US-Canada Tax Strategies for US Entities Expanding to Canada

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Bill Macaulay, CPA, CA
Expanding Business into Canada
Overview

• Key issues for US advisors to identify upfront
• Overview of Canadian domestic tax framework
• Key treaty considerations
• Structuring strategies and pitfalls
Key Issues to Identify Upfront

• 15% withholding tax on services performed in Canada by a non-resident – refundable/creditable on filing of return
  o Cash flow impact
  o Waivers possible, but challenging
  o Consider using a Canadian entity if providing services in Canada
  o Payments by US person to US subcontractor are also caught

• Some very unexpected Treaty rules
  o Hybrids
  o Deemed PE where significant services performed in other country

• Federal Goods and Services Tax ups the ante
  o Registration is important and should be done early

• Canadian entity selection is important
  o Branch
  o Unlimited liability company versus regular corporation
Key Issues to Identify Upfront (cont’d)

• **US entity considerations will affect Canadian tax**
  o S Corporations and C Corporations are straightforward
  o LLCs are problematic in several ways
    • Canadian historical perspective
    • Look-through rules in the Treaty (e.g., non-US members)
    • Adverse deeming rules in Treaty (challenges with ULCs and look-through)

• **Treaty look-through rules can surprise**
  o If non-US resident (e.g., Canadian or UK residents) members of an LLC or partnership, will not get 100% treaty benefit
  o Do not always get you there (e.g., two step dividend)

• **If fiscally transparent entity used in Canada, ensure you understand the amounts and timing of income subject to Canadian taxation**
  o e.g., timing of construction profits
Domestic Tax Framework

• Canadian income tax system
  o Federal and provincial taxes
  o Corporate tax rates
  o Carrying on business in Canada
  o Branch tax (under ITA - whether branch or not)
  o 15% withholding tax on services performed in Canada by non-residents
  o Capital gains on “taxable Canadian property”
  o Employment income and payroll compliance

• Sales and related tax systems
  o Federal tax on goods and services ("GST")
  o Harmonized provincial and federal tax on goods and services ("HST") ("QST")
  o Provincial sales tax in some provinces that are not harmonized
Principal Taxing Jurisdictions

- Federal system administered by Canada Revenue Agency
- 10 provinces
- 3 territories
Federal Income Taxation of Non-Residents

• Part I of Income Tax Act
  o Employed in Canada
  o Carried on a business in Canada
  o Disposed of a “taxable Canadian property”

• Part XII.2 of Income Tax Act
  o Re Canadian resident trusts earning “designated income”

• Part XIII of Income Tax Act
  o 25% withholding tax on (generally) passive income

• Part XIV of Income Tax Act
  o 25% Branch tax
Provincial Income Taxation

• All provinces and territories have an income tax regime
• Provincial income tax acts generally parallel and cross-reference to the federal Act
• Generally administered through the federal Canada Revenue Agency together with federal income tax
• Quebec has its own personal tax returns and administration
• Alberta and Quebec have their own corporate tax returns and administration
Illustrative Tax Rates - Individuals

- Individuals - top combined federal and provincial marginal rates on employment income for 2015
  - Ontario 42.16%
  - Alberta 40.25%
  - BC 45.80%
  - Quebec 54.75%

- Lower thresholds for top rates than in the US
- No joint returns for spouses
• Corporations - combined rate on 2015 business income earned by a corporation (not a “Canadian-controlled private corporation”) with a permanent establishment in
  o Ontario 26.5%
  o Alberta 25.0%/27.0% change at July 1, 2015
  o BC 26.0%
  o Quebec 26.9%

• No consolidated returns
**The Treaty**

- **The Canada – US Treaty provides relief -- for example**
  - No tax on profits from carrying on business in Canada if not through a Permanent Establishment ("PE")
  - Branch tax exemption on first Cdn$500,000 of profits
  - Branch tax reduced to 5% from 25%
  - Dividend withholding tax generally reduced to 5% or 15% from 25%
  - Non-arm’s length interest withholding tax reduced to 0% from 25%

- **Treaty deems a PE in certain service situations**
- **Treaty denies treaty benefits in certain hybrid entity situations**
- **Treaty benefits denied to recipients of payments from hybrid entities**
- **Canada does not view an LLC as eligible for treaty benefits in its own right**
  - 2007 Fifth Protocol introduced look-through provision in Article IV, paragraph 6
Treaty - Permanent Establishment

- Fixed place of business, etc.
- Special deeming rules for
  - Service providers with significant time presence in the other country
    - Two parallel 183 days in any 12 month period tests
    - This is very key for service providers and can impact employee taxation
  - Building site, construction or installation project if, but only if, it lasts > 12 months
  - Use of an installation or drilling rig or ship to explore for or exploit natural resources, if, but only if, use is for >3 months in any 12 month period
  - Dependent agent who has authority to conclude contracts and habitually exercises that authority
- Exclusions
  - Independent agent who acts in the ordinary course of its business is excluded
  - Preparatory or auxiliary activities, maintenance of stock, etc. but must be used solely for one or more of these delineated activities
Carrying on Business in Canada

• Filing requirement – Treaty-based return
  o Late-filing penalty of $25 per day to maximum $2,500 per return
  o Voluntary disclosure program

• If Permanent Establishment in Canada
  o Taxable on profits attributable thereto pursuant to Treaty framework

• The concept of “carrying on business in Canada”

• Extended definition of “carrying on business in Canada”

• Jerry Dykopf’s presentation on contractors
• Selection of Canadian entity type is important for **US tax** purposes
  o Will impact availability of losses and FTCs for underlying Canadian tax

• Canada considers LLCs and S-Corps to be corporations
  o Canada has historically not recognized LLCs as eligible for Treaty benefits

• Treaty changes from 2007 Fifth Protocol are fundamental
  o Flow-through provision for US fiscally transparent entities such as LLCs and partnerships
  o Canada adopted Limitation on Benefits article
  o Canada administratively gives S-Corps eligibility in their own right
  o Payments from a ULC to US resident generally not eligible for treaty benefits

• If services are provided in Canada, will tend to prefer Canadian legal entity to a branch to avoid 15% withholding tax
Important Structuring Concepts (cont’d)

• Paid-up capital is very important in liquidation, redemption, etc. in determining deemed dividend
  o Important to have shares issued with high paid-up capital
  o Do not just capitalize debt, issue shares
  o Use new Canadian holding company on acquisition of Canadian target

• Thin capitalization interest deduction denial if debt/equity ratio is >1.5:1
  o Caution – don’t lend to second tier subsidiary as no direct equity owned
  o Now excess is also a deemed dividend subject to withholding tax

• Remember foreign currency issue on intercompany debt
  o Debtor or creditor will eventually have a currency gain and the other will have a loss
Types of Canadian Entities - Inbound

- Corporation
- Unlimited Liability Corporation (ULC)
- Branch
- Partnership
Typical Acquisition Structure

- **US Parent**
- **PurchaseCo (Canada)**
- **TargetCo (Canada)**

Amalgamate to form Amalco
Advantages of Structure

- Bump in ACB of Amalco’s non-depreciable capital assets
- If debt associated with the purchase, offset of interest expense against TargetCo profits
  - (No consolidated tax returns in Canada)
- Ability to distribute purchase price without Canadian withholding tax
- Potential bump in cost base under foreign Parent’s tax rules
Disadvantages of Structure

- Thin capitalization considerations
- Cross-border interest subject to withholding tax (25% - subject to treaty – Should be 0% if US holder)
- Returns of capital may be taxed in Parent’s jurisdiction as dividends
- No flow through of Amalco losses
- May be foreign corporation concerns in Parent’s jurisdiction
Paid-up Capital

• On the repurchase, redemption, cancellation of a share
  o Proceeds in excess of PUC of share is a deemed dividend

• Consider statutory PUC reduction

• Withholding tax on cross-border dividends (25% reduced by treaty, generally 5% in corporate structure)

• No earnings & profits concept as in the US
Paid-up Capital (cont’d)

• PUC for tax purposes starts with the legal paid-up capital
  o Par value for par value shares
  o Stated capital for no par value shares

• Various adjustments to get tax PUC
• Rather than using a Canadian PurchaseCo, US purchaser buys shares from Canadian shareholders directly
• Assume the US purchaser pays $5 million to buy all 1,000 existing common shares
• Par value $1 per share
• PUC is only $1,000
• Exposure to large deemed dividend
PUC Pitfall on Direct Purchase

US Parent

1,000 common shares
Cost $5 million
PUC $1,000.

Canco

On cancellation of common shares, there will be a deemed dividend of $4,999,000 subject to withholding tax and a capital loss of the same amount.
Maximize PUC on Acquisition

- **US Parent**
  - 1,000 common shares
  - Cost $5 million
  - PUC $5 million

- **PurchaseCo (Canada)**
  - 1,000 common shares
  - Cost $5 million
  - PUC $1,000

- **TargetCo (Canada)**

**Amalgamate to form Amalco**
Pitfall on PUC Fix Attempt

• US purchaser may attempt to increase PUC by transferring Canco’s low PUC shares to a related Canadian company in return for high PUC shares

• S. 212.1 will deem dividend on restructuring to extent of non-share consideration in excess of low PUC shares

• S. 212.1 will grind PUC of new shares to the PUC of old shares
The ULC for US Investors

• US investors will typically use a Canadian Unlimited Liability Company as the Canadian PurchaseCo or the entity to carry on business directly in Canada
• ULC - a flow through entity for US tax
• ULC - a corporation for Canadian tax
Advantages of ULC

• Same Canadian tax advantages as in traditional acquisition structure
  • Bump in ACB of Amalco’s eligible assets
  • If debt associated with the purchase, offset of interest expense against TargetCo profits
    • (No consolidated tax returns in Canada)
• Ability to distribute purchase price without Canadian withholding tax
Advantages of ULC (cont’d)

• US tax advantages
  • Flow through of losses
  • Not subject to Subpart F regime
  • Interest from ULC is disregarded
  • Bump in cost base of ULC’s assets
Disadvantages of ULC

• Same Canadian tax disadvantages as a corporation
  o Thin capitalization considerations
  o Cross-border interest subject to withholding tax (25% - subject to treaty reduction to 10%)

• Additional liability exposure

• US tax disadvantages
  o Flow through of income
  o Complex allocation of interest
  o Timing issues on Canadian dividend withholding
ULC Non-Tax Considerations

• Corporate jurisdiction
  o Nova Scotia (NSULC)
  o Alberta
  o British Columbia

• US parent company will want to insert an intervening US entity as a liability blocker
• 25% branch tax on notional distributions of net assets from Canadian branch to foreign head office
  o Substitute for the dividend withholding tax if Canadian subsidiary was used
• Generally reduced to treaty rate for dividends to parent corporation
• 5% specified in Canada-US Treaty
• Special considerations post-Fifth Protocol
• Cdn$500,000 profit exemption in Canada-US Treaty Article X paragraph 6
Partnership

- Advantages/Disadvantages
  - If not a “Canadian partnership”
    - Exposure to withholding tax
    - Exposure to withholding tax on disposition of real property or resource property (Taxable Canadian Property)
    - No transfer of assets in or out on a tax-deferred basis
- All members must be Canadian residents to be a Canadian partnership for tax purposes
Debt/Equity Considerations

- **Equity**
  - Paid-up capital important on repurchase/redemption/winding-up

- **Debt**
  - Principal can be repaid without withholding tax
  - No recharacterization concerns
  - Interest subject to withholding tax (25% - subject to treaty reduction)
  - Interest deduction in Canada is subject to thin capitalization rule
Thin Capitalization

• To the extent there is interest expense on debt constituting excess debt owed to specified non-residents, the deduction of that interest is denied

• Debt/equity ratio of 1.5:1 for Canadian resident corporations

• Debt/assets ratio of 3:5 for a non-resident corporation with a Canadian branch
  o Applicable for taxation years beginning after 2013

• Denied interest is deemed to be a dividend subject to withholding tax (25% - subject to treaty reduction)
Thin Cap Pitfall - Loan to 2\textsuperscript{nd} Tier Sub

Debt $20 \text{ mm} \text{ at } 7\%$

- US Parent
  - Equity $10 \text{ mm} \text{ PUC}$
    - PurchaseCo (Canada)
      - TargetCo (Canada)

Non-deductible interest expense
Loan to 2nd Tier Sub – The Fix

- US Parent
  - Equity $10 mm
  - PUC
- PurchaseCo (Canada)
  - Debt $20 mm at 7%
  - Debt $20 mm at 7.1%
  - TargetCo (Canada)
  - Deductible interest expense

US

Canada

Debt $20 mm at 7%

Debt $20 mm at 7.1%

Deductible interest expense
C Corp and Regular Canadian Corp

- US C Corp
- Canco

**Withholding tax on dividend of 5% under Treaty**

- Canadian corporate tax (say) 26%
- No special Treaty considerations
Flow-Through Entities  S Corp & ULC

- **US S Corp**
- **Canadian ULC**

**Withholding tax on regular dividend of 25% under Treaty, but reduced to 5% if two step dividend**

- Canadian corporate tax (say) 26%

- There would typically also be an intervening Q Sub blocker

- **S Corp is generally eligible for Treaty benefits**

- **Canada**

- Article IV(7)(b) will deem S Corp to not be eligible for Treaty benefits on certain amounts paid from ULC to the S Corp so must be managed

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We recently worked with US tax advisors to convert a closely-held LLC to an S Corp that would own a Canadian ULC through a newly formed Q Sub blocker corporation.

US conversion considerations included:
- Preservation of special allocations of income and loss because S Corps can only have one class of stock.
- Exposure to US tax on conversion if the LLC’s liabilities exceeded the basis of its assets.
- Whether the state jurisdiction allows simple conversions by tax election without a change of corporate form.
- Whether a person that would not be a permissible S Corp shareholder would be considered as a potential business investor in the foreseeable future.
Flow-Through Entities LLC & ULC

LLC is generally not itself eligible for Treaty benefits; must apply look-through rule.

Withholding tax on regular dividend of 25% under Treaty, and is NOT reduced to 5% if two step dividend due to wording of look-through rule.

There would typically also be an intervening blocker entity.

Canadian corporate tax (say) 26% 

Article IV(7)(b) will deem LLC to not be eligible for Treaty benefits on certain amounts paid from ULC to the LLC so must be managed.
LLC Pitfall – Look-Through Rule

**Canadian Member 10%**

**US Member 60%**

**UK Member 30%**

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**US**

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**Canada**

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**Canco**

LLC would only get 60% of its Treaty benefits
Two Step Dividend

- The Canada Revenue Agency has an administrative policy to generally not apply the General Anti-Avoidance Rule to a Two Step Dividend arrangement undertaken to obtain a 5% withholding tax rate rather than a 25% rate (as a result of the application of Treaty Article IV(7)(b)) on a dividend distribution by a ULC to a US parent corporation.

- The two steps are:
  - A statutory increase in paid-up capital (which gives rise to a deemed dividend for Canadian tax purposes equal to the amount of the PUC increase).
  - A distribution of cash with an offsetting reduction in PUC (no dividend consequences for Canadian tax purposes).

- As the US tax treatment is the same irrespective of whether or not the ULC is treated as a fiscally transparent entity for US tax purposes the US recipient will be eligible for the Treaty rate of 5% if the US recipient is viewed as a corporation by Canada and meets the ownership threshold.
Foreign Employees in Canada

• Personal tax considerations for the employees
• Employees’ Treaty exemption may be impacted by the tax status of the employer
• Regardless of employees’ exemption, payroll withholding is required
• Jerry Dykopf will cover employee/employer considerations and recent legislative initiatives relating to payroll compliance in respect of foreign employees working in Canada
Sales and Other Taxes

• Sales and related tax systems
  o Federal tax on goods and services
  o Harmonized provincial and federal tax on goods and services
  o Provincial sales tax in most provinces that are not harmonized
  o See following map

• Get sales tax advice and be very alert to the need for timely registration
Canadian indirect tax rates – April 2014

April 2014
Non-Tax Issues

- Your client will be faced with many non-tax issues, too
- For example,
  - Jurisdiction for incorporation
  - Residency of directors requirements
  - Banking and treasury issues
  - Employment law
  - Intellectual property law
  - Acquisition structuring
- We can introduce them to professionals that can help them expand their business to Canada
Bill Macaulay CPA, CA
Partner, Tax
Smythe LLP
Vancouver, BC, Canada
direct phone 604-694-7536
general phone 604-687-1231
bmacaulay@smythecpa.com