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Corporate Tax 2022

Canada: Law & Practice

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CANADA

Law and Practice

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1. TYPES OF BUSINESS ENTITIES, THEIR RESIDENCE AND BASIC TAX TREATMENT

1.1 Corporate Structures and Tax Treatment

There are several options available when doing business in Canada. The choice of structure is generally dictated by a number of factors, based mainly on tax and liability considerations. The most used structures are:

- corporations;
- unlimited liability companies (ULCs);
- partnerships;
- joint ventures; and
- sole proprietorship.

Corporations

Businesses are generally carried on by corporations, which are distinct legal entities with a patrimony distinct from their shareholders'. Such entity may be incorporated under the Canada Business Corporations Act or under the equivalent law of a province or territory. Corporations' popularity stems from two main factors:

- the shareholders' liability exposure is limited to their investment in the corporation; and
- the corporation is taxed as a separate legal entity at lower rates than individuals.

ULCs

A ULC structure is only available in four provinces of Canada (Alberta, Nova Scotia, British Columbia and Prince Edward Island) and the regime may vary quite a bit between each. The common baseline is that a ULC is a distinct legal entity, but in some situations the shareholders' liability is unlimited. Under Canadian tax laws, ULCs are considered corporations and are taxed as separate legal entities. They are usually used where there are US shareholders since ULCs may be treated as "disregarded entities" under US tax laws, therefore allowing taxation of the ULC's income in the US shareholders' hands directly for US tax purposes.

Partnerships

A partnership – be it a general partnership, a limited partnership or a limited liability partnership – is a relationship between two or more persons who carry on a business, with such relationship being governed by provincial legislation. In a general partnership, each partner is liable for all of the partnership's debts and liabilities in relation to third parties. In a limited partnership, there are two kinds of partners:

- general partners, who are exposed to unlimited liability; and
- limited partners, whose liability is limited to their capital investment if the limited partners take no part in the management or control of the business.

Multiple provinces have legislation in place allowing only certain professionals to practise through limited liability partnerships, such as lawyers and accountants, a structure under which the partners are not liable for the actions of those who are not under their direct control or supervision. A partnership is not subject to income tax as a separate entity. It is rather a "flow-through" entity where the net income is calculated at the partnership level and allocated to its partners, who are liable for the taxes on such income.

Joint Ventures

A joint venture shares some similarities with a partnership but, unlike a partnership, where two or more partners conduct business together, a joint venture is created when two or more persons collaborate for a specific project. A joint venture is not taxed as a separate legal entity and the liability of each partner is set out in the joint venture agreement. Such agreement must clearly state that the parties do not wish to form a partnership or else the joint venture could be considered as such and each partner would become liable for all of the partnership's debts and liabilities.

Sole Proprietorship

A sole proprietorship is an unincorporated business owned by a single individual. Such individual's liability is unlimited, and the income generated by the business is added to the individual's other income, if any, and taxed at the personal rates.

1.2 Transparent Entities

Partnerships are commonly used to create investments funds, as the potential limitation of liability and the absence of taxation at the entity level are valuable advantages to the partners (see **1.1 Corporate Structures and Tax Treatment**). Since the income and loss are calculated jointly for the parties in a joint venture, such entity is popular in real estate investments as the joint parties may personally determine the depreciation expense that will be utilised when calculating their income, instead of having it calculated at the partnership level.

1.3 Determining Residence of Incorporated Businesses

The residence of an incorporated business is determined in two steps:

- first, by reviewing the deeming provisions of Canada's Income Tax Act (ITA); and
- if none are applicable, by application of the common law.

The ITA deems a corporation to be a Canadian resident throughout a tax year if the corporation was incorporated in Canada. If the corporation was not incorporated in Canada, or if it was incorporated in Canada prior to 26 April 1965, such corporation may be determined to be a resident of Canada by application of common law principles.

The general principle is that a corporation is a resident of the country where its central management is located, and in which control is executed. The ITA also includes a non-deeming provision, pursuant to which a corporation will not be determined to be a resident of Canada under the ITA if it is deemed a resident of another country under a tax treaty with said other country.

A partnership with one or more non-resident partners is not a "Canadian partnership" and is therefore treated as a non-resident partnership. Although partnerships are flow-through entities for Canadian tax purposes, they are considered taxpayers for certain Canadian tax purposes, so their residency is relevant.

1.4 Tax Rates

The federal tax rates applicable to incorporated businesses vary depending on whether or not the corporation qualifies as a Canadian-controlled private corporation (CCPC). The federal tax rates of a CCPC are as follows:

- active small business income (up to CAD500,000): 9%;
- active business income (above CAD500,000): 15%; and
- investment income (other than dividends): 38.67%, of which 30.67% is refundable upon payment of taxable dividends by the corporation at a rate of CAD1 of tax reimbursed for each CAD2.61 of dividends paid by the corporation.

The federal tax rate applicable to a corporation that does not qualify as a CCPC is 15% for all types of income.

As for dividend income, if the dividends are paid by a private Canadian corporation "connected" to the Canadian corporation receiver, the inter-corporate dividends received are not taxable, subject to some exceptions. If the dividends are paid by a public Canadian corporation or by a Canadian corporation that is not "connected" to the Canadian corporation receiver, the dividends received are subject to 38.33% tax, which is refundable upon the payment of taxable dividends at a rate of CAD1 of tax reimbursed for each CAD2.61 of dividends paid by the receiver corporation. A payer corporation is connected to the receiver corporation if the latter (or persons not dealing at arm's length with the latter) controls the payer corporation or if the receiver corporation owns more than 10% of the shares in votes and value.

As of 2021, the federal tax rates applicable to individuals carrying on a business directly are as follows, with it being understood that "taxable income" includes all taxable income earned by such individual other than dividends, whether through a business or not:

- 15% on the first CAD50,197 of taxable income; plus
- 20.5% on the next CAD50,195 of taxable income (on the portion of taxable income between CAD50,197 and CAD100,392); plus
- 26% on the next CAD55,233 of taxable income (on the portion of taxable income between CAD100,392 and CAD155,625); plus
- 29% on the next CAD66,083 of taxable income (on the portion of taxable income between CAD155,625 and CAD221,708); plus
- 33% of taxable income over CAD221,708.

The net income of a partnership is taxable in the hands of its partner, at the rate applicable to the partner since it is a flow-through entity.

Corporations and individuals are also subject to provincial income tax.

2. KEY GENERAL FEATURES OF THE TAX REGIME APPLICABLE TO INCORPORATED BUSINESSES

2.1 Calculation for Taxable Profits

The taxable income of a corporation is composed of business income, investment income (interest, rent, royalties and dividends) and 50% of capital gains, and is the result of its gross income for the year minus the allowable deductions. The deductions a corporation is allowed to claim are expenses incurred for the purpose of earning income. This usually covers salaries, insurance expenses, maintenance and repairs, licences, accounting and legal fees and advertising expenses.

The net income reported on financial statements will often not be the same as the net income calculated for tax purposes, since some income and expenses reported in financial statements may not be used in the calculation of net income for tax purposes. Income is generally reported using the accrual method – only farmers, fishermen or self-employed commission sales agents may use the cash method.

2.2 Special Incentives for Technology Investments

The Scientific Research and Experimental Development Program (SR&ED) encourages all Canadian businesses, regardless of their size or sector, to develop new, improved or technologically advanced products by using three tax incentives:

- an income tax deduction;
- an investment tax credit (ITC); and

• a refund, in specific circumstances.

The maximum ITC and the availability of a refund under the SR&ED depend on whether or not the corporation is a CCPC, and on the amount of qualified expenditures carried out in Canada (such as wages, machinery, equipment, etc). Unused ITCs may be carried back three years or forward for 20 years. Provincial incentives are also available.

2.3 Other Special Incentives

A Canadian film or video production tax credit is available for certain labour expenses for certified films or videos (similar credits are also offered by provinces). Also, an accelerated investment incentive was introduced in 2018 that provides for an enhanced first-year depreciation deduction on depreciable properties, and for the immediate write-off of the full cost of machinery and equipment for manufacturing and processing businesses and of the full cost of specified clean energy equipment for clean energy businesses.

2.4 Basic Rules on Loss Relief

A corporation may incur two types of losses:

• capital losses; and
• non-capital losses.

Capital Losses

Capital losses occur upon the disposition of a capital property for an amount less than its cost. Generally, a capital loss may only offset capital gains – it cannot be applied to other income unless it qualifies as an allowable business investment loss. Capital losses may be carried back three years or carried forward indefinitely.

Non-capital Losses

Conversely, a non-capital loss is any loss occurring other than upon the disposition of a capital property. Non-capital losses may offset all sources of income. They can also be carried back three years or carried forward for the subsequent 20 years (or ten years with respect to allowable business investment loss, which will be converted into a capital loss upon the 11th year). An allowable business investment loss for a corporation is a capital loss incurred on the sale to a third party of shares of a small business corporation or upon the bankruptcy, insolvency or winding-up of a small business corporation that ceased to operate a business. The allowable business investment loss may offset all sources of income. A limited partner's share of a limited partnership's loss from a business or property may only be deducted by the limited partner if such loss does not exceed the limited partner's "at-risk amount" for the year. The exceeding loss can be carried forward indefinitely.

2.5 Imposed Limits on Deduction of Interest

Interest expenses are deductible if they are reasonable, and are payable under a legal obligation to pay interest on money borrowed for purposes of earning income from a business or property. Under certain exceptions, interest payable on money borrowed by a corporation to redeem shares, return capital or pay dividends may be deductible. Under the thin capitalisation rules, the deduction for interest paid by a corporation to a non-resident shareholder is limited where the debt-to-equity ratio exceeds 1.5:1.

2.6 Basic Rules on Consolidated Tax Grouping

Unlike other jurisdictions, Canada does not have a formal system providing for the consolidated taxation of corporate groups. Separate company losses may be used through reorganisations or financing arrangements, but such transactions require thoughtful planning, and some may even require tax rulings.

2.7 Capital Gains Taxation

Only 50% of the capital gain of a corporation is taxable and the resulting amount is taxed at a rate of either 15% if the corporation is not a CCPC or 38.67% if the corporation is a CCPC. Out of the 38.67% tax rate, 30.67% is refundable upon the payment of taxable dividends by the corporation, at a rate of CAD1 of tax reimbursed for each CAD2.61 of dividends paid by the corporation. There are no exemptions or reliefs on the taxation of capital gains for corporations.

2.8 Other Taxes Payable by an Incorporated Business

In addition to the federal income tax, corporations may be subject to federal and provincial goods and services tax, municipal taxes, land transfer taxes, withholding taxes, federal and provincial social security contributions and provincial payroll taxes. Corporations are also subject to provincial income tax.

2.9 Incorporated Businesses and Notable Taxes

See **2.8 Other Taxes Payable by an Incorporated Business**.

3. DIVISION OF TAX BASE BETWEEN CORPORATIONS AND NON-CORPORATE BUSINESSES

3.1 Closely Held Local Businesses

Most businesses are carried on by corporations.

3.2 Individual Rates and Corporate Rates

One of the main advantages of providing services through a corporation is the ability to benefit from the small business deduction, which provides a preferential tax rate of 9% at the federal level on the first CAD500,000 of active business income earned by a corporation that qualifies as a CCPC. The active business income above CAD500,000 is taxed at a federal rate of 15%.

However, this preferential tax rate does not apply to personal services businesses carried on by a corporation. A personal services business is one that provides services where the individual who performs the services on behalf of the corporation (ie, the incorporated employee) would reasonably be regarded as an employee of the person or partnership to which the services were provided, but for the existence of the corporation. These rules are not restricted to professionals.

The taxable income of a personal services business is taxed at a flat rate equal to the top marginal personal tax rate, thus removing the advantage afforded by the lower corporate tax rates.

3.3 Accumulating Earnings for Investment Purposes

Passive income rules provide for a gradual reduction of the small business active income limit of CAD500,000 available to CCPCs (the Business Limit) on which the preferential tax rate of 9% applies where a corporation, together with its associated corporations, earned investment income of between CAD50,000 and CAD150,000 in a year. The reduction is effectively decreasing the annual Business Limit by CAD5 for each CAD1 of investment income earned in excess of CAD50,000.

Pursuant to such rules, when the aggregate investment income of a CCPC earning active income and its associated corporations is CAD150,000 or higher for a given year, the CCPC will not have access to the preferential tax rate of 9% applicable to active business income and will therefore be taxed at the regular rate of 15%.

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3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends from Private Corporations

Three types of dividends can be paid by a corporation resident in Canada in favour of an individual resident in Canada:

- eligible dividends (dividends paid by a corporation taxed at the 15% rate);
- non-eligible dividends (dividends paid by a corporation taxed at the 9% rate); and
- capital dividends.

At the federal level, if an individual receives an eligible dividend, a grossed-up amount equal to 138% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 15.02% of the grossed-up amount, the whole resulting in an eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 24.81%.

At the federal level, if an individual receives a non-eligible dividend, a grossed-up amount equal to 115% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 9.03% of the grossed-up amount, the whole resulting in a non-eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 27.57%.

Eligible and non-eligible dividends are also taxable at the provincial level.

A capital dividend is a dividend paid by a corporation out of its capital dividend account (which is essentially composed of the non-taxable portion of capital gains realised by the corporation) and is not taxable in the hands of the individual.

Gain on the Sale of Shares in Private Corporations

50% of a capital gain realised by an individual is taxable at the individual's applicable federal and provincial income tax rate, including a capital gain realised on shares of a private corporation. This results in an effective marginal tax rate for capital gains of between 22.25% and 27%, depending on the applicable provincial rate.

An eligible individual resident in Canada is entitled to a lifetime capital gains exemption on gains realised on the disposition of qualified small business corporation shares. If the capital gain realised by the individual qualifies under these rules, the capital gain, up to the limit, will be exempt from income tax. The lifetime capital gains exemption limit is indexed annually, and is CAD913,630 for 2022.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends from Publicly Traded Corporations

Dividends received from a Canadian public corporation are eligible dividends. Therefore, at the federal level, a grossed-up amount equal to 138% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 15.02% of the grossed-up amount, the whole resulting in an eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 24.81%.

Dividends received from a company residing in another country are not subject to the gross-up nor the dividend credit. The entire dividend amount is taxable in Canada and may be subject to withholding in the other country.

Gain on the Sale of Shares in Publicly Traded Corporations

50% of a capital gain realised by an individual is taxable at the individual's applicable federal and provincial income tax rate, including a capital gain realised on shares of a publicly traded corporation.

4. KEY FEATURES OF TAXATION OF INBOUND INVESTMENTS

4.1 Withholding Taxes

Canada imposes a federal 25% withholding tax on certain types of passive income from Canadian sources, such as interests, dividends and royalties paid or credited to non-residents.

Subject to limited statutory exemptions, the Canadian payer is required to withhold tax from the gross amount paid or credited to the non-resident payee and to remit it to the tax authorities on its behalf. The withholding tax rate can often be reduced to 15%, 10% or even 0% under Canada's tax treaties. However, before withholding less than 25%, the Canadian payer should normally require a completed Form NR301 (or equivalent) to confirm that the non-resident payee qualifies for treaty relief.

4.2 Primary Tax Treaty Countries

Canada currently has 94 tax treaties in force with foreign countries, which – subject to exceptions – mainly follow the OECD Model Tax Convention.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The OECD Multilateral Instrument entered into force in Canada on 1 December 2019 and introduces a "principal purpose test" into most of Canada's tax treaties, which will deny the benefits of the applicable treaty where one of the principal purposes of the arrangement or transaction is to obtain the benefits of the treaty. For example, if determination is made that one of the principal purposes for using a subsidiary in a particular treaty jurisdiction is to access the benefits of that treaty, then the benefits of that treaty are denied.

The tax authorities' position is that, in certain circumstances, Canada's General Anti-Avoidance Rule could be applied to transactions that are undertaken primarily to secure a tax benefit afforded by a tax treaty.

4.4 Transfer Pricing Issues

Transactions regarding goods, services (ie, management) and intangibles (ie, patent, trade marks) with non-arm's length non-residents are required to occur under arm's length terms and conditions. Otherwise, adjustments will be made to ensure that the Canadian payer's transfer prices or cost allocations reflect arm's length terms and conditions.

Should the Canadian tax authorities adjust transfer pricing, penalties could apply if the taxpayer has not made reasonable efforts to determine and use arm's length transfer prices. Prescribed documentation must be maintained since a taxpayer who fails to do so will not be considered to have made "reasonable efforts" to determine and use arm's length transfer prices.

Multinational business groups with more than EUR750 million in annual consolidated revenues must file a country-by-country report containing various financial and operational information. Country-by-country reporting requirements in Canada were added in congruence with recommendations made as part of the OECD Base Erosion and Profit Shifting (BEPS) project.

4.5 Related-Party Limited Risk Distribution Arrangements

Related-party limited risk distribution arrangements should reflect arm's length terms and conditions in line with the transfer pricing principles outlined in **4.4 Transfer Pricing Issues**.

In addition, consideration should be given to Article 12 of the OECD Multilateral Instrument regarding the avoidance of permanent establishment status through the use of an agent that is not independent.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Canadian transfer pricing rules are generally in line with the OECD principles.

4.7 International Transfer Pricing Disputes

The Canada Revenue Agency (CRA) encourages taxpayers who are subject to double taxation to consider the Mutual Agreement Procedure (MAP) programme.

In its 2019 MAP Program Report, the CRA mentions that:

- it had 147 negotiable MAP cases as of 1 January 2019, involving taxpayers from 23 different jurisdictions, with the USA representing 48% of these MAP cases;
- during 2019, it accepted 75 new MAP cases and closed as many as 60;
- the average time to complete a negotiable MAP case was 17.6 months; and
- of the 60 MAP cases closed in 2019, 41 (68.3%) resulted in full relief from double taxation upon negotiation, five (8.3%) were withdrawn by the taxpayer, and four (6.7%) were resolved via domestic remedy. In the remaining ten cases (16.7%), either the objection was not justified, unilateral relief was granted, partial relief was obtained, no agreement was made or MAP access was denied.

5. KEY FEATURES OF TAXATION OF NON-LOCAL CORPORATIONS

5.1 Compensating Adjustments when Transfer Pricing Claims Are Settled

Under domestic law, upward and downward adjustments can be made to transfer pricing disputes. It should be noted that downward adjustments are made only if, in the opinion of the tax authorities, the circumstances indicate the adjustments are appropriate.

The CRA has mentioned that it may decide not to exercise its discretion with regards to downward adjustments where the taxpayer's request has been prompted by the actions of a foreign tax authority. The taxpayer has the right to request relief under the MAP article of the applicable treaty, or such request can be considered abusive.

Unless the issue is one that the CRA has decided not to consider, as a matter of policy, the CRA is willing to negotiate MAP cases when taxpayers themselves initiate a downward transfer pricing adjustment in Canada within the treaty time limits. The CRA will engage in the MAP process if the other jurisdiction is willing to make a corresponding upward adjustment, provide a position statement and engage in negotiations. This approach is said to be consistent to avoid both double taxation and double non-taxation.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

A non-Canadian entity may operate in Canada through a subsidiary or a branch.

Through a Canadian Subsidiary

Assuming it is a resident of Canada for tax purposes, a Canadian subsidiary will be taxed on its worldwide income from all domestic law sources. In general, a corporation is a Canadian resident if it is incorporated or has its central management and control in Canada.

Subject to treaty relief, the Canadian subsidiary will have to withhold tax on several types of payments to non-residents, including dividend distributions, interest paid to non-arm's length parties, participating interest, certain management or administration fees and rents, royalties and similar payments.

Through a Canadian Branch

Under the branch scenario, the non-resident corporation will be liable for income tax on its Canadian-source business income at the same rates as Canadian resident corporations.

Moreover, and as a general rule, a 25% branch tax (which may be reduced under certain tax treaties to the rate applicable to dividend distributions) will apply to the after-tax profits of a non-resident corporation that are not invested in qualifying property in Canada.

The branch tax is intended to approximate the withholding tax that would have applied to taxable dividends from a Canadian subsidiary if the non-resident corporation had incorporated a Canadian subsidiary to carry on business in Canada instead of using a branch.

5.3 Capital Gains of Non-residents

Generally, Canada does not tax the capital gains realised by a non-resident on the disposition of shares of a Canadian resident corporation.

An exception to that principle applies if the disposed shares qualify as "taxable Canadian property" (ie, shares of corporations that are not listed on a designated stock exchange) and if more than 50% of the fair market value of the shares was derived from one or any combination of the following at any time in the previous 60-month period:

- real or immovable property located in Canada;
- resource property located in Canada;
- timber resource property located in Canada; or
- options or interests in any of the above.

In general, tax on the disposition of taxable Canadian property should not result in double taxation for a non-resident residing in a jurisdiction with which Canada has a tax treaty.

5.4 Change of Control Provisions

Change of control provisions will not trigger immediate tax or duty charges. However, the following occurs when there is a change of control:

- the taxation year of the corporation is deemed to end, and a new taxation year is deemed to begin;
- the corporation cannot deduct non-capital loss carry-forwards unless it carries on the business that gave rise to the loss for a profit or with a reasonable expectation of profit. In such case, the losses are deductible only against the corporation's income from the same or a similar business;
- the corporation's net capital loss carry-forwards expire;
- accrued capital losses cannot be carried forward; and
- the carry-forward of ITCs is restricted following the change of control.

The disposal of an indirect holding in a Canadian corporation higher up the foreign group could trigger the change of control provisions because "indirect control" has to be considered, as well as "direct control".

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There is no mandatory formula to determine the income of a foreign-owned local affiliate selling goods or providing services in Canada. Transactions with the corporate group's foreign entities should rely on the "arm's length principle" of the transfer pricing rules.

5.6 Deductions for Payments by Local Affiliates

Generally, a local affiliate's expenses are non-deductible, unless they are made or incurred for the purposes of earning income from a business or property. Hence, local affiliate expenses that are made or incurred for the purposes of earning foreign business or property income would normally be deductible to reduce the taxpayer's net income.

5.7 Constraints on Related-Party Borrowing

Canada has a set of thin capitalisation rules that may apply where the lender to a Canadian corporation is a non-resident person who, alone or with other related persons, owns more than 25% of the Canadian corporation's shares (by vote or value). The interest expense on the loan would otherwise be deductible to the Canadian corporation. These rules may also apply to trusts and to partnerships of which a Canadian-resident corporation is a member.

The acceptable level of non-arm's length interest-bearing debt allowed for the Canadian thin capitalisation rules is a debt-to-equity ratio of 1.5:1. Interest deduction will be limited proportionally if a debtor's outstanding debts to a "specified non-resident shareholder" exceed that ratio.

Any non-deductible "excess" interest is treated as a dividend for withholding tax purposes and would trigger withholding tax at a rate of 25% (which may be reduced under certain tax treaties).

Debt financing provided by a Canadian corporation to its non-resident shareholders or any other non-resident persons connected to the non-resident shareholders is generally deemed to be a dividend paid to the non-resident and is subject to Canadian withholding tax at a rate of 25% (which may be reduced under certain tax treaties).

Notable exceptions are where the loan is repaid within one year after the end of the lender's taxation year, and the repayment is not part of a series of loans and repayments. In such a scenario, the loan is considered "pertinent loan or indebtedness" (PLOI) under the PLOI regime, which requires the Canadian corporation to include a deemed interest income in its taxable income.

6. KEY FEATURES OF TAXATION OF FOREIGN INCOME OF LOCAL CORPORATIONS

6.1 Foreign Income of Local Corporations

A Canadian resident corporation is subject to Canadian corporate income tax on worldwide income. Foreign income is taxed in Canada at the same federal corporate tax rate as local income, which does not include provincial taxes.

However, if a corporation has income sourced from another country and is taxed in that other country, it could be entitled to apply for foreign tax credits against its tax payable in Canada to prevent double taxation on the same income. Separate foreign tax credit calculations are prescribed for business and non-business income on a country-by-country basis.

6.2 Non-deductible Local Expenses

Generally, local expenses are non-deductible unless they are made or incurred to earn income from a business or property. Hence, local expenses made or incurred for the purpose of earning foreign business or property income would normally be deductible to reduce the taxpayer's net income.

6.3 Taxation on Dividends from Foreign Subsidiaries

Canadian taxation of a dividend received from a foreign corporation will depend on the foreign corporation's qualification. As a general rule, dividends must be included in computing the recipient's taxable income. If the foreign corporation is not a foreign affiliate (FA) of the dividend recipient, no relief will be available for the foreign corporation's underlying taxes. An FA is a foreign corporation of which a Canadian corporation owns an equity percentage of at least 1% of any class of its outstanding shares, and the same Canadian corporation owns – alone or together with related persons (individuals or corporations) – an equity percentage of at least 10% of any class of its outstanding shares, in which the notion of "equity percentage" refers to shares held directly or indirectly, through another entity.

When an FA pays a dividend to a Canadian corporation, the FA's surplus account must be determined. The four different surplus accounts (exempt surplus, taxable surplus, hybrid surplus and pre-acquisition surplus) accumulate differently.

Exempt Surplus Treatment

An exempt surplus is generally active business income earned by an FA that carries on an active business in a country with which Canada has signed a tax treaty. A dividend from this surplus account is fully deductible to the Canadian parent corporation receiving it. If the FA is in a non-treaty country, the dividend paid to the Canadian parent may also qualify as exempt surplus if the foreign country has entered into a tax information exchange agreement with Canada.

Hybrid Surplus Treatment

Hybrid surplus will generally include 100% of any gains from the sale of shares of an FA and/or partnership interest by another FA. Dividends out of hybrid surplus are only included in the Canadian corporation's taxable income at a rate of 50%.

Taxable Surplus

Taxable surplus generally captures "net earnings" from an active business carried on by the FA in a country with which Canada does not have a tax treaty and in respect of its foreign accrual property income (FAPI – see **6.5 Taxation of Income of Non-local Subsidiaries under Controlled Foreign Corporation-Type Rules**). Dividends paid out of this surplus account will be taxable in Canada if the FA's foreign tax rate is lower than Canada's tax rate.

Pre-acquisition Surplus Treatment

Finally, a dividend from a pre-acquisition surplus is a fully deductible capital return that reduces the cost of the shares in the FA.

6.4 Use of Intangibles by Non-local Subsidiaries

Non-Canadian subsidiaries can use intangibles developed by Canadian corporations. However, the Canadian corporation that owns and markets the intellectual property must charge an arm's length price to the related entity for the use of the intangible under the transfer pricing rules. The income earned from this agreement with the foreign subsidiary, such as royalties from a licensing agreement, is taxable in Canada for the Canadian parent.

6.5 Taxation of Income of Non-local Subsidiaries under Controlled Foreign Corporation-Type Rules

Canadian corporations are taxed on the FAPI of an FA controlled by the Canadian taxpayer (controlled foreign affiliate – CFA) in the proportion of ownership in the CFA. FAPI is essentially passive income generated in the CFA, notably property income and capital gains. For example, if a Canadian corporation controls 80% of the CFA, 80% of the FAPI earned in the CFA at the end of each taxation year will have to be reported in the controlling Canadian corporation's tax return.

If the CFA is taxed in the foreign jurisdiction, the Canadian parent is allowed an equivalent deduction known as foreign accrual tax to avoid double taxation. It is also possible to generate a foreign accrual property loss, which can apply against FAPI.

This position is no different for foreign branches of Canadian corporations, since the Canadian resident taxpayer is subject to tax on its worldwide income, subject to foreign tax credits to which it may be entitled.

6.6 Rules Related to the Substance of Non-local Affiliates

Canadian domestic legislation does not directly require substance in foreign subsidiaries. However, where an FA does not employ more than five full-time employees (or five full-time equivalent hours) in the active conduct of its business, the income of such business will constitute FAPI of the FA.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

A Canadian resident corporation is taxable in Canada on its worldwide sources of income, including capital gains from the sale of FAs. Only half of the capital gain is included in the taxpayer's net income in Canada (as described in detail under **2.7 Capital Gains Taxation**).

7. ANTI-AVOIDANCE

7.1 Overarching Anti-avoidance Provisions

The ITA contains a General Anti-Avoidance Rule (GAAR) that applies to abusive tax avoidance cases where the ITA provisions result in a tax benefit outside of their original purpose. A transaction is considered an avoidance transaction when all three of the following conditions are met:

- tax benefit must result from one transaction or a series of transactions, namely a reduction, avoidance or deferral of tax or an increased tax refund;
- tax benefit resulting directly or indirectly from a transaction that is considered an avoidance transaction, unless the transaction can reasonably be undertaken, or arranged primarily for business purposes, other than to obtain a tax benefit; and
- tax avoidance as a result of not being able to reasonably conclude that the tax benefit is consistent with the object, spirit or purpose of the provision invoked by the taxpayer.

It is incumbent on the taxpayer to establish that the first two conditions do not apply, while the burden for the third condition lies with the tax authorities.

Any GAAR issued assessment will have to be reviewed by a committee established by the CRA. If the CRA establishes abusive tax avoidance, the GAAR will apply and the tax benefit will be denied. If there is ambiguity with respect to abusive tax avoidance, benefit of doubt is given to the taxpayer.

8. AUDIT CYCLES

8.1 Regular Routine Audit Cycle

Canadian tax law does not outline specific rules regarding audit cycles; thus, Canada has no periodic routine audit cycle. Tax audits are typically carried out at the tax authorities' discretion. As such, an audit of a timely filed tax return can be conducted at any time by the Canadian tax authorities with all due dispatch.

The Audit Process

Auditors have consequential investigative powers and may require the filing and disclosure of documents and information necessary for the assessment.

In general, the audit may begin with a formal demand letter requesting access to specific information, a physical visit to the place of business and/or a meeting with the individual taxpayer. In addition, the auditor may request, and be granted, access to third-party information, including banking and supplier documents and, to a limited extent, accountant files.

The process usually results in a draft or preliminary assessment, allowing for a 21-day window for the taxpayer to submit new information regarding the draft assessment issues. The formal time limit for issuing a reassessment notice is three years following the initial assessment notice for a given year. However, this time limit may be extended in cases of negligence and/or fraud. Some corporations will also face varying deadlines depending on the nature of the audit.

9. BEPS

9.1 Recommended Changes

Canada has implemented the BEPS recommended changes, as follows.

- Action 1: "Address the tax challenges of the digital economy" – since 1 July 2021, foreign-based vendors selling digital products or services to Canadian consumers are required to register for, collect and remit sales tax on their taxable sales, and Canada has proposed to implement a corporate tax on corporations providing digital services, with effect from 1 January 2022. These propositions would apply until a common approach acceptable to Canada and its international partners comes into force.

In October 2021, a statement of the OECD/G20 Inclusive Framework on BEPS on a Two-Pillar solution to further this action was proposed and accepted by more than 130 countries, including Canada. Pillar One is focused on nexus and profit allocation, applying to certain multinational enterprises (MNEs) that have consolidated revenues of more than EUR20 billion and profitability margins exceeding 10%. This pillar indicates that, regardless of whether an MNE has a physical presence in a country, a portion of profits is to be reallocated from the MNE's home country to the countries where the MNE earns profits. Canada has a strong preference for the multilateral approach, which yet has to be adopted by OECD members. In the interim, Canada has proposed a Digital Services Tax to protect its interests.

Pillar Two is focused on a global minimum corporate tax rate of 15% on profits for MNEs with revenues of more than EUR750 million. Canada committed to implement Pillar Two in its domestic legislation.

- Action 2: "Neutralise the effects of hybrid mismatch arrangements" – Canada has proposed to implement the recommendations made by the OECD.
- Action 3: "Strengthen CFC Rules" – Canada has adopted CFC rules and applies a rather wide definition of CFC and legal and economic control tests to define a CFC.
- Action 4: "Limit base erosion via interest deductions and other financial payments" – Canada has proposed to introduce a rule that will limit interest deductions made by certain Canadian entities and branches of non-resident taxpayers to a proportion of their tax EBITDA. Although legislative proposals have not been released, these proposals would be introduced as of 1 January 2023.
- Action 5: "Counter harmful tax practices more effectively, taking into account transparency and substance" – Canada agreed to exchange information regarding cross-border rulings relating to preferential regimes, to transfer pricing legislation, to downward adjustment not directly reflected in the taxpayers' accounts, to permanent establishment determination, and to related-party conduit rulings.
- Action 6: "Prevent treaty abuse" – Canada announced that it would adopt the principal purpose test to address treaty abuse in 2017, according to the OECD's minimum standard. The principal purpose test is an anti-abuse provision that seeks to deny treaty benefits where one of the main objectives of an arrangement or transaction is to obtain treaty benefits.
- Action 7: "Preventing the artificial avoidance of permanent establishment status" – Canada will not include the new definition of a permanent establishment in its tax treaties to reflect the recommendations set out in this Action 7.
- Actions 8 to 10: "Transfer pricing" – Canada's transfer pricing guidelines are consistent with those established by the OECD.
- Action 12: "Disclosure of aggressive tax planning" – Canada proposed revisions to widen the range of transactions that will be required to be reported. For example, this requirement will extend to reporting uncertain tax treatments for specified corporations. Draft legislation is still pending, and the application of the revisions should only apply to taxation years beginning after 2021.
- Action 13: "Re-examine transfer pricing documentation" – Canada implemented country-by-country reporting from 1 January 2016. This reporting applies to multinational corporations whose total annual consolidated group revenue is EUR750 million or more. Such corporations will be required to file a country-by-country report with the CRA within one year of the end of the fiscal year to which the report relates.
- Action 14: "Dispute resolution" – Canada has reviewed stage two of Action 14 and has made recommendations. Canada opted for the mandatory binding agreement as proposed by BEPS Action 14.
- Action 15: "Develop a multilateral instrument" – Canada ratified the Multilateral Instrument (MLI) in 2019. The MLI applies to some of Canada's tax treaties, effective as early as 1 January 2020, for Canada's treaty partners that have also ratified the MLI.

Where Canada has not implemented specific legislative changes concerning the above-mentioned BEPS Actions, it can generally be explained by the fact that it has introduced a series of measures over the past decade to prevent perceived abuses also targeted by the BEPS Actions.

9.2 Government Attitudes

Canada has been actively involved in the BEPS project deployed by the G20 and OECD, and continues to work with the international community to ensure a coherent and consistent response to BEPS. Canada has endorsed all the recommendations developed under the BEPS project. Canada and other G20 members believe that broad and consistent implementation will be critical to the project's effectiveness. While some BEPS Actions have already been implemented, Canada is continuing to analyse recommendations related to other aspects of BEPS.

Pillars One and Two

Although Canada wishes to abide by the multilateral approach by way of Pillar One, it released draft legislation to carry out its own domestic Digital Services Tax (DST), which will apply as of 1 January 2024 if the OECD's multilateral approach to Pillar One is not implemented by that date. The DST will concern revenue earned commencing on 1 January 2022.

Canada committed to implement Pillar Two in its domestic legislation.

9.3 Profile of International Tax

International taxation has gained a high public profile in Canada, with the government taking active steps in the fight against aggressive international tax avoidance, protecting the Canadian tax base and enhancing the overall fairness and transparency of Canada's tax administration.

9.4 Competitive Tax Policy Objective

Canada recognises the significance of business income tax in improving its international competitiveness. It believes that certain BEPS Actions will enhance Canada's international competitiveness.

9.5 Features of the Competitive Tax System

Canada has implemented several tax incentives for Canadian businesses, such as income tax credits for activities relating to research and development, which has stimulated the Canadian economy and increased investments.

9.6 Proposals for Dealing with Hybrid Instruments

BEPS Action 2 seeks to neutralise the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction.

In 2021, Canada proposed to implement the BEPS Action 2 recommendations, with appropriate adaptations to the Canadian income tax context. Canada proposed to introduce new rules to address "hybrid mismatch arrangements", which would be implemented as two separate legislative packages, respectively applicable as of 1 July 2022 and after 2022.

Under these main proposed rules, payments made by Canadian residents under hybrid mismatch arrangements would not be deductible for Canadian income tax purposes to the extent that they give rise to a further deduction in another country or are not included in the ordinary income of a non-resident recipient. Conversely, to the extent that a payment made under such an arrangement by a non-resident of Canada is deductible for foreign income tax purposes, no deduction in respect of the payment would be permitted against the income of a Canadian resident. Any amount of the payment received by a Canadian resident would also be included in income, and, if the payment is a dividend, it would not be eligible for the deduction otherwise available for certain dividends received from foreign affiliates.

Canada also relies on the GAAR to prevent undue tax benefits.

9.7 Territorial Tax Regime

Canada has a worldwide tax regime for resident corporations' income but has some aspects of a territorial tax regime for its FAs.

For example, all dividends derived from active income earned by an affiliate will be fully exempt from tax if the affiliate is a resident of and earns active income in a country with which Canada maintains a tax treaty. However, passive income is treated as FAPI. As the primary base erosion measure, FAPI rules classify interests, royalties, rents, other passive investment income and unincorporated foreign branches' income as taxable. Regardless of whether or not the profits are repatriated, FAPI income is taxed on a current basis to mitigate the tax advantage of shifting domestic income to low-tax jurisdictions.

9.8 Controlled Foreign Corporation Proposals

This question is not applicable in Canada.

9.9 Anti-avoidance Rules

Recent case law on the application of the GAAR to perceived abuse of a tax treaty concluded that whether the income is subject to taxation in a foreign jurisdiction (double non-taxation situation) and the residence of the ultimate shareholder were irrelevant in determining whether a transaction is abusive, and that treaty shopping arrangements are not inherently abusive for Canadian tax purposes.

The introduction of the modified preamble and the principal purpose test in the MLI makes it uncertain that this case law can be relied upon in the future.

9.10 Transfer Pricing Changes

BEPS Actions 8 to 10 addressed several transfer pricing areas related to the arm's length principle and introduced significantly revised guidance in the form of amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Canada has played an important role in developing additional guidance on issues identified in the course of the BEPS Project and believes that the current Canadian practices are consistent with the OECD transfer pricing guidelines.

9.11 Transparency and Country-by-Country Reporting

Canadian country-by-country reporting legislation generally conforms to the OECD model legislation, with the notable exceptions that it has not adopted the OECD's master or local file requirements. Under domestic law, contemporaneous transfer pricing documentation is required in place of the local file requirements. As recommended by BEPS Action 13, country-by-country reporting applies to multinational enterprises with an annual consolidated group revenue equal to or exceeding EUR750 million in the previous year, and applies for fiscal years beginning on or after 1 January 2016.

Reports filed are automatically exchanged with other jurisdictions in which the multinational business group operates, provided that the other jurisdiction has implemented country-by-country reporting legislation, that both Canada and the other jurisdiction have a legal framework in place for the automatic exchange of information, and that both have entered into a qualifying competent authority agreement.

9.12 Taxation of Digital Economy Businesses

Canada has proposed implementing a tax on corporations providing digital services, which will apply to revenue earned from 1 January 2022 unless a multilateral agreement is reached by 2024. Canada remains committed to a multilateral solution but is concerned about the delay in arriving at a consensus.

Canada's digital services tax would apply at a rate of 3% on certain revenue earned by large businesses from certain digital services reliant on the engagement, data and content contributions of Canadian users, as well as on certain sales or licensing of Canadian user data.

The digital services tax would apply to large businesses, both foreign and domestic, that meet both of the following revenue thresholds:

- a total revenue threshold of EUR750 million; and
- a Canadian revenue threshold of CAD20 million.

If a taxpayer is a member of a consolidated group, these thresholds would be calculated on a group basis.

With regard to In-Scope Revenue, the four proposed categories in the legislation are:

- online marketplace services revenue;
- online advertising services revenue;
- social media services revenue; and
- user data revenue.

In addition, Canada has agreed to implement Pillar Two in its legislation as of 2023 to adopt a global minimum corporate tax rate of 15% on profits for MNEs with revenues above EUR750 million.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Offshore intellectual property deployed within Canada may result in taxation under generally applicable Canadian principles. Royalties paid to foreign recipients are among the categories of income subject to withholding tax. The 25% withholding rate may be reduced by treaty.

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