

# A Brief Overview Of Canadian Taxation

Canada has three levels of government which levy taxes: The federal government, 10 provinces (and 3 territories) and municipal governments. Only the federal and provincial governments (including the territories) levy income taxes.

The tax liability arising from your investment in Canada will depend on a number of factors, including residence, the province in which you invest, the legal entity used to make the investment and the nature of the income it generates.

## ***Residence: The Basis Of Taxation***

Like many countries (including Germany), Canada taxes on the basis of residence. Tax legislation does not specifically define residence, although it does include several rules under which an individual may be “deemed” to be resident. But in general, residence is determined by common law principles developed over many years. Under these rules, an individual is generally considered to be resident if he has a “continuing state of relationship” with Canada as evidenced by a dwelling held for year-round use, the presence of a spouse or other family members in Canada, or the maintenance of personal property or other social ties in Canada, such as bank accounts, furniture, club memberships, and other ties.

A corporation is considered resident in Canada if it was either incorporated in Canada or its mind and management are in Canada. A German incorporated company whose mind and management are in Canada will have its residence status determined by the competent authorities under the Canada-Germany Tax Treaty.

Residents of Canada, whether individuals or corporations, are subject to Canadian tax on their world income, regardless of where it is earned. Non-residents are only subject to income earned from Canadian sources. Therefore, unless you plan on taking up Canadian residence in the course of your investment, you need not be concerned that investing in Canada will subject your other sources of income to Canadian taxation.

## ***Taxation of Non-Residents***

Non-residents are subject to income tax on the following Canadian-source items:

- 1) Income from employment in Canada.
- 2) Income from “carrying on business” in Canada. The concept of carrying on business in Canada is quite broad. It includes soliciting orders or offering anything for sale in Canada, whether or not there is an actual physical presence.
- 3) Capital gains from the disposition of Taxable Canadian Property. This includes Canadian real property, property used or held in a business in Canada, eligible capital property in respect of or property included in the inventory of a business in Canada, shares of private corporations, shares of public corporations where the non-resident or related parties own more than 25% of the issued shares of any class of shares, and certain interests in partnerships and trusts. An interest in a foreign corporation or a trust will also be considered to be a taxable Canadian property if more than half of the entity’s property, held directly or indirectly, consists of Canadian real property (or other Taxable Canadian Property) and more than half of the value of the shares or trust interest is derived from Canadian real estate holdings (or other Taxable Canadian Property).

Canada also levies a 25% withholding tax on passive income such as interest, dividends, rents, royalties and pensions derived from sources in Canada.

The Canada-Germany Tax Treaty overrides these general rules for German residents in several respects.

First, only business income earned by a German resident through a permanent establishment (PE) in Canada will be subject to Canadian tax. A PE is a fixed place of business, such as a branch, office or factory, and includes a dependent agent or employee who has the authority to conclude contracts. Business income earned by making direct sales into Canada without a PE is exempt under the treaty. Similar relief is included in most of Canada’s other tax treaties. Effective for taxation years that begin after 1998, non-residents that are carrying on a business in Canada are required to file a return with the Canada Customs and Revenue Agency, if income earned is exempt from Canadian tax under a tax treaty.

Secondly, the treaty restricts Canada to taxing only capital gains derived from the disposition of a direct or indirect ownership in Canadian real estate or assets used in a business (see section entitled **Capital Gains** below).

German corporations (and other foreign corporations owned by German residents) will be exempt from the rule above for foreign corporations under the treaty. No treaty protection is available for German trusts or partnerships.

Capital gains from the sale of shares of a private or public corporation which is resident in Canada by a German resident will not be taxable in Canada, provided the corporation's assets are not primarily real estate.

It is worth noting that if a share transaction is exempt under the treaty, it will still be necessary to report the transaction and then claim treaty protection so that there is no tax.

Finally, the treaty reduces the withholding tax rate on most investment income to 15%. The exception is rental income from real property, which remains subject to the 25% rate.

The treaty also modifies the tax treatment of employment income, but this subject is beyond the scope of this book.

## ***Choosing a Structure for Your Investment***

There are no legal restrictions on the form of business organization you may use in making your investment. The choice will depend on factors such as the nature of the investment, the tax treatment (both in Canada and in Germany) and the investor's personal situation and objectives. There are however, some general considerations which may impact on the decision.

### ***Direct Investment by German Individual***

If you invest directly in assets that generate passive investment income, such as interest and dividends, you will only be subject to withholding tax at the reduced treaty rates (see **Portfolio Investments**).

If you purchase or start up a business with a permanent establishment in Canada, your business income will be subject to income tax under the same progressive federal tax rate structure that applies to Canadian residents. Rates range from 16% to 29%. The business income will also be subject to provincial taxes. As these tax rates vary by province, the applicable rate will depend on where the permanent establishment is located. The combined effect of these taxes produce rates that range from approximately 22% to approximately 49% depending on the level of income and the province where the permanent establishment is located.

For German purposes, the income from your Canadian business will be excluded from taxable income. However, the amount of any Canadian business income will be taken into account in determining your German tax rate.

If you sell assets used in your business, 50% of any capital gains realized will be subject to Canadian tax (see **Capital Gains** below). This is in contrast to the German treatment of such gains on German business assets, which are fully included in income. As for business income, the Canadian capital gains will not be further taxed in Germany.

German resident individuals with taxable income earned in Canada that is not earned in a province are not subject to provincial taxes. They are subject to the same federal tax rate structure that applies to Canadian residents, plus an additional federal tax of 48% of the basic federal tax (before surtaxes). Under proposals in the 2000 federal budget, this additional tax was reduced from 52% for 2000 and subsequent taxation years. This is intended to put non-residents on an equal footing with residents who pay provincial tax. The combined effect of these taxes produce rates that range from 23.68% to 42.92% depending on the level of income.

There is an important consequence of direct investment by an individual. Under Canadian law, when an individual dies, he is deemed to dispose of all assets at fair market value. A separate inheritance tax (Erbschaftsteuer) as in Germany does not exist. This may give rise to capital gains and an income tax liability on death. For this reason, some non-residents choose to hold significant investments or investments that are expected to appreciate in value through a non-resident corporation. While this strategy may not work for non-residents in general due to the capital gains rules (see **Capital Gains** below), German residents can continue to use German or other foreign corporations to eliminate the Canadian tax consequences arising on death due to provisions in the treaty.

## ***Investment through a Canadian Corporation***

### ***a) General Information***

A Canadian corporation is resident for tax purposes, and is therefore subject to tax on its world income from all sources. If you make your investment through a Canadian corporation, you would not normally use it to make other non-Canadian investments since you would be exposing this income to Canadian tax.

A Canadian corporation can be either a public or private corporation. A public corporation is a corporation which is either listed on a prescribed stock exchange in Canada, or has fulfilled prescribed conditions under which it has elected or been designated by the tax authorities to be a public corporation. In this

respect it is very similar to a joint stock corporation (Aktiengesellschaft) in Germany, and is generally only used if you intend to finance your investment by raising funds on Canadian markets.

A private corporation is a corporation which is not a public corporation and is not controlled in any way by one or more public corporations. It is similar to a German GmbH in that it is usually preferred for closely held businesses.

Both types of corporations can be formed under either federal or provincial jurisdiction. The choice as to which to use will generally depend on the different requirements for financial disclosure, residency requirements for directors and the location of the principal business activities. A federal corporation (incorporated under the Canada Business Corporations Act) can generally carry on business in any province, while provincially incorporated corporations (e.g. under the Ontario Business Corporations Act) must obtain an extra-provincial licence and register to do business in other provinces.

#### ***b) Tax Rates***

All corporations are subject to the same federal and provincial tax rates, regardless of whether they are public or private, or the jurisdiction in which they are incorporated (see the table on the following page). The provincial rates that apply depend on the jurisdiction in which the income is earned. Income earned through permanent establishments in more than one jurisdiction is allocated amongst the jurisdictions according to a formula that takes into account the gross revenues and salaries attributable to each establishment. Note that the federal government and several provinces provide reduced rates for manufacturing income of corporations.

	<b>Manufacturing Income</b>	<b>Other Business Income</b>
<b>Federal:</b> - rate	21.00	27.00 <sup>(1)</sup>
- surtax	1.12	1.12
<b>Provincial:</b>		
Newfoundland	5.00	14.00
Prince Edward Island	7.50	16.00
Nova Scotia	16.00	16.00
New Brunswick	17.00	17.00
Québec	9.04	9.04
Ontario	12.00 <sup>(2)</sup>	14.00 <sup>(2)</sup>
Manitoba	17.00	17.00
Saskatchewan	10.00	17.00
Alberta	14.50 <sup>(3)</sup>	15.50 <sup>(3)</sup>
British Columbia	16.50	16.50
Northwest Territories	14.00	14.00
Nunavut	14.00	14.00
Yukon	2.50	15.00

[Note: The above rates may not apply to certain types of industries where special provisions override (e.g. resource companies, financial institutions, insurance corporations, and others).

**Notes to Table:**

1. Rate effective January 1, 2001. Rate to be reduced to 25% effective January 1, 2002, to 23% effective January 1, 2003 and to 21% effective January 1, 2004.
2. Rate effective January 1, 2001.
3. Rate reduced to 13.5% effective April 1, 2001. Rate to be further reduced to 11.5% effective April 1, 2002, to 10.0% effective April 1, 2003 and to 8% effective April 1, 2004.

Most provinces have their corporate taxes levied by the federal government on the federal corporate tax return. Ontario, Québec and Alberta collect their own taxes and require their own calculations of taxable income, though these usually follow the federal rules.

A Canadian-controlled private corporation (CCPC) is a special type of private Canadian corporation that is not controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations or by any combination thereof. CCPCs are eligible for special tax reductions both federally (from 27% to 12%) and provincially (depends on province) on active business income under \$200,000. Under 2000 federal and Ontario budget proposals, which will be effective January 1, 2001, tax rate reductions and threshold changes will be made. Alberta has also announced tax rate reductions and threshold changes, effective April 1, 2001. Previously, it was possible to structure arrangements with 50-50 non-resident/Canadian ownership, with the non-resident essentially in control. Anti-avoidance rules now prevent

any arrangements that provide factual control to non-residents. In our experience, most Germans are unwilling to structure their investments as CCPCs.

After-tax income of a Canadian corporation can be paid out to its German shareholders in the form of dividends, in which case withholding tax will apply. There may also be German tax on the dividends. See **Repatriation of Funds** below for further details.

#### *c) Using a Canadian Holding Company*

There are a number of situations in which the use of a Canadian holding company may provide tax benefits. Such a company may be used to hold assets separately from other Canadian corporations in which the business activity is undertaken. Assets such as cash can be removed from the operating company to a holding company on a tax-free basis, since intercorporate dividends between two Canadian corporations are not taxed in Canada. Also, taxpayers often hold business assets such as land and buildings in a holding corporation and lease them to the operating company to protect them from business risk. This is related to the German concept of "Betriebsaufspaltung".

Using a Canadian corporation may provide other advantages for both German individuals and corporations in repatriating their original investment without selling it. A shareholder of a Canadian corporation is entitled to extract the paid-up capital of the corporation without tax consequences. See **Tax Considerations in Financing** below.

#### ***Investment through a Partnership***

A partnership is an arrangement whereby two or more persons combine some or all of their resources, skills or industry, in a business undertaking with a view to making a profit to be shared by all members of the partnership.

The most common forms of partnership are general and limited partnerships. In a general partnership (similar to a German Offene Handelsgesellschaft - OHG), the members are not only jointly liable (liable in equal shares) for the debts of the partnership, but in addition are severally liable (each member liable for the full amount).

A limited partnership (similar to a German Kommanditgesellschaft - KG) is composed of at least one general partner, who conducts and manages the business carried on by the partnership, along with one or more limited partners. A limited partner is normally liable to the partnership or its creditors only to

the extent of the capital he has agreed to contribute, and no more. He may share in profits according to a partnership agreement but may take no part in the management of the firm.

A member of a partnership may be either an individual or a corporation. Under Canadian rules, net income for tax purposes is calculated at the partnership level. Each partner's share of the different types of income of the partnership then flows out to him to be taxed in his hands.

For income tax purposes, the portion of a limited partner's share of business losses which may be used to reduce his income from other sources is limited to the partner's share of the capital of the partnership ("at-risk" amount) for income tax purposes. A similar rule has existed in German tax law since 1980 (sect. 15a EStG).

### ***Branch of a German Corporation***

A German corporation establishing a Canadian branch will be carrying on business through a permanent establishment for tax purposes. As such, it will be subject to corporate tax at the rates set out in the table on page 10.

Under the Canada-Germany Tax Treaty, the corporation's Canadian business income will be determined under the separate accounting method, with the branch treated as a separate business entity. Transactions between the branch and its head office or other non-Canadian branches must be carried out on an arm's length basis.

The after-tax profits of a branch that are available for repatriation and that are not reinvested in Canada are subject to an additional "branch tax" of 25% (reduced to 15% under the treaty). This tax attempts to equalize the total tax burden of branches and subsidiaries: profits of a branch can be withdrawn without further taxation whereas profits of a subsidiary can only be repatriated by way of dividends subject to withholding tax. Under the Canada-Germany Tax Treaty, the first \$500,000 of a branch's income is exempt. Subsidiaries do not receive a similar exemption when repatriating profits.

Canadian branch profits and losses are not included in income for German tax purposes.

Once a branch becomes profitable and has used up the \$500,000 branch profits tax exemption, the branch operation can be transferred to a Canadian corporation on a tax-free basis using special "rollover" provisions in the Canadian tax rules.

Also, if your Canadian investment is in corporate form, there will be a 15% Canadian withholding tax on dividends paid. Holding it through a German corporation will mean that 95% of any

dividends from the Canadian corporation will be exempt of German tax, regardless of the percentage ownership and holding period, effective 2001. If the investment were held directly by a German resident individual, effective 2001, 50% of the dividends would be taxable in Germany and the withholding tax could be claimed as a foreign tax credit. A withholding tax rate reduction to 5% on dividends paid is likely in the future under a renegotiated Canada-Germany Tax Treaty, if a German company holds the investment.

Finally, a branch (as opposed to a Canadian corporation) is not subject to the thin capitalization rules. However, proposals announced in the 2000 federal budget may change this, as Canadian branches of a non-resident corporation may be subject to the thin capitalization rules in the future (see **Tax Considerations in Financing**). A consultation process will be undertaken to determine what changes will be implemented.

The following table compares the combined German and Canadian tax consequences of earning \$100,000 of business income through various alternative structures available to a German individual or corporate investor, in 2001.

	GERMAN INDIVIDUAL INVESTOR				GERMAN CORPORATE INVESTOR		
	Direct	Through Canadian Corporation	Through German Corporation	Through Canadian Sub. of German Corp.	Direct - Branch of German Corporation	Through Canadian Subsidiary	
Taxable Income	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	
<b>CANADIAN TAX</b>							
Corporate Tax	N/A	28,120	28,120	28,120	28,120	28,120	
Federal Tax <sup>(1)</sup>	N/A	14,000	14,000	14,000	14,000	14,000	
Provincial Tax <sup>(1)</sup>	N/A	N/A	8,682	N/A	8,682	N/A	
Branch Tax <sup>(1)</sup>	N/A	42,120	50,802	42,120	50,802	42,120	
Total Corporate Tax	N/A	57,880	49,198	57,880	49,198	57,880	
Total After Tax	N/A	57,880	N/A	57,880	N/A	57,880	
Dividend to Non-Resident	N/A	8,682	N/A	8,682	N/A	8,682	
Withholding Tax <sup>(1)</sup>	33,536	N/A	N/A	N/A	N/A	N/A	
Personal Tax <sup>(1)</sup>	66,464	49,198	49,198	49,198	49,198	49,198	
<b>Net After-all Canadian Taxes</b>							
<b>GERMAN TAX</b>							
Corporate Tax	N/A	N/A	NIL	724 <sup>(1)</sup>	NIL	724 <sup>(1)</sup>	
Personal Tax	NIL <sup>(1)</sup>	5,354 <sup>(1)</sup>	11,931 <sup>(1)</sup>	11,755 <sup>(1)</sup>	N/A	N/A	
<b>NET RETURN</b>							
- for German individual investor	\$66,464	\$43,844	\$37,267	\$36,719			
- for German corporate investor					\$49,198	\$48,474	

**Notes to Table:**

1. Federal corporate tax is calculated for the 2001 calendar year.
2. Corporate rates, for 2001, for the Province of Ontario are used here.
3. 15% for German corporations (reduced from a statutory 25% rate) for profits not reinvested in Canada and exceeding C\$500,000, on a cumulative basis.
4. Withholding tax of 15% on dividends to German residents (reduced from a statutory rate of 25%).
5. German resident individual subject to both federal and Ontario income tax at 2001 rates and estimated income thresholds, assuming permanent establishment of business is in Ontario.
6. The Canadian income itself is not subject to further German taxation. However, the tax rate applicable to German or other income not excluded from German taxation may be affected.
7. From 1999 onwards, 5% of foreign dividends are deemed to be non-deductible expenses, attracting corporate tax in Germany at a rate of 25%, in 2001.

Effective 2001, the remaining 95% of foreign dividends received by a German corporation are tax-free in Germany, regardless of the percentage of ownership.

8. A German personal income tax rate of 48.5% minus a credit for Canadian withholding taxes paid is used here.
9. Assumes income earned through a German corporation is paid out as a dividend to the German individual taxed at 48.5%.

## ***General Canadian Tax Rules***

The following commentary outlines general Canadian tax rules that apply to most types of income and expenses. In the sections that follow, we'll examine additional rules that apply to more specific types of investments, such as portfolio investments, real estate and manufacturing operations.

Individuals are taxed on a calendar year basis, but may choose a different fiscal period for their business. If a non-calendar fiscal year is selected, income is adjusted on a prorata basis to reflect an estimate of income on a calendar year basis. Corporations are taxed on a fiscal year basis.

Generally, the starting point for calculating taxable income is the accounting income of the entity, determined in accordance with normal commercial practices. However, there are a number of specific rules which adjust accounting income to income for tax purposes, the most important of which are outlined below.

**a) Business Deductions** - Generally, two conditions must be met in order for an expense to be deductible for Canadian tax purposes. First, it must be incurred for the purpose of earning business or property income. The connection between the expense and the

income earned need not be direct, but the expense must contribute in some way to the income earning process. Secondly, the expense must be reasonable in the circumstances. Outlays of a personal or living expense nature are not allowed.

Most expenses recognized for accounting purposes will meet these conditions. However, certain expenses are specifically denied, regardless of the purpose for which they were incurred. Club dues and membership fees for sporting or recreational clubs, and the expenses of ownership, use or maintenance of a camp, lodge, yacht or golf course or similar facility are not deductible. Also, 50% of all business meals and entertainment expenses are disallowed.

**b) Tax Depreciation** - Under Canadian tax rules, tax depreciation is referred to as "capital cost allowance" (CCA). The costs of capital assets are added to pools according to the class of asset and its use, with each class having its own CCA rate. Most classes are depreciated on a declining balance basis, although a few, such as leasehold improvements, are written off on a straight line basis over some measure of the life of the asset determined by specific rules. When an asset is sold, the proceeds of disposition up to the original capital cost of the asset are deducted from the pool balance.

At the end of each fiscal year, if assets in the pool are still on hand, the balance in the pool is multiplied by the applicable rate to determine the maximum CCA that may be claimed. Taxpayers may claim any amount up to the maximum. The amount claimed is deducted from the pool and the balance is carried forward to be deducted in future years.

For most classes of assets, the cost of acquisitions in the year less the proceeds of any dispositions are only counted as one-half in the year of acquisition (the half-year rule - do not confuse this with the "half-year rule" existing in Germany for the depreciation of newly acquired assets). If the pool balance becomes negative (due to proceeds of disposition exceeding the pool balance), the amount is taken into income as "recapture" of depreciation. If the pool has a positive balance but no assets remain, the balance may be written off in the year as a terminal loss.

**c) Election to Capitalize the Cost of Borrowed Money** - Instead of deducting items such as borrowing costs and interest, a taxpayer may elect to add them to the cost of the depreciable property in respect of which the expenses were incurred. This is advantageous when a business is in the start-up period and revenues are small or non-existent. Rather than adding to business losses which may expire before sufficient profits have been generated, such costs may be effectively deferred and later claimed as capital cost allowance.

**d) Capital Gains** - A capital gain arises when the proceeds of disposition of a capital asset exceed its original cost and selling expenses. Only 50% of a capital gain (the taxable capital gain) is included in income. Only 50% of a capital loss (the allowable capital loss) is deductible, and only against capital gains. Capital losses may be carried back three years and forward indefinitely. Note that the 50% inclusion rate is applicable for capital gains and capital losses realized after October 17, 2000. The applicable inclusion rate for capital gains and capital losses realized prior to February 28, 2000 was 75%, and the applicable inclusion rate for the period February 28, 2000 to October 17, 2000 was 66 2/3%.

Under the Canada-Germany Tax Treaty, gains from the sale of immovable property, the sale of business assets, the sale of interests in real estate companies, as well as ships and aircraft, are generally taxable in Canada. Other gains realized by German residents are taxable in Germany, to the extent they are taxable under German domestic law.

For this purpose, real estate companies are defined as corporations whose value is based principally on real property situated in Canada (including resource properties), as well as investments in partnerships or trusts and estates which meet the same criteria. Investments in other real estate companies are counted as part of immovable property for this purpose. For investments in corporations, Canadian tax applies only if the investment is 10% of the shares or more.

Based on these rules contained in the treaty, German investors who hold Canadian real estate or resource properties through Canadian corporations will normally be taxable in Canada on any gain from the sale of shares of the Canadian companies.

If shares of a Canadian corporation are held by a German corporation, effective 2001 Germany will no longer tax gains on the disposition of the shares of the Canadian company, regardless of the holding period and percentage ownership. Similarly, losses on disposition will no longer be deductible.

If an individual resident in Germany realizes a gain on the sale of investments, the gain is taxed in Germany, effective 2001, if the percentage ownership is 1% or more or if the investment was held for one year or less. Gains from the sale of Canadian investments, where the percentage ownership was 1% or more, or where the investment was held for one year or less, are taxed at 50% of regular rates, effective 2001. Any Canadian tax on a gain on sale is credited to the extent that German tax is payable.

Only 50% of losses from the disposition of Canadian investments are deductible.

**e) Losses** - Operating losses may occur where a business is in the start-up phase or in other circumstances. Such losses can generally be carried back three years and forward seven years to be applied against income and therefore reduce taxes payable in those years. Where control of a corporation has changed, deductibility of such losses may be restricted.

Note that rental losses of non-residents, that are losses from property, cannot be carried forward or back to other years, even if the non-resident subsequently becomes a Canadian resident.

**f) Inadequate Consideration** - Canadian laws contain specific provisions which deal with receipts from or payments to non-residents who are not dealing at arm's length with a taxpayer carrying on business in Canada. In general terms, these laws require such payments to be the same as those which would be received or paid had the non-resident been dealing with the Canadian taxpayer on an arm's length basis.

**g) General Anti-avoidance Rule (GAAR)** - Canadian tax law contains a general anti-avoidance rule which is aimed at so-called "avoidance transactions". These are transactions which result in a significant reduction, avoidance or deferral of tax and which cannot reasonably be considered to have been carried out primarily for non-tax purposes. Where such transactions are considered to offend the object and spirit of the tax law, they can be ignored for tax purposes and their tax consequences re-determined as is reasonable in the circumstances. This measure has resulted in significant uncertainty in tax planning. Tax advisors should be consulted before undertaking any tax planning step.