Repatriation Of Funds

Canada places no currency restrictions on the repatriation of capital or earnings from a Canadian business to foreign investors. However, such transactions may have tax consequences, in both Canada and Germany. Throughout this book, we have referred to some of these issues as they arose. Here's a brief summary of the main methods of repatriating capital and earnings, and the tax rules that apply.

Branch Assets

As previously mentioned, the business profits of a branch are taxed in Canada at the normal rates applicable to either individuals or corporations. For individuals, the after-tax income is then available for repatriation without further Canadian or German tax consequences. However, the amount of the foreign branch income is taken into account in determining the individual's German tax rate. For corporations, the after-tax income is subject to the 15% Canadian branch tax, but no further German tax.

The amount subject to branch tax is the earnings of the branch, less the following:

- business losses in previous years
- the Canadian taxes on the profits (other than the branch tax)
- the profits reinvested in Canada
- a basic one-time deduction of $500,000 or its equivalent in Deutschmarks.

From the above notes, you can see that any funds repatriated to Germany result in a reduction of the profits reinvested in Canada and therefore increase the branch tax.

Interest

Where a non-resident chooses to finance his investment in Canada by way of loans, he will receive his return in the form of interest payments. The interest payments will be deductible to the Canadian corporation, provided the loan was used to earn income from business or property, the rate is reasonable in the circumstances and the company is not thinly capitalized.

The interest payments will be subject to Canada's 25% withholding tax, reduced to 15% under the treaty for payments to German residents. Therefore, the profits of the corporation that are used to pay the interest will have been returned to the German

investor after bearing only 15% tax. There is no possibility for using withholding tax exemptions for long-term debt, since the corporation and the German investor will likely not be dealing at arm's length.

The German investor, whether an individual or corporation, will include the interest in income for German tax purposes gross of the Canadian tax withheld. However, he will be entitled to a foreign tax credit against German taxes paid, resulting in the return on the investment bearing roughly the same tax as if it had been earned directly in Germany. If no credit is possible, the tax can be deducted as an expense, in essence only reporting the net amount received.

Where the German investor (individual or corporation) operates in Canada through a branch, he is deemed to be a Canadian resident to the extent the branch manufactures or processes in Canada or extracts natural resources. Therefore, any interest paid to non-resident lenders which is allocated by the German investor to the branch and deducted for Canadian tax purposes will be subject to Canadian withholding tax at the rate applicable to residents of the country of the lender.

Dividends

Where a German resident's investment in Canada is undertaken by capitalizing or purchasing a Canadian corporation, his return will be in the form of dividends. The Canada-Germany Tax Treaty reduces the general withholding tax rate from 25% to 15% for dividends paid to German residents.

Many of Canada's tax treaties include a further reduction of the withholding tax rate to 10% where the non-resident receiving the dividend owns at least 10% of the capital of the Canadian payee. Unfortunately, this provision is not currently in the Canada-Germany Tax Treaty, but may be included when negotiations to revise this treaty have been completed. In its 1992 budget, the federal government indicated its intention to enter into negotiations with treaty partners to reduce this rate, on a reciprocal basis, to 5%. Such a clause has already been included in some new and revised Canadian tax treaties and we expect others to follow.

In general, any dividends you receive from a Canadian corporation will be included in income at a rate of 50%, effective 2001, for German tax purposes gross of the 15% tax withheld, with a tax credit against your German tax liability. There is no gross-up and credit for the underlying Canadian tax paid by the payee corporation.

However, the Canada-Germany Tax Treaty provides that, where at least 10% of the capital of a Canadian company is held by a German company, any dividends paid will be exempt from further German taxation. Therefore, in most control situations the Canadian tax (both income and withholding) will be the final tax on the income from the Canadian investment.

Effective 2001, the 10% ownership limitation loses its significance: 95% of any dividends received by a German corporation are tax-free in Germany, regardless of percentage ownership or holding period. If the dividend is distributed to a German individual shareholder, the individual will have to include 50% of the dividend in German taxable income.

Management Fees

It's common for a foreign parent company or individual investor to provide management or other services to a Canadian corporation. Where such a corporation pays management fees to the non-resident, the amounts would normally be subject to withholding tax, unless they represent the reimbursement of specific expenses. However, under the Canada-Germany Tax Treaty, management fees received by a German resident from a Canadian corporation will not be taxable in Canada (and therefore not subject to the withholding tax) if the management fees are business profits for the German resident and the German resident does not have a permanent establishment in Canada.

Management fees are deductible by the Canadian corporation if they are incurred for the purpose of earning income, are reasonable in the circumstances and are well documented. Therefore, management fees represent a means of repatriating earnings from a Canadian corporation free of any income or withholding tax, provided the amounts can be justified.

For a corporation operating in the province of Ontario, a portion of the management fees paid to a German resident with whom the payer does not deal at arm's length will be disallowed as an expense for provincial tax purposes. The amount that must be added back to income is 5/14ths of the fee. With a provincial tax rate of 14% on most income, this in essence results in a 5% Ontario "withholding tax" on the management fee. The disallowance does not apply to management fees that are reimbursements of specific expenses. Where management fees are calculated based on cost plus mark-up, the portion of the fee equal to the total specific expenses incurred by the non-resident for the benefit of the corporation will not be disallowed. As well, the disallowance does

not apply to an amount paid or payable to a non-resident, where the non-resident is subject to Ontario or federal income tax and has included the amount in their taxable income earned in Canada.

Effective 2001, for German tax purposes, a German corporation receiving management fees will incur corporate tax of 25% plus the solidarity surcharge, as well as the applicable trade tax (approximately 17%).

Royalties

If a German investor provides a Canadian corporation with intellectual property, such as the right to use patents or copyrights, any royalties paid to the German resident are subject to a 10% withholding tax (reduced from 25% under the treaty). The amounts paid will be fully deductible for Canadian tax purposes but a portion thereof may be disallowed in Ontario.

Royalty income received by a German resident must be included in income for German tax purposes.

In its 1993 budget, the federal government indicated its intention to enter into negotiations with treaty partners to eliminate the withholding tax on royalty payments for the use of patented information or information concerning scientific experience, and for use of computer software. This may be included in the Canada-Germany Tax Treaty when negotiations to revise this treaty have been completed.

Loans to the Investor

In view of the withholding and other tax consequences of payments from a Canadian corporation, a German investor may be tempted to just have the corporation loan him the funds instead. Under Canadian tax rules, a loan to a shareholder must be included in income unless it meets one of the specific exemptions and reasonable repayment terms are entered into at the time the loan is made or the amount owing is repaid within one year. Note that a non-resident investor will generally not qualify for one of these exemptions. If the shareholder is non-resident, the loan is deemed to be a dividend for withholding tax purposes. If the loan is repaid after one year, the non-resident can apply for a refund of withholding tax.

There are also tax consequences to the corporation. Where a non-resident owes an amount to a corporation resident in Canada and the amount remains outstanding for one year or longer without interest at a reasonable rate being included in the corporation's income, the corporation will have a deemed interest income inclusion. This income inclusion is generally the excess of interest at a prescribed rate over interest already included in income in respect of the amount owing. Note that this provision will not apply if the loan is made to a subsidiary controlled corporation which uses the funds to earn income from an active business. As well, the provision will not apply if the amount owing is subject to non-resident withholding tax. However, this exemption will not apply if the non-resident withholding tax is ultimately refunded. Also, charging interest will not eliminate the withholding tax on a deemed dividend discussed above.

Return of Capital

As noted previously, 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. 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 of the shares, not the amount paid by a shareholder for the shares from a third party.

Wind-up

The final repatriation of funds occurs when an investor decides to dispose of his investment or otherwise wind it up.

If an investor operates a branch, the procedure is fairly straight-forward. All assets are sold for whatever is negotiated and a final tax return is filed. Tax may be payable depending on the nature of the property sold and whether or not a profit is realized on such a sale. In any event, if the assets to be disposed of include Taxable Canadian Property, Canadian law requires the non-resident to advise Canadian tax authorities of the proposal to sell such property, in advance, and to remit a specified percentage of the gain, if any, at that time. Such remittance is creditable against the tax calculated on the final tax return. Any gains on sales are of course subject to the branch profits tax if the investor is a corporation.

In the event the Canadian business is carried on through a subsidiary corporation, it may either be liquidated by selling the assets or the shares themselves may be sold. If the Canadian corporation is liquidated, it must file a final tax return upon

liquidation and pay tax on any income realized. In addition, the net funds remaining after such a liquidation will be deemed to be a dividend to the extent of the excess received over the legal paid-up capital. As a result, the appropriate withholding tax will apply and must be remitted to the Canadian tax authorities.

If the shares are sold, the non-resident must advise the Canadian government of the proposal to sell, because the shares are Taxable Canadian Property. However, for a German investor, there is unlikely to be any tax unless the assets of the corporation consist primarily of real estate. Effective 2001, only 50% of the gain on the sale of shares of a Canadian subsidiary by a German individual is taxable, for German tax purposes.

If the shares are sold to another corporation resident in Canada which is not at arm's length with the investor, any non-share consideration received in excess of the paid-up capital of the shares sold will be deemed to be a dividend and subject to withholding tax.