Tax Considerations In Financing

Thin Capitalization Rules

The taxes on income earned by Canadian corporations can be quite high. Non-residents might prefer to finance their Canadian corporations by way of debt rather than shares. The non-resident would receive interest income, which is a deductible expense for the Canadian corporation, rather than dividend income, which is not deductible. As a result, any excess profit which would have been subject to high rates of tax would be converted to interest subject to tax at a lower withholding tax rate (15% for German lenders) which is usually creditable against the recipient's own taxes.

Canadian law restricts this practice by disallowing part of the interest as an expense if certain conditions prevail. Generally speaking, if loans from a non-resident shareholder and related persons (who together hold at least 25% of the corporation's shares of any class) exceed two times (three times for taxation years beginning before 2001) the non-resident's share of the Canadian corporation's paid-up capital and surplus, and total retained earnings, a portion of the interest expense charged by the non-resident will be disallowed as an expense of the Canadian corporation. The entire amount of interest paid, regardless of whether it was allowed as an expense or not, will be subject to non-resident withholding tax.

Using a Canadian Holding Company

In some cases, it may make sense to finance your Canadian investment through a Canadian holding company. One of the main advantages to using a Canadian holding company to acquire an operating company is the ability to return the original capital investment tax-free, through a reduction in paid-up capital.

The paid-up capital of a corporation is basically the amount originally contributed to the corporation on the issuance of shares. This is typically an amount far less than the market price paid by someone who subsequently purchases the shares, particularly where the corporation has been successful. If a German individual or corporation first capitalizes a Canadian holding company to acquire an operating company, they will be able to have the operating company pay dividends to the holding company and use the funds to return the holding company's paid-up capital tax-free. If the operating company had been acquired directly, only its paid-up capital could be returned tax-free.

For example, let's say a German investor is considering purchasing a Canadian corporation for $10,000,000. The paid-up capital of the company is $1,000,000, with $9,000,000 of accumulated retained earnings.

If the German purchases the corporation directly from the owner, his shares will have a cost base of $10,000,000, but he will only be able to extract $1,000,000 tax-free from the corporation on a return of capital. If instead he had used the $10,000,000 to capitalize a Canadian holding company, the operating company could pay dividends (tax-free) to the holding company which could then use the funds to return capital to the German investor.

Such a structure may also help avoid Canada's thin capitalization rules. The paid-up capital owned by non-residents in the holding company, which is the amount against which the level of debt is measured, will be much greater.

A Canadian corporation can always return the capital received on the issue of shares (paid-up capital) regardless of how much accumulated retained earnings it has. However, the amount that can be returned is the amount received by the corporation on issue, not the amount paid by a shareholder for the shares from a third party.