Doing Business in Canada

Prior to a United States company carrying on business in Canada, careful planning is required. Choosing the right business structure can significantly reduce exposure to Canadian income tax. Currently, the highest marginal combined federal and provincial individual income tax rate is 50% (in Nova Scotia).

In addition to tax issues, careful consideration must be given to Canadian foreign investment regulation, financing alternatives, securities regulation, immigration procedures, employment law, directors and officers liability, international trade regulations, competition law, sale of goods and consumer protection, franchising, and intellectual property concerns.

What is Subject to Taxes?
Similar to the U.S., Canada has multiple taxing jurisdictions. The federal government of Canada and each of its provinces and territories have the ability to levy income and sales taxes (excluding Alberta, which does not have a sales tax regime). Unlike the U.S., the provinces generally follow the federal government’s lead when enacting income tax legislation. As a result, the starting point will usually be to examine the ability of the federal government to assess tax on a U.S. entity's activities in Canada.

The federal government's ability to tax is outlined in the Income Tax Act (Canada) (the "Act"), which allows Canada to tax non-residents of Canada, including on income from business carried on in Canada. However, the Act does not specifically define the parameters of business carried on in Canada. The Act does deem certain activities of a non-resident to constitute carrying on business in Canada, such as offering anything for sale in Canada. Therefore, generally a U.S. entity selling goods into Canada is subject to Canadian income tax according to Canada’s domestic tax law.

While U.S. entities selling goods in Canada are deemed to be “carrying on business” in Canada, it does not necessarily mean that Canadian tax will be payable on this net income. Canada and the U.S. have entered into a bilateral Tax Treaty with respect to taxation, providing agreed upon rules to be used to determine when a resident of one country will be subject to tax in the other country.

Permanent Establishments
Under the Treaty, a U.S. corporation carrying on business in Canada will be exempt from Canadian tax if it does not have an actual or deemed permanent establishment in Canada. A permanent establishment means a fixed place of business through which the business is carried on and includes a place of management, a branch, an office, and a factory.

An employee of a U.S. entity exercising authority, in Canada, to conclude contracts in Canada is deemed to be a permanent establishment. The use of a Canadian independent sales representative in and of itself will not constitute a permanent establishment provided the representative is acting in the ordinary course of the representative's business.

If a U.S. corporation has a permanent establishment in Canada, that U.S. corporation is subject to Canadian tax only on the amount of business profits attributable to the permanent establishment.

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It should be noted that the permanent establishment is not a separate legal entity and only the actual expenditures of the corporation can be allocated and deducted to determine the business profits allocated to the permanent establishment. This precludes notional deductions, such as charging rent for the temporary use of owned equipment used by the permanent establishment in Canada.

A U.S. corporation carrying on business in Canada without a permanent establishment in Canada is required to file a federal tax return disclosing that it is claiming exemption under the Treaty. The tax return is due six months after the corporation’s fiscal year-end with no provision for extensions failing which it could incur a minimum penalty of C$100 increasing by C$25 per day late to a maximum of C$2,500.

**Unincorporated Businesses**

A U.S. unincorporated business, such as a proprietorship, carrying on business in Canada is subject to a slightly different rule in determining Canada’s ability to tax Canadian source profits.

The Treaty provides that independent personal services of a U.S. resident will only be taxable in Canada if the person has or had a fixed base regularly available in Canada. While this looks very much like the definition of a permanent establishment, caution should be taken in equating these terms as a fixed place of business can arise even where that place is temporary in nature.

An unincorporated entity with a fixed base in Canada is subject to tax in Canada on the business profits attributable to that fixed base.

An unincorporated entity claiming exemption under the Treaty does not have a Canadian filing requirement. However, where Canadian tax is withheld on payments received, it may be prudent to file a Canadian income tax return to claim a refund of tax withheld.

**Corporation**

A corporation is the form of entity most frequently utilized in Canada. As in the U.S., a Canadian corporation is a legal entity separate and distinct from the owners. The corporation has unlimited life and the shareholders are not typically liable for the debts or obligations of the legal entity. The corporation is taxed separately from the shareholders (see the tax rates section).

**Tax Rates**

Federal taxes on personal income are marginal, increasing with the amount of income. The 2011 federal marginal rates for individuals are: 15% on the first C$41,544 of taxable income; 22% on the next C$41,544; 26% on the next C$45,712; and, 29% on amounts in excess of C$128,800. In addition to federal income tax, provincial or territorial tax is also assessed on income. The marginal combined federal and provincial individual income tax rates currently vary from 39% (Alberta) to 50% (Nova Scotia).

The federal corporate tax rate is currently 16.5% effective January 1, 2011. Provincial corporate tax rates on general corporate income vary by province, ranging in 2010 from 10% (Alberta) to 16% (Nova Scotia and Prince Edward Island). Preferential rates are available for all or a portion of the active business income earned in Canada by "Canadian-controlled private corporations".

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Commodity and Sales Taxation
The federal government and most provincial governments also impose various taxes on the sale of goods and services and, in some cases, on the transfer of real property. These taxes include excise, sales and fuel taxes.

Excise and Value-Added Taxes
Canada imposes excise taxes and a multi-stage goods and services tax ("GST"). The GST is a 5% tax (2010) on the consumption of goods and services in Canada. GST is collected by all businesses at each stage in the production or marketing of goods and services and, due to a system of input credits, it is then paid by the ultimate consumer. Under this system, businesses collect taxes on sales and then claim a credit for any tax paid on their purchases. While most sales of goods and services are subject to GST, some goods and services are exempt or zero-rated.

Provincial Retail Sales Tax
All provinces, except Alberta, impose a sales tax. Manitoba, Saskatchewan and Prince Edward Island levy a retail sales tax directly on the purchaser, consumer or lessee of taxable goods and services. It is generally levied on the sale or lease price of the goods or services being taxed. Tax rates vary among provinces and range from 5% to 10%.

Five provinces (British Columbia, Ontario, New Brunswick, Newfoundland and Nova Scotia) have harmonized their retail sales tax with the federal GST. In these provinces, a harmonized sales tax ("HST") is (or will be) levied at the appropriate HST rate (12% in British Columbia, 15% in Nova Scotia and 13% in the other harmonized provinces) on the same goods and services as are subject to GST (rather than GST plus provincial tax). In Québec, a separate sales tax is levied, but it is generally applicable to the same goods and services as the GST.

Businesses providing goods or taxable services in a province that levies a retail sales tax must obtain a provincial vendor’s license. The licensed vendor then acts as an agent of the province by collecting the tax imposed on the purchaser or consumer. In the case of the GST/HST or the Quebec sales tax, a registrant is entitled to input credits to ensure tax is paid by the ultimate consumer. Other provinces use exemptions to achieve similar results. One such exception is provided for sales between licensed vendors, as long as the goods are acquired for resale and not for person consumption.

Provincial Taxes
As noted above, the federal government is one taxing jurisdiction and the provincial authorities follow its lead. If the U.S.-based business is exempt under the Treaty, it will not be subject to income tax at the provincial level.

If it is taxable, it will be taxable in any province in which there is a permanent establishment (for a corporation) or carries on business (for an unincorporated business). Under Canadian rules, 100% of the income of a business is subject to a provincial tax or it is subject to additional federal tax. The income is allocated to the provinces based on a formula using payroll and sales.
Conclusion
Canada and the U.S. share the world's longest undefended border. This proximity results in considerable commerce. In fact, the U.S. is by far Canada's largest trading partner. Prior to investing in Canada, a U.S. entity must become familiar with the complex tax laws of Canada and how they interrelate with the tax laws of the U.S. or risk surprising results. Companies are encouraged to evaluate their options based on their particular case and business objectives.

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