PERSPECTIVE

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When doing business in Canada, taxes matter

By Robert W. Wood

Canadian businesses frequently expand into the U.S. and they must be savvy about U.S. taxes. Similarly, U.S. businesses often expand into Canada, and they need to consider Canadian tax rules. However, perhaps because of American market dominance, Canadians generally do a better job of paying attention to U.S. tax considerations than the reverse.

Even U.S. businesses operating within Canada frequently may not have a clue about key steps — or missteps — they might make. These tax rules can shape how businesses expand across the border in ways you might not expect. One of the first legal considerations faced by U.S. businesses expanding into Canada is whether to separately incorporate in Canada. It is not legally required. In fact, one can simply operate in Canada through an unincorporated branch of the U.S. business.

However, most U.S. companies conduct business in Canada through a Canadian corporation. Typically it is a subsidiary of the U.S. parent. One advantage of a separate Canadian entity is the ability to create a clear delineation of functions, risks and income between the Canadian company and its U.S. parent.

Moreover, by using agreements between the two companies, profits can usually be shifted between them if it is later desirable to alter the financial outcome of the two entities. Having a Canadian subsidiary also isolates Canadian tax filing obligations. Having a separate Canadian company can generally reduce the extent to which the U.S. parent's operations and financials will be scrutinized in the Canadian tax filings.

Avoiding withholding. A separate Canadian subsidiary also helps limit any Canadian withholding on monies sent to the U.S. There are many types of tax withholding beyond payroll taxes. In fact, when one encounters multiple countries there is usually a withholding tax regime. The idea is that the only time the taxing authorities can get money for certain is when they know taxes are being withheld and remitted to them directly.

Canadian tax rules provide a 15 percent withholding on amounts paid to a nonresident for services physically rendered in Canada. Having a Canadian corporation generally avoids this rule so monies can be freely transferred in both directions across the border. Without a Canadian company, it isn't so easy. U.S. enterprises doing business in Canada through an unincorporated branch must resort to seeking waivers of the withholding.

Withholding can be a problem when Canadian profits are sent back to the U.S. However, paid-up capital in a Canadian company can be repatriated to the U.S. free of Canadian tax. Paid-up capital is stated capital under Canadian corporate law, subject to certain adjustments. U.S. businesses that establish a Canadian subsidiary often want to maximize paid-up capital since it can be repatriated free of withholding tax to non-Canadian shareholders.

Issuing debt or equity. If a U.S. company forms a Canadian subsidiary, basic capitalization questions should be asked. U.S. businesses face these issues too on this side of the border, but these issues can be more sensitive in Canada. Should the subsidiary issue stock to its U.S. parent, issue debt, or issue both stock and debt?

Moreover, if both stock and debt will be issued, what is an acceptable range of ratios between stock and debt? Usually, both stock and debt will be issued. However, Canada has thin capitalization rules that are more rigorous than their counterparts in U.S. tax law. These rules can limit the deductibility of interest on debt owed by a Canadian subsidiary to its foreign parent.

Hybrid entities. As noted, forming a Canadian corporation will usually be preferable to operating an unincorporated branch of a U.S. business in Canada. However, a U.S. company may not want to form a Canadian corporation but may want to launch a hybrid entity. Canadian unlimited liability corporations (ULCs) and U.S. limited liability companies (LLCs) can be treated as disregarded entities or partnerships for U.S. federal income tax purposes.

Critically, though, they may be taxed as corporations for Canadian income tax purposes. These hybrid entities lead to a change in the U.S.-Canada tax treaty in 2010 that can trigger a 25 percent Canadian withholding tax in some cases. Thus, extra care with these hybrid entities is required.

Buying assets or shares. Often, a U.S. business's expansion into Canada receives a jump start by buying an existing Canadian business. But should the purchase be of stock or assets in the Canadian company? Many U.S. business people are aware that when someone buys a company in the U.S., the buyer usually wants to buy assets, not stock. That way the buyer isn't acquiring all the historical liabilities of the target. Furthermore, by buying assets, the buyer gets a stepped-up tax basis in the assets.

In contrast, sellers in the U.S. usually want to sell stock, primarily because of tax reasons. A U.S. seller of a C corporation pays only a single level of tax upon selling stock. If the C corporation sells its assets, however, the corporation will pay one tax and the amount distributed to shareholders will then be taxed a second time. For that reason, there is often a tension in sale negotiations centered around these issues. The rules for S corporations and LLCs are more flexible so one generally does not face the same double-tax problem one does for C corporations.

Based on their experience with U.S. buyers and sellers, many U.S. businesses assume that Canadians would only sell stock. The assumption seems to be that selling stock would be favorably taxed in Canada, as it would be in the U.S.

However, unlike the U.S. tax system, Canada generally applies an integrated approach to the tax treatment of acquisitions. Thus, Canadian tax law taxes a company and its shareholders in a similar fashion regardless of how the sale is structured.

A Canadian corporation may sell its assets and then distribute the after-tax proceeds to its Canadian shareholders. Put another way, whether the transaction is a stock or an asset sale, the Canadian taxes should be about the same. In general, the after-tax cash proceeds for the shareholder should not be substantially different from the after-tax cash proceeds such shareholders would receive in a stock transaction. On the other hand, the purchaser will have the benefit of a step-up in the depreciable assets.

Conclusion

The U.S. tax system is considerably more complex than the Canadian system. Of course, given the market dominance of the U.S., our tax system is also considerably more important, especially to American businesses. Yet the lure of Canadian market share can be strong and many U.S. companies do business in Canada. A little planning can go a long way.

In some cases, businesses find that U.S. tax considerations point to one way of effectuating a business goal, while Canadian tax considerations point to another. Evaluating alternatives and tradeoffs should be part of the process.

Despite the cursory summary here, U.S. businesses contemplating an expansion into Canada should get some specialized tax advice. Prudence dictates obtaining Canadian tax advice before launching a Canadian expansion or acquisition.

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