch in Ottawa (which is also in charge of rulings). This is a case where the question must be one of law rather than of fact. For example, if there are two provisions in the Act that do not interface properly or if there is something which is ambiguous, the Legislation Branch can be requested to confirm or disagree with your interpretation of the law.

Turning to the treatment of non-residents carrying on business in Canada, a branch operation is the less common operation, presumably as much for commercial reasons as for tax reasons. If a corporation is carrying on business in Canada (unless it is subject to treaty provisions), it is subject to Canadian tax on its income from its operations in Canada. Obviously, carrying on business in Canada means more than merely trading with or exporting goods into Canada. It means that there is a permanent office in Canada from which business is conducted, or an agent is conducting the business in Canada. There are deeming provisions in the Act determining what is meant by "carrying on business in Canada," but bascially the old classic rules are followed. There are one or two implications drawn from "carrying on business in Canada."

In the first place, a corporation is subject to the same corporate rate of tax as a Canadian corporation. An individual is subject to Canadian individual rates of tax. A corporation is also subject to an additional tax called the branch tax which is parallel to the withholding tax on dividends, but has the inconvenience that it is levied in the very year that the profits are earned, whether or not remittances flow of Canada, whereas the withholding tax on dividends is only levied when a dividend is paid up from the subsidiary. The amount of the branch tax is nominally twenty-five percent but it is reduced by treaty, generally to fifteen percent.

The choice of carrying on business in Canada through a branch or through a subsidiary is therefore influenced by the branch tax which has the inherent disadvantage, as mentioned above, of levying the tax automatically when the earnings are made rather than when the dividend or profits are distributed. There are one or two other implications as well. If you have a branch, you can carry your losses forward to future years of the branch, but you cannot carry them into a subsidiary if at any time the branch is incorporated into a subsidiary. One of the advantages of a branch over a subsidiary is that the thin capitalization rules do not apply to the branch. I believe the United States also has thin capitalization rules. Basically, these are designed to prevent a Canadian subsidiary from exhausting its profits by paying off enormous amounts of interest to its foreign parent. Basically, interest is not deductible if paid to a foreign-related company to the extent the debt-equity ratio of the Canadian subsidiary exceeds three-to-one. For some reason this has not been applied to branches.

There are different rules applicable to the withholding tax paid by a foreign lender to a Canadian branch as opposed to a Canadian subsidiary. It is hard to say which rules are more favourable, but the one major exemption from withholding tax is on interest paid at arm's length on a loan of five years or more. This exemption is not available to a branch, which therefore makes the branch structure less attractive.

Finally, whether you have a branch or a subsidiary there is an impact on your rights under the tax treaty. For instance, under article 8 of the Canada-United States Tax Treaty, an American company is exempt from Canadian tax on its capital gains in most circumstances unless it has a permanent establishment in Canada, in which case it loses the exemption under the Treaty, regardless of whether or not the permanent establishment has anything to do with the gain.

Now I will turn to the situation of a Canadian subsidiary of a United States parent, which is the more common situation. The Canadian corporate tax rates are approximately fifty percent when the federal and provincial tax rates are combined. Canada has a small business deduction. This is not available to non-resident controlled companies, so it is not of concern here. It reduces the corporate tax rate for small Canadian corporations. There is also a reduction of corporate tax by some six percent when the profits concerned are derived from manufacturing and processing.

There are no consolidated corporate tax returns in Canada. This has been a hotly contested issue for the last few years. However, as a recent measure to appease those who wanted consolidated returns, the 1977 Budget introduced measures permitting tax losses to be carried forward to the successor corporation on an amalgamation, or carried forward to the parent company on the liquidation of a wholly-owned Canadian subsidiary into a Canadian parent. This has been a great improvement and it led to the liquidation or amalgamation of a number of companies at the end of 1977. Previously, there was a virtually perfect flow through on an amalgamation or a liquidation of a 100% subsidiary of all the tax attributes, but the one exception was tax losses. This exception now has been eliminated allowing the flow through of losses.

Another reform in 1977 which spurred a number of liquidations at the end of the year was the elimination of designated surplus. This was an anti-dividend stripping measure.

Finally, we come to withholding taxes in Canada. The basic rate is twenty-five percent on dividends. However, if there is a so-called "degree" of Canadian ownership, that is to say, if the Canadian company has at least twenty-five percent Canadian ownership and certain other requirements are also met, the rate is reduced by five points. Thus, if there is no treaty protection, the withholding tax rate on dividends drops from twenty-five percent to twenty percent. As far as the United States is concerned, through the complement of the tax treaty provision and Canada's Income Tax Application Rules, the rate is fifteen percent, and if there is a degree of Canadian ownership, it drops to ten percent on dividends. The rate is also reduced to fifteen percent on interest, rents, royalties and certain other income.

One rule which is of particular interest is that there is an exemption from withholding tax for bona fide cost-sharing research contributions. If, for instance, an American parent or subsidiary receives money from a Canadian corporation (and this applies equally if they are at arm's length) and the payment contains no profit element, but is basically a contribution to or recovery of research costs, even though the money can appear to be a royalty or a percentage of sales, there is no withholding tax. A comparable provision is in the area of management fees and charges. If a Canadian company pays a proportionate share of the overhead and administrative costs of a United States company (even if it is on a proportionate share basis rather than a specific expense basis), as long as there is no profit element involved but it is merely a recovery of cost, and if management services were truly performed for the Canadian company, then again there would be no withholding tax. The statutory provision which provides this exemption would suggest that there are certain restrictions governing when this exemption can be obtained, but as a practical matter it can usually be obtained. Both the withholding tax, free royalty with respect to research, and the management fees and charges are deductible by the Canadian company.

Finally, where a Canadian company has a United States subsidiary or, in fact, a subsidiary anywhere abroad, Canada's Subpart F can apply. Apart from the rules which attribute passive income on a current basis to the Canadian shareholders, the rules of greatest interest are those which permit dividends to come up free of Canadian tax to a Canadian company which holds at least ten percent of the foreign subsidiary, if those dividends come out of so-called exempt surplus. This includes active business earnings earned in the United States and any of a long list of countries with which Canada either has a tax treaty or will soon have a tax treaty. Some of these countries of course do not provide specific exemptions from tax in certain circumstances, so the situation can arise where, by repatriating profits by way of a tax-free dividend to Canada, no tax is suffered abroad. Where the dividend does come out of earnings of this sort but not from one of these listed countries, then the dividend is taxable in Canada, but full recognition may be given to the foreign tax which was paid on the underlying profits.