Canadian Corporate Tax Guide
About This Guide

If you are considering doing business in Canada, this guide may help. It has been created to provide a practical reference on Canada’s tax regime for executives in and counsel to U.S.-based and other foreign organizations.

It is a companion publication to our highly regarded Goodmans *Doing Business in Canada: A Concise Guide*, which provides brief chapters on Canadian laws governing:

- Types of Business Organization
- Acquiring or Establishing a Business in Canada
- Financing a Business in Canada
- Importing or Trading Goods
- Employment and Labour
- Business Visits and Relocation
- Privacy and Data Protection
- Industrial and Intellectual Property
- Environmental Law
- Real Estate

If you would like to receive a copy of the Goodmans *Doing Business in Canada: A Concise Guide*, please contact Carline Bertrand: Tel: +1.416.979.2211 Ext. 3006; Email: updates@goodmans.ca. Or, visit our website, [www.goodmans.ca](http://www.goodmans.ca).

**Please note:** the discussion in this guide is confined to the laws of the provinces of Ontario and British Columbia as well as the federal laws of Canada that apply in those provinces as of October 2007. This guide is very general and should not be relied upon as legal advice. We invite you to contact us directly with specific questions or problems.
About Goodmans LLP

Goodmans is widely recognized across Canada and internationally for its excellence and market leadership in large-scale corporate transactions as well as a broad range of specialized practice areas important to our clients. We are committed to providing the highest quality legal services to our clients – wherever they do business. The firm is home to more than 190 lawyers in offices in Toronto and Vancouver.

Our Business Approach and Firm Philosophy

Our clients range from sole proprietorships to multinational corporations, major financial institutions and crown corporations involved in all business sectors in Canada and around the world. The firm’s tradition of working with entrepreneurial clients has shaped our approach to practicing law: we handle every matter entrusted to us thoroughly, creatively and cost-effectively.

Our lawyers have developed close relationships through several generations of client growth, providing strategic and tactical advice to support our clients’ short-and long-term business objectives. Today, those clients include some of the most successful businesses in Canada.

Overall, we’ve earned a reputation for focusing our attention on challenging problems – often international in scope – that demand creative solutions. Our lawyers invest the time needed to understand the business implications of the legal matters we handle for clients. We’ve long realized that clients want solutions that achieve the desired result cost-efficiently and with a minimum of complexity. And we understand that clear, responsive communication between client and lawyer is critical to building a solid, effective and mutually rewarding relationship.

Goodmans’ Tax and Tax Litigation Groups

Goodmans’ Tax Group offers the best combination a client could want – sage tax experts who have worked on the country’s biggest deals, working with newly-minted professionals – energetic, at the top of their game, and as current as the newest legislation.

Our client list says it all, with many of the largest companies in Canada entrusting many of their most complex tax matters to our team. Cross-border M&A, income funds and transfer-pricing are our tax specialties but our tax group covers it all: besides providing a comprehensive range of highly regarded tax planning advice, our group also consistently scores major tax litigation successes.

Our Tax Litigation Group advises clients on all aspects of tax disputes in Canada and around the world. Our group consists of experienced individuals skilled at negotiating with tax authorities and at conducting appeals before the tax courts. Our clients, both individuals and corporations, receive top-notch advice and counsel in reaching settlements.

Our lawyers have a wealth of experience in litigation matters, having appeared at every type of tax and trade tribunal including the Tax Court of Canada, the Ontario Municipal Board, the Canadian International Free Trade Tribunal, the Federal Court of Canada, the Supreme Court of Ontario, the Supreme Court of Canada, before NAFTA dispute panels and at the World Trade Organization.
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Income Tax

In Canada, income tax is imposed by the federal government and all provincial governments. The primary basis for taxation in Canada is the residence of the taxpayer. Both the federal Income Tax Act (the “Tax Act”) and provincial tax legislation impose tax on income from all sources and most capital gains of Canadian residents, regardless of the country in which the income is earned. A non-resident is subject to withholding tax on most forms of passive income paid to him or her by a resident of Canada. The Canadian government has, however, proposed to eliminate withholding tax on most interest paid to non-residents with whom the payer deals at arm’s length. A non-resident is also subject to “ordinary” income tax on Canadian-source employment and business income and capital gains realized on the disposition of “taxable Canadian property”.

Taxable Canadian property includes, among other things, real property situated in Canada, assets used in carrying on business in Canada, shares of a private corporation resident in Canada and interests in certain Canadian resident trusts. The definition of “taxable Canadian property” also includes interests in non-resident private corporations, partnerships and non-resident trusts where 50% or more of the value of the applicable entity is derived from “taxable Canadian property” at any time in a previous 60-month period. An interest in or an option to acquire property that is “taxable Canadian property” will also constitute “taxable Canadian property”. If applicable, an international tax treaty may reduce or eliminate a non-resident’s liability for Canadian tax.

Except where specifically mentioned, the tax rates in the following discussion do not take into account the effect of tax treaties.

Resident in Canada

Corporations

A corporation incorporated in Canada after April 26, 1965 (or, in certain situations, before this date) is deemed to be resident in Canada. A corporation incorporated outside Canada may also be resident in Canada if its central management and control is located in Canada. This is generally the case if the corporation’s board of directors meets in Canada.

Individuals

Whether an individual is resident in Canada depends on his or her particular circumstances. Generally, an individual who, in a settled routine, regularly or normally lives in Canada will be considered to be resident in Canada for Canadian tax purposes. In addition, an individual who sojourns in Canada for 183 or more days during a year will be deemed to be resident in Canada for the year.

Trusts

A trust is generally considered to be resident where the trustee (or majority of trustees) who manages the trust or controls the trust assets resides. The jurisdiction in which the legal rights with respect to the trust are enforceable and the location of trust assets may be relevant factors in determining the residence of a trust.
Application of Tax Treaty

A corporate or individual taxpayer who is considered under domestic law to be a resident of Canada and of another country may, by an applicable tax treaty, be deemed to be resident in only one country for tax purposes. A person is deemed not to be a resident of Canada for the purposes of the Tax Act if, at that time, the person is by the operation of a tax treaty deemed to be resident in another country and not resident in Canada. Conversely, a person who, under an international agreement, is exempt from tax in his or her country of residence because that person was related to or a member of the family of a Canadian resident will be deemed to be a resident of Canada.

Change of Residence

A non-resident taxpayer who becomes a resident of Canada is deemed to have disposed of each property (other than, in the case of individuals, “taxable Canadian property”, inventory or eligible capital property in respect of a business carried on in Canada and certain excluded rights and interests) then owned for proceeds equal to the fair market value of such property just prior to the time of immigration, and to have reacquired the same property at a cost equal to such proceeds at the time of immigration. The taxation year of a corporation or a trust becoming a resident of Canada is deemed to have ended immediately before the change in its residency status.

Similarly, a taxpayer who ceases to be resident in Canada at any time is deemed to have disposed of and immediately reacquired each property owned by the taxpayer at the time of emigration for proceeds equal to the property’s fair market value at that time. Where the taxpayer is an individual, the deemed disposition and acquisition rules will not apply to many assets of the taxpayer, including: (i) real property situated in Canada; (ii) capital property, eligible capital property and inventory used in carrying on business in Canada through a Canadian permanent establishment; (iii) stock options; (iv) certain pension and similar rights; (v) certain interests in resident and non-resident trusts; and (vi) an interest in a Canadian life insurance policy. The taxation year of a corporation or a trust – and, in some instances, the fiscal period of a business carried on by an individual taxpayer – will be deemed to have ended immediately before the change in the corporation’s or individual’s residence status, as the case may be.

Individual Income Tax

Federal Income Tax

An individual who is resident in Canada is subject to federal income tax on his or her worldwide income at graduated rates, depending on the taxpayer’s taxable income. In 2007, the federal rates vary between 15.5% and 29%.

Business, Property and Employment Income

Business and property income is generally equivalent to the profit from the business or property, calculated in accordance with accepted accounting and commercial practice and adjusted as required by specific rules in the Tax Act. An individual taxpayer is permitted to deduct reasonable expenses incurred to earn business and property income, as well as other specific deductions provided for in the Tax Act. Any losses realized in a taxation year in the course of carrying on a business generally
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will, subject to specific rules in the Tax Act, be available to reduce current year income or to be carried back three taxation years or carried forward twenty taxation years to reduce any income in those taxation years. Employment income includes any salary and wages and most in-kind or fringe benefits provided by an employer. Deductions in computing income from employment are very limited.

A non-resident individual is required to pay Canadian tax on employment and business income derived in Canada. An applicable tax treaty, however, may provide an exemption from Canadian tax in certain situations. For example, a treaty may provide that business income earned by a non-resident in Canada will not be subject to Canadian tax unless such income is earned through a “permanent establishment” in Canada. A non-resident taxpayer’s taxable income earned in Canada will be computed without reference to the taxpayer's income or loss from a business carried on in Canada or from a property, where any income or gain arising therefrom could be exempt from tax under the Tax Act pursuant to an agreement between Canada and another country.

Capital Gains and Losses

A resident of Canada who realizes a gain on a disposition of capital property must pay tax at normal rates on the taxable portion of the capital gain (i.e., a “taxable capital gain”). Currently, the taxable portion of any capital gain realized is equal to one-half of the total gain. A capital gain will be realized on the disposition of a capital property to the extent that the proceeds of disposition exceed the adjusted cost base (ACB) of the property (generally, the acquisition cost for the property, adjusted in accordance with the rules in the Tax Act) and any reasonable costs associated with the disposition of the property. A capital loss will be realized to the extent that the ACB of the property and any reasonable costs associated with the disposition exceed the proceeds of disposition for the property. One-half of any capital loss (i.e., “allowable capital loss”) can generally be used to offset any current year taxable capital gains or carried back three taxation years or carried forward indefinitely to offset any taxable capital gains in those years.

As described earlier, a non-resident is required to pay tax on capital gains arising from the disposition of “taxable Canadian property”. A person, whether or not a Canadian resident, who acquires “taxable Canadian property” from a non-resident is liable to withhold and remit an amount equal to 25% of the purchase price to the Canadian government on behalf of and on account of any tax payable by the non-resident, unless the purchaser is provided with a clearance certificate from the Canada Revenue Agency. The applicable rate of withholding is increased to 50% of the purchase price with respect to certain types of “taxable Canadian property” (for example, depreciable property).

Provincial Income Tax

The Province of Ontario utilizes graduated tax rates which range from 6.05% to 11.16% for the 2007 taxation year.

Ontario also levies a two-tiered surtax which is calculated as a percentage of basic Ontario tax in excess of certain specified amounts. For the 2007 taxation year, the surtax is calculated as 20% of Ontario income tax in excess of $4,100 plus 36% of Ontario income tax in excess of $5,172.
For the 2007 taxation year, the maximum combined federal and Ontario marginal income tax rate for individuals is 46.41%. The provincial capital gains inclusion rate is 50%, to accord with the federal capital gains inclusion rate.

In the Province of British Columbia, personal income tax is calculated based on graduated rates which will range between 5.70% and 14.7% for the 2007 taxation year, resulting in a maximum combined federal and provincial marginal income tax rate of 43.7% for the 2007 taxation year. British Columbia does not impose a surtax on personal income taxes.

**Corporate Income Tax**

**General**

In 2007, the basic rate of tax for a corporation carrying on business in Ontario, including a non-resident corporation, is 36.1% (a combination of the basic federal rate of 38%, a federal tax abatement of 10% intended to provide “tax room” for the provinces to impose their own income tax, a federal surtax of 4%, a federal rate reduction of 7% and the Ontario rate of 14%). The general corporate tax rate will be reduced to 34.5% in 2008 and 34% in 2009. In addition, the 4% corporate surtax is proposed to be eliminated for all corporations effective January 1, 2008. In British Columbia, the basic combined corporate tax rate for 2007 is 34.1%.

**Manufacturing and Processing**

In 2006, due to prior reductions in the general corporate income tax rate, the federal income tax rate applied to manufacturing and processing income is the same as the tax rate applied to general corporate income. However, in 2007, the Ontario income tax rate is currently reduced in respect of profits from Canadian manufacturing and processing from 14% to 12%. British Columbia does not provide for any tax rate reduction in respect of manufacturing and processing income.

**Canadian-Controlled Private Corporations**

In 2007, a “Canadian-controlled private corporation” (CCPC) may claim a federal small business tax credit on the first $400,000 of income from an active business carried on in Canada. A CCPC is generally defined to be a private Canadian corporation that:

- Is not controlled, directly or indirectly, by non-resident persons, public companies or any combination thereof;
- Would not, if each share of the capital stock of the corporation owned by a non-resident person or a public corporation were owned by a particular person, be controlled by the particular person; and
- Has no class of shares of its capital stock listed on a prescribed stock exchange.

A corporation that is owned equally by residents and non-residents and that is not controlled in law or fact by the non-residents may qualify as a CCPC and benefit from the small business tax credit. The federal tax credit is currently 16% of qualifying income of up to $400,000 which must be apportioned among associated corporations. A CCPC will be subject to the basic federal corporate tax rate of 22.1% for 2007 (to be reduced to 20.5% in 2008, 20% in 2009 and 19% in 2010) for
income over this threshold amount. In 2007, the tax rate on income eligible for the small business deduction is 13.1% (including the 2% surtax), which will be reduced to 11.5% in 2008 and 11% in 2009 and subsequent years. The small business tax credit is gradually reduced for corporations having taxable capital employed in Canada (including that of associated corporations) in excess of $10 million, and is completely eliminated where such taxable capital reaches $15 million.

For 2007, the Ontario small business tax rate is 5.5% on the first $400,000 of Ontario source income. An Ontario surtax is imposed on the taxable income of CCPCs that claim the Ontario small business deduction where their taxable income exceeds $400,000. This surtax will eliminate the benefits of the small business deduction when the taxable income of the CCPC and any associated corporations exceeds approximately $1,120,000.

Ontario imposes a corporate minimum tax, which applies to all corporations that are liable for Ontario corporate income tax and that, together with associated corporations, have either gross revenues in excess of $10 million or total assets in excess of $5 million. The rate of corporate minimum tax is 4% of the corporation’s net income otherwise calculated with certain specific adjustments.

British Columbia’s preferential corporate tax regime for small businesses is similar to the federal system. In 2007, any corporate income subject to the federal small business tax credit (i.e., corporate income up to $400,000) will be taxed by British Columbia at a rate of 4.5%. For income in excess of $400,000, British Columbia levies tax at a rate of 12%.
Capital Tax

Prior to 2007, the federal government imposed a Large Corporations Tax (LCT) on the “taxable capital employed in Canada” in excess of $50,000,000 of any corporation that was resident in Canada or any non-resident corporation that carried on business in Canada through a permanent establishment. LCT was eliminated as of January 1, 2006.

In Ontario, capital tax is imposed on the taxable paid-up capital of any corporation carrying on business through a permanent establishment in Ontario. This tax is imposed at the rate of 0.3% of the taxable paid-up capital used in Ontario, with special rules and rates applying to certain financial institutions. Paid-up capital includes the corporation’s paid-up capital stock, its surpluses, its reserves, and its secured and unsecured liabilities (other than its accounts payable and certain other prescribed exceptions).

The 2004 and 2007 Ontario budgets included proposals for the gradual elimination of capital tax in Ontario. For 2007, the deduction from taxable paid-up capital is $12.5 million and will be increased by $2.5 million on a yearly basis until the deduction reaches $15 million on January 1, 2008. For 2007, corporations are entitled to claim a deduction of $12.5 million in calculating their taxable paid-up capital. Accordingly, no capital tax will be payable by a corporation whose taxable paid-up capital does not exceed $12.5 million. The $12.5 million deduction must be shared among associated corporations. Starting January 1, 2009, capital tax rates would be reduced each year until the capital tax is fully eliminated on July 1, 2010. Certain small business corporations that are not financial institutions are exempt from capital tax.

British Columbia currently only levies capital tax on corporations that qualify as financial corporations.
Summary: 2007 Individual and Corporate Tax Rates

The following table summarizes the applicable rates for the 2007 taxation year:

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<th>British Columbia</th>
<th>Ontario</th>
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<tr>
<td><strong>Combined maximum rates for individuals</strong>&lt;sup&gt;(1)&lt;/sup&gt;</td>
<td></td>
<td></td>
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<tr>
<td>Income Tax</td>
<td>43.7%</td>
<td>46.4%</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>21.9%</td>
<td>23.2%</td>
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<tr>
<td>Canadian Ineligible Dividends</td>
<td>31.6%</td>
<td>31.3%</td>
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<tr>
<td>Canadian Eligible Dividends</td>
<td>18.5%</td>
<td>24.6%</td>
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<th>Ontario</th>
<th>Federal</th>
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<tr>
<td>Basic Rate</td>
<td>12%</td>
<td>14%&lt;sup&gt;(2)&lt;/sup&gt;</td>
<td>22.1%</td>
</tr>
<tr>
<td>Small Corporations</td>
<td>4.5%</td>
<td>5.5%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Investment Income</td>
<td>12%</td>
<td>14%</td>
<td>22.1%&lt;sup&gt;(3)&lt;/sup&gt; (or 35.8%)</td>
</tr>
<tr>
<td>Capital Tax</td>
<td>&lt;sup&gt;(4)&lt;/sup&gt;</td>
<td>0.3%</td>
<td>&lt;sup&gt;(5)&lt;/sup&gt;</td>
</tr>
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1. Including, where applicable, surtaxes.
2. This rate is reduced to 12% for Canadian manufacturing and processing income.
3. Higher rates of tax are applicable to investment income earned by a CCPC. These higher rates of tax include an additional refundable tax of 6-2/3%, the refund being triggered once sufficient dividends are paid out by the CCPC. The general federal rate reduction of 7% that applies to active business income does not apply to investment income earned by a CCPC.
4. In British Columbia, capital tax is only levied on certain financial corporations. Special rules and rates apply to financial institutions in Ontario.
5. The large corporation tax was completely eliminated in January 2006, although financial institutions continue to be subject to tax of 1.25% applied to taxable capital over $1 billion employed in Canada.
Non-Residents - Special Rules

Withholding Tax

A resident of Canada who makes a payment to a non-resident in respect of most forms of passive income (including dividends, management fees and royalties) is generally required to withhold tax equal to 25% of the gross amount of the payment. This rate may be reduced under an applicable tax treaty. Generally, interest paid by a resident of Canada to a non-resident of Canada is subject to withholding tax. The Canadian Government has, however, prepared to eliminate withholding tax on most interest paid to non-residents with whom the payer deals at arm’s length.

Generally, withholding tax will be due whether or not the resident payer is related to or dealing at arm’s length with the payee. Although the tax is imposed on the non-resident, the resident payer is required to deduct the tax and remit it to the Canadian tax authorities on behalf of the non-resident. A Canadian resident payer may obtain a waiver from the Canadian tax authorities not to withhold tax in respect of the payment of any amount to a non-resident if that amount is reasonably attributable to a business carried on in Canada by the non-resident through a permanent establishment.

In certain circumstances, a non-resident of Canada will be deemed to be a resident of Canada for withholding tax purposes. For example, a non-resident that carries on business in Canada will be deemed to be resident in Canada and must consequently withhold tax on any payment (such as interest) made by it to another non-resident, to the extent that the payment is deductible in computing the payer’s taxable income earned in Canada for any taxation year (unless the income from the business is exempt from Canadian tax pursuant to an applicable tax treaty).

There are certain exemptions from withholding tax, such as interest paid by a Canadian corporation on money borrowed from an arm’s length lender where the borrower may not, under the terms of the loan, be required to repay more than 25% of the principal of the loan within five years from the date on which the loan was made. Other exemptions exist for certain management fees paid to arm’s length non-residents.

Branch Operations in Canada

In addition to liability for normal income tax on its Canadian source business income, a non-resident corporation that carries on business in Canada through an unincorporated branch is liable for a branch profits tax of 25% of an amount approximately equal to the after-tax earnings of the branch not reinvested in Canada. This branch tax is intended to approximate Canadian withholding tax which would have been payable in respect of dividends paid by a Canadian resident subsidiary to a non-resident parent corporation. The rate of branch tax may be reduced by an applicable tax treaty.

Canadian Subsidiaries

A Canadian incorporated subsidiary of a non-resident corporation is a Canadian resident for Canadian income tax purposes and is therefore subject to tax in Canada on its worldwide income at the corporate tax rates discussed above.
Doing Business in Canada

Certain types of payments (including dividends, interest, management fees and royalties) made by a Canadian subsidiary to its non-resident parent are subject to withholding tax as discussed above.

Provincial tax legislation effectively increases Ontario taxes payable by a Canadian subsidiary on management fees, royalties and other such tax deductible payments (but not interest) by disallowing the deduction of a portion (5/14 in 2006) of these amounts paid by the subsidiary to a non-resident parent corporation (or any other non-arm’s person). The denial of a tax deduction for these payments represents an indirect method of imposing withholding tax on such amounts. There is no similar provincial legislation in British Columbia.

Branch Operation or Canadian Subsidiary?

Whether a company should carry on business in Canada through a Canadian subsidiary corporation or an unincorporated branch depends on many factors, including the tax considerations summarized below.

Branch Operation

Advantages

- The non-resident corporation may be able to utilize losses incurred by the Canadian branch.
- Funds can flow freely between the head office and the branch (subject to the branch tax discussed above).

Disadvantages

- A Canadian branch of the non-resident corporation will, subject to any applicable treaty relief, be liable for the branch tax discussed above.
- The non-resident corporation will have to file tax returns in Canada. The non-resident corporation must also maintain books and accounting records in respect of its Canadian operations at its Canadian place of business (or at such other place designated by the Canadian tax authorities), which must be made available for audit by Canadian tax authorities.
- There may be difficulties in allocating income and expenses between the head office and the branch.
- Opportunities to minimize taxes through intercompany transactions are limited.
- The costs and practical aspects of transferring branch assets into a Canadian corporation should be taken into account if this is contemplated for the future.
- Branch employees who are non-residents of Canada may be liable to pay Canadian income tax (subject to any exemptions available through an applicable tax treaty), in which case the non-resident corporation is required to deduct and remit the required amounts from their wages or salaries.
- There is no direct control over the timing of the incidence of branch tax as would be the case with withholding tax payable in respect of dividends paid by a Canadian subsidiary, since they would arise only upon the payment of such dividends.
Canadian Subsidiary

Advantages

- The Canadian subsidiary will not be liable for branch tax (but see withholding taxes noted below).
- The non-resident corporation will not be required to file tax returns in Canada, although the subsidiary will have such an obligation.
- It is easier to separate income and expenses of the subsidiary from the non-resident corporation, and inter-company transactions (see the discussion of transfer pricing below) may provide some flexibility to reduce Canadian tax.
- The timing and incidence of withholding tax can be controlled by timing the actual payment of amounts (e.g., dividends).

Disadvantages

- The start-up losses and other losses of the subsidiary are not available to the non-resident corporation.
- The “thin capitalization” rules discussed below may apply, rendering a portion of the interest payable by the subsidiary non-deductible.
- Withholding tax will apply to dividends, interest, royalties, and other forms of passive investment income paid to the non-resident corporation.

Capitalization and the Thin Capitalization Rule

A capital investment in the Canadian subsidiary of a non-resident corporation may, to the extent of paid-up capital, generally be returned tax-free to the non-resident shareholder. However, any distribution of capital made to the non-resident shareholder in excess of paid-up capital is generally deemed to be a dividend that is subject to withholding tax.

Repayment of principal loaned to a Canadian subsidiary by its non-resident parent is not subject to withholding tax but tax must be withheld in respect of interest paid on the loan.

Subject to the thin capitalization rules discussed below, a Canadian subsidiary may, in accordance with the usual rules relating to interest deductibility, deduct interest paid by it to a non-resident in computing its income, provided that the amount of interest does not exceed a reasonable amount in the circumstances and the borrowed money is used to gain or produce income from business or property. On October 31, 2003, the Canadian federal government released, for public comment, proposed amendments to the Tax Act that relate to the deductibility of interest and other expenses for income tax purposes for taxation years commencing after 2004. In general, the proposed amendments may deny the realization of losses in respect of a business or property if there is no reasonable expectation that the business or property will produce a cumulative profit over the period that such business or property can reasonably be expected to be carried on or held. In response to concerns expressed by the tax community relating to the breadth of these proposed amendments,
the government has indicated that it intends to release an alternative proposal that is more modest in scope.

Accrued and unpaid interest that has been deducted by the Canadian subsidiary in certain non-arm’s length cross-border transactions will be added back to the income of the Canadian subsidiary for income tax purposes.

The thin capitalization rules are intended to prevent a Canadian incorporated subsidiary from reducing its taxable Canadian profits, and hence its liability for Canadian tax, by maximizing its interest expense to non-resident creditors who do not deal at arm’s length with the subsidiary. The rules will operate to deny a portion of the resident subsidiary’s interest deduction on debt owed to “specified non-resident shareholders” (or non-resident persons not dealing at arm’s length with a “specified shareholder”) to the extent that the amount of such debt exceeds twice the total shareholders’ equity (i.e., retained earnings, contributed surplus and the paid-up capital of shares held by “specified non-resident shareholders”) in the subsidiary. For the purposes of determining this limit, an average ratio of debt to equity for the year is used. Borrowing from an arm’s length source or from a lender who is resident in Canada is not subject to the thin capitalization rule, although specific rules prevent “back-to-back” loan arrangements designed to take advantage of these exceptions. In addition, the rules do not apply to funds loaned to an unincorporated Canadian branch.

It should be noted that, subject to certain exceptions, when a Canadian resident corporation lends money to a non-resident corporation which pays no interest for one year or more, interest calculated at prescribed rates will nevertheless be added to the income of the Canadian resident corporation. This rule is also applicable if the lender is a trust or a partnership in which a Canadian resident corporation has an interest. In addition, if the borrower is a non-resident shareholder and the loan bears less than a reasonable rate of interest, the non-resident shareholder may be considered to realize a benefit that will be deemed to be a dividend and therefore subject to Canadian withholding tax. Further, if the loan is not repaid within one year from the end of the taxation year during which the loan was made, the entire principal amount of the loan will be deemed to be a dividend paid to the non-resident shareholder and will be subject to Canadian withholding tax.

Transfer Pricing

Whether a branch or a subsidiary is used, consideration should be given to the issue of transfer pricing. Transfer pricing, sometimes referred to as inter-company pricing, is the pricing of goods or services transferred between related parties.

In a related party transaction, the price of goods and services is not generally determined by the dynamics of the market. Therefore, the taxing authorities of the jurisdictions where the vendor and purchaser reside attempt to ensure that a reasonable profit is being earned and subjected to tax and that only reasonable deductions are claimed for tax purposes.

Canadian tax provisions require that prices charged in related party transactions conform to prices charged in comparable arm’s length transactions. Where the terms or conditions of a transaction between a taxpayer and a non-arm’s length non-resident would not have been made between arm’s length parties or may reasonably be considered not to have been entered into primarily for non-tax
bona fide purposes, amounts in respect of the transaction could be subject to adjustment to reflect transactions that would have been entered into by persons dealing at arm’s length.

Given that a non-resident corporation and its Canadian subsidiary are deemed not to be dealing at arm’s length, it is very important to pay particular attention to inter-company pricing issues where a subsidiary is used. Transfer pricing is much less of an issue in determining the income of a Canadian branch, as mark-ups or profit margins cannot normally be recognized on intra-company transactions. Payments that may raise transfer pricing issues include management and administration fees, development charges, royalties and interest, and prices for the sale of goods.

Penalties related to the failure to establish transfer prices in accordance with the Tax Act are significant. However, when a corporation shows that it has made reasonable efforts to determine arm’s length transfer prices, the amount on which the penalty is calculated may be reduced. Related party transactions should be properly documented in accordance with Canada’s transfer pricing rules.

An annual information return (Form T106) must be filed by every Canadian branch or corporation that engages in certain transactions with a related non-resident person if the total value of such transactions exceeds $1 million. Generally, these transactions include the purchase or sale of goods or services, the payment of rents, royalties, dividends and interest, and the lending of money between the related parties. The branch or corporation must include in the information return, among other things, the name and principal business activity of the non-resident person and the amount of any consideration paid or received in respect of the transaction. The information return must be filed by the branch or corporation within six months after the end of its taxation year.

Partnerships Involving Non-Residents

A non-resident corporation that belongs to a partnership which carries on business in Canada is generally subject to tax in Canada on its share of the partnership profits as if it carried on the partnership business directly as a Canadian branch of the non-resident corporation. A partnership with a non-resident member that pays an amount to a non-resident person is considered to be a resident of Canada for the purposes of withholding tax to the extent that the amount paid is deductible in computing the income or loss of the partnership from a Canadian source. When an amount is paid to a partnership of which a non-resident is a member, the partnership is deemed to be a non-resident person in respect of the payment of that amount, which will generally be subject to withholding taxes as discussed above.

General Anti-Avoidance Rule

The Tax Act includes a broadly-worded anti-avoidance rule designed to prevent “avoidance transactions”. The rule is not intended to apply to a transaction that is undertaken primarily for bona fide purposes other than to obtain a tax benefit, or that does not result in a misuse of the provisions of the Tax Act or an abuse of the Tax Act read as a whole. Canadian tax authorities may determine the tax consequences of an avoidance transaction as they consider reasonable in the circumstances.
Tax Treaties and Conventions

Canada has entered into bilateral income tax agreements or tax treaties with a number of other countries. These agreements are designed to avoid double taxation and to prevent tax evasion. They usually apply when the same income of a taxpayer is subject to both the Tax Act and the taxing legislation of another country. Generally, the country in which the income is earned has priority for tax purposes, while the country of residence permits the taxpayer to deduct tax paid in the other country from domestic tax on the same income by way of a foreign tax credit.

Non-Resident Trusts and Corporations

The Tax Act contains rules to prevent the use of entities in foreign jurisdictions in order to avoid or reduce Canadian tax on what is generally passive or investment type income. On February 16, 1999, modifications to the Tax Act regarding non-resident trusts and “foreign investment entities” were first proposed by the Canadian federal government. After lengthy consultations and a series of revisions, the most recent version of the rules were proposed on July 18, 2005, to be effective as of January 1, 2003. Under these provisions, subject to certain exceptions, a non-resident trust will be considered resident in Canada and subject to Canadian taxation in accordance with the usual rules that govern trusts if a Canadian resident contributes to the non-resident trust, even if there are no Canadian beneficiaries. In most cases, the Tax Act provides that the income of a trust must be taxed even if this income has not been distributed to the beneficiaries. Accordingly, taxpayers cannot defer the payment of taxes by accumulating income in the trust.

The foreign investment entity rules are extremely complex and are generally directed at offshore investment funds that derive their value principally from portfolio investments but they can have a much broader application. In very general terms, a foreign investment entity is any non-resident entity more than 50% of the assets of which are “investment property”. If an entity is a foreign investment entity, a taxpayer will have to include in income an amount, based on one of three possible methods of calculation, representing undistributed income of the foreign investment entity. Rules are in place to ensure that there is no double taxation where an investment which is subject to these rules actually distributes income. There are numerous exceptions and exemptions to the foreign investment entity rules. Two important exemptions are:

- The foreign entity is a “controlled foreign affiliate” (see below); and
- It is reasonable to conclude that the taxpayer had no tax avoidance motive for investing in the foreign entity and one of several other conditions are satisfied (for example, the entity may be resident in a country with which Canada has a tax treaty and the investment is widely held and actively traded).

The Tax Act also contains specific rules that apply to certain non-resident corporations or “foreign affiliates”. If a foreign affiliate is a “controlled foreign affiliate” of a taxpayer, the taxpayer will have to include in income the allocable portion of any “foreign accrual property income” earned by the controlled foreign affiliate, whether or not the taxpayer receives a distribution of such income. Foreign accrual property income can generally be described as passive or investment type income. There are rules to ensure there will be no double taxation when income previously taxed as foreign accrual property income is actually distributed.
Fiscal Incentives for Scientific Research and Development

Federal Government – Deduction from Income

The Tax Act allows a taxpayer doing business in Canada to deduct from its business income certain amounts spent on scientific research and development (“Scientific R&D”), including current expenses of the following nature:

(i) Expenses connected with Scientific R&D carried on in Canada, conducted by the taxpayer or on its account and relating to the taxpayer’s business; and

(ii) Payments to a corporation resident in Canada or certain other approved entities (e.g., a university) that conduct Scientific R&D in Canada related to a business of the taxpayer, to the extent that the taxpayer is entitled to exploit the results of such Scientific R&D.

A taxpayer can also deduct certain capital expenses (i.e., expenses incurred to acquire depreciable property other than land or a leasehold interest in land) for Scientific R&D carried on in Canada related to the business of the taxpayer.

Qualifying expenses for Scientific R&D can be claimed in the year they are incurred or deferred to another taxation year to the extent that the Scientific R&D expenses are identified as such in the prescribed form (Form T-661) on or before the day that is 12 months after the taxpayer’s filing due date for the year.

Definition of Scientific R&D

Scientific R&D is defined, in general terms, as a systematic investigation or research carried out in a field of science or technology through experiment or analysis, and includes pure research and applied research. Also included in the definition of Scientific R&D is experimental development – namely, work undertaken to achieve technological advances for the purposes of creating new (or improving existing) materials, devices, products or processes, including incremental improvements thereto or work with respect to engineering, design, operational research, mathematical analysis, computer programming, data collection, testing and psychological research, where such work is commensurate with and directly in support of the needs of pure or applied research or experimental development undertaken in Canada by or on behalf of the taxpayer.

The following activities are excluded from the definition of Scientific R&D:

- Market research or sales promotion;
- Quality control or routine testing of materials, devices, products or processes;
- Research in social sciences or the humanities;
- Prospecting, exploring, or drilling for or producing minerals, petroleum or natural gas;
- The commercial production of a new or improved material, device or product, or the commercial use of a new or improved process;
Scientific R&D expenses generally include, with certain exceptions, all expenses (or portion thereof) directly related to the research and development, such as salaries and equipment costs. It should be noted that certain employee expenses incurred by members of an associated group of companies must be shared between them. Also, special rules apply to expenses (other than salary and wages of an employee of the taxpayer) payable in respect of Scientific R&D performed by another person or partnership that does not deal at arm’s length with the taxpayer for whom the Scientific R&D was performed.

Generally, Scientific R&D expenses made in a year are fully deductible. However, those expenses that are not deducted in the year in which they are incurred are placed in a pool and may be deducted in any future year in which the taxpayer carries on business in Canada.

A taxpayer can choose an alternative elective method for determining which expenditures incurred in Canada will qualify as Scientific R&D expenses to be included in the pool and deducted in subsequent years. This elective method, which is generally simpler, lists six types of expenditures to be considered as Scientific R&D expenses and included in the pool. All other expenses will generally be deductible in the year incurred as general business expenses. This method is simpler because it allows the taxpayer to avoid having to identify, item by item, the portions of general expenses directly attributable to Scientific R&D in Canada.

The Tax Act provides a further incentive to invest in Scientific R&D activity in the form of an investment tax credit which results in a direct reduction of the taxes payable by the taxpayer. This credit is discussed further below.

**Tax Credits**

The most important advantage flowing from the provisions of the Tax Act with respect to Scientific R&D is the possibility of claiming an investment tax credit with respect to these expenses.

(a) Rate of deduction

Taxpayers are generally permitted to claim an investment tax credit equal to 20% of allowable Scientific R&D expenses made during the taxation year. However, where the taxpayer is a CCPC and meets certain other criteria mentioned below, an additional tax credit equal to 15% on up to the first $2 million of Scientific R&D expenses made during the taxation year may be claimed. This $2 million annual limit may be reduced or eliminated as discussed below.

The amount of the investment tax credit so calculated may be refundable, meaning that any amount of the tax credit that is not applied to taxes otherwise payable for the taxation year in question will result in a cash refund to the taxpayer. The extent to which a refund is available is a function of the status of the taxpayer, the nature of the expenditure that gave rise to the credit and the jurisdiction in which the expenditure was made. In the case of CCPCs, all investment tax credits that earn the additional 15% tax credit are fully refundable and are otherwise refundable at a rate of 40%.
(b) Conditions of application for the additional 15% tax credit for CCPCs

As mentioned above, CCPCs meeting certain prescribed conditions may claim a tax credit at an increased rate of 35%. These conditions are as follows:

- The taxpayer must be a CCPC;
- The taxable capital of the company (and that of associated companies) cannot exceed $10 million;¹ and
- The company must, for its previous taxation year, have had a taxable income that does not exceed its business limit ($400,000 for 2007) for the purposes of claiming the small business tax credit.²

Definitions – Associated Companies & CCPCs

In very general terms, for the purposes of the above rules, two or more companies are associated when they are subject to the same direct or indirect control.

Tax Incentives in Ontario

Ontario used to provide a “super-allowance” for Scientific R&D conducted in Ontario. This super-allowance permitted an additional deduction in computing Ontario taxable income for qualified expenditures. The “super-allowance” could allow a deduction that exceeded the qualified expenditures. Ontario has eliminated this super-allowance and now allows corporations a deduction in computing their Ontario taxable income that is equal to a portion of the federal investment tax credit that can reasonably be considered to relate to qualified Ontario Scientific R&D expenditures.

Ontario Innovation Tax Credit

Ontario tax legislation also provides a refundable innovation tax credit (OITC) to certain eligible corporations with permanent establishments in Ontario. The OITC provides qualifying corporations with a 10% refundable tax credit for Scientific R&D carried out in Ontario.

Qualified expenditures for the purposes of the OITC are, subject to certain exceptions, generally similar to those that are incurred in respect of Scientific R&D in Ontario and which are eligible for the federal investment tax credit discussed above. 100% of a corporation’s current qualifying expenditures will be added to its Scientific R&D expenditure pool while only 40% of qualifying capital expenditures will be added.

Qualified expenditures for the purposes of the OITC are subject to an annual limit calculated in accordance with the federal investment tax credit rules discussed above. This limit must be shared among associated corporations and is subject to graduated phase-out rules based on the

¹ The annual limit of $2 million is phased out on a straight-line basis for CCPCs (including any associated corporations) having taxable capital between $10 and $15 million in the prior year.

² When the amount of taxable income of CCPCs (including that of associated corporations) exceeds $400,000, the annual limit of $2 million is phased out on a straight-line basis until taxable income reaches $600,000.
corporation’s taxable income and taxable paid-up capital in a manner similar to that for the federal investment tax credit rules.

**Ontario Business-Research Institute Tax Credit**

The Ontario Business-Research Institute (OBRI) tax credit permits certain corporations carrying on business in Ontario through a permanent establishment to claim a 20% refundable tax credit for expenditures relating to Scientific R&D that are incurred in Ontario as part of an eligible research institute contract. An eligible research institute contract is generally defined as a contract under which an eligible research institute (e.g., a provincially-assisted post-secondary educational institution, a qualifying hospital research institute, or a qualifying prescribed non-profit research organization) to perform Ontario R&D related to a business carried on in Canada by the corporation and the corporation is entitled to exploit the results of the Ontario R&D. Corporations are required to obtain an advance ruling stating that the terms of the contract meet all of the applicable criteria. Qualifying expenditures may be eligible for both the 20% OBRI tax credit and the 10% Ontario innovation tax credit, for a combined tax credit of 30%.

**Tax Incentives in British Columbia**

British Columbia also provides additional tax relief for certain small businesses conducting R&D in British Columbia. Under these rules, certain CCPCs with a permanent establishment in British Columbia will be entitled to a refundable tax credit equal to 10% of the corporation’s “SR&ED qualified BC expenditures”. The credit is non-refundable for other types of qualifying corporations and for qualifying expenditures of a CCPC that exceed the $2 million annual limit discussed above in respect of federal investment tax credits. It should be noted that this credit is considered to be government assistance and therefore reduces expenditures for both the federal Scientific R&D deduction and the federal investment tax credit mechanism discussed above.

The term “SR&ED qualified BC expenditure” is defined by statute to include expenditures incurred by the corporation that (i) are in respect of scientific research and experimental development carried on in British Columbia (see the discussion above of the definition of Scientific R&D for federal purposes); (ii) were incurred after August 31, 1999 and before September 1, 2014; and (iii) are incurred at a time when the corporation maintains a permanent establishment in British Columbia. Expenditures made by partnerships and trusts do not give rise to tax credits in the hands of the corporate members of such partnerships or the corporate beneficiaries of such trusts.

**Tax Shelters and Credits for Film and Television Productions**

Please ask for a copy of our publication, “Location Canada: A Guide to Producing in Canada and Doing Business with Canadians”, for an overview of tax shelters and credits.
Goods and Services Tax

Canada’s federal sales tax is a comprehensive, multistage, value-added tax on the consumption of nearly all property and services in Canada. The tax, known as the “goods and services tax” (GST), generally applies at a rate of 6%. A parallel system of input tax credits (ITCs) is designed to ensure that tax is paid at every stage in the chain of supply on the value added at that stage until final consumption, when the final consumer effectively pays the aggregate GST.

General Rules

GST is imposed on every person who receives a “taxable supply” of property or a service “in Canada”.

Property is broadly defined to include virtually every kind of real, personal, tangible and intangible property other than money. Service is also broadly defined to include anything other than property, money and, significantly, employment duties. A taxable supply of a property or service means the provision of property or a service by any means whatever (including by sale, transfer, lease, license, and gift) in the course of the supplier’s commercial activities, unless the supply is expressly exempt (see below under “Exempt Supplies”). In short, every commercial provision of a property or service, with only relatively limited exceptions, is subject to GST.

Every person who carries on a commercial activity in Canada is required to register with the federal government. An exception is provided for “small suppliers”, generally defined as persons whose aggregate annual supplies do not exceed $30,000. This $30,000 threshold is determined with reference to the value of a person’s worldwide supplies and supplies of “associated persons”. Therefore, any non-resident that makes a taxable supply in Canada and has worldwide sales of $30,000 or more (including Canadian sales and non-Canadian supplies) will be required to register.

A registrant is entitled to claim an ITC equal to all GST that the registrant has paid in connection with property or services acquired by it for consumption, use or supply in its commercial activities. Consumers or persons engaged in certain exempt activities are not entitled to claim ITCs and so bear the full incidence of the tax.

The tax, although imposed on the recipient, must in most cases be collected and remitted to the federal government by the supplier. If the supplier is a registrant, it may net its ITCs against the GST collected and remit only the balance (if any) to the government. The government will refund to the registrant the amount by which the registrant’s ITCs exceed its GST collectible.

A simplified example illustrates how the GST system works. A shoe manufacturer purchases leather for $100 and sells the finished shoes to a retailer for $125 who in turn sells them to a customer for $200. Both the manufacturer and the retailer are “registrants”. If the leather merchant has no ITCs, the GST consequences will be as follows:
Purchase of leather:

Manufacturer pays price $100.00
   Plus GST @ 6% 6.00
   Total paid to leather merchant $106.00

Manufacturer earns ITC=GST paid $ 6.00

Leather merchant collects GST $ 6.00
   Deducts its ITC 0.00
   Remits net GST to government $ 6.00

Sale of shoes to retailer:

Retailer pays wholesale price $125.00
   Plus GST @ 6% 7.50
   Total paid to manufacturer $132.50

Retailer earns ITC=GST paid $ 7.50

Manufacturer collects GST $ 7.50
   Deducts ITC 6.00
   Remits net GST to government $ 1.50

Sale of shoes to customer:

Customer pays retail price $200.00
   Plus GST @ 6% 12.00
   Total paid to retailer $212.00

Customer’s ITC $ 0

Retailer collects GST $ 12.00
   Deducts ITC $ 7.50
   Remits NET GST to government $ 4.50

The total GST remitted to the government of $12.00 ($6.00 + $1.50 + $4.50) is effectively borne by the final retail customer. The customer (even if a registrant) is not entitled to an ITC because he or she acquired the shoes for personal consumption and not in the course of commercial activities. Each supplier in the chain recovers its own GST expense through its ITCs. If a supplier’s ITCs in the reporting period were more than the GST collected, the government would refund the excess. Thus GST does not represent a net cost to suppliers, although the delay between payment of GST and recovery through ITCs may create a temporary cash flow cost.

Exempt Supplies

Supplies of certain types of property and services, known as “exempt” supplies, are expressly exempted from the GST. An exempt supply is not subject to GST and the supplier of an exempt supply is not entitled to claim any ITCs. An exempt supplier must therefore either recover its GST expense through its product pricing or bear the cost of GST itself. A supplier who makes both
exempt and taxable supplies must prorate its GST expense reasonably between them, and claim ITCs accordingly.

The principal categories of exempt supplies are:

(a) Supplies of financial services;

(b) Supplies of used residential real estate; and

(c) Supplies of most medical and dental services.

“Financial services” are broadly defined to include, among other things, any payment of interest or dividends, the issue or transfer of debt and equity securities and insurance policies, and the operation of a bank or other similar account.

**Zero-Rated Supplies**

Supplies of certain types of property or services are referred to as “zero-rated” supplies. A zero-rated supply is technically subject to GST, but at a rate of 0%. No GST is charged on a zero-rated supply but, unlike the supplier of an exempt supply, the supplier of a zero-rated supply can recover GST expenses incurred in the course of making the supply through ITCs. This means that zero-rated goods and services are effectively GST-free.

The categories of zero-rated supplies in part reflect Canadian political and social policy, and in part the basic theory that GST is intended only to tax consumption in Canada. The principal categories of zero-rated supplies are:

(a) Supplies of most forms of property or services for export;

(b) Supplies of prescription drugs and basic groceries;

(c) Supplies of certain agricultural products; and

(d) Supplies of most forms of financial services to a non-resident.

**Compliance and Enforcement**

GST and ITCs are calculated, reported, and paid or refunded on a regular periodic basis. The reporting period of a registrant may be monthly, quarterly or annually, depending upon the amount of the registrant’s revenues from taxable and zero-rated supplies.

The GST legislation gives the federal government considerable investigative powers, and provides significant civil and criminal penalties for non-compliance. Subject to a defence of due diligence, a director of a corporation is personally liable for the full amount of the corporation’s net GST liability. Certain members of an unincorporated organization are also personally liable for the organization’s net GST liability.
Other Commodity Taxes

Businesses involved in importing goods into Canada, exporting goods to Canada, or manufacturing and selling goods in Canada may be affected, directly or indirectly, by certain other taxes and duties imposed in Canada. Many products imported into Canada are subject to two types of commodity taxes in addition to the GST: customs duties and provincial sales tax. Products such as alcohol and tobacco are subject to additional excise duties.

Customs Duties

The rate of customs duty payable on imported goods depends upon both the country of origin of the goods and the classification of the goods.

The amount of duty is based on the “value for duty” of the imported goods, which is generally determined by the “transaction value” of the goods. The transaction value is the price paid or payable by the importer of the goods, subject to adjustment for such items as commissions, brokerage fees, royalties, packaging and transportation costs. There are special methods of valuation when the transaction value is not accepted or cannot be determined. This would be the case, for example, where a relationship between the vendor and the purchaser has affected the price or where the importer is a Canadian branch of the foreign exporter. Under certain circumstances, refunds, drawbacks and remission of duty are available.

The Canadian tariff classification system incorporates the principles of the Harmonized Commodity Description and Coding System, an internationally accepted system of classification.

Canada has entered into free trade agreements with several countries, including the United States, Mexico, Israel, Chile and Costa Rica. Pursuant to these trade agreements, Canada has reduced or eliminated customs duties payable on goods imported into Canada that originate in these countries.

Excise Duties and Taxes

Certain goods (including jewellery and gasoline) manufactured in or imported into Canada are subject to an excise tax which applies at varying rates depending on the product manufactured or imported, in addition to any applicable customs duties.

Excise duties are a special form of federal tax applicable to specific goods, which are imposed in addition to GST and customs duties. Spirits, beer and tobacco products manufactured in Canada are subject to excise duties. Where such goods are imported fully manufactured, they are subject to the excise duty on importation. The amount of the excise duty is added to the value for duty when calculating customs duties payable on importation.

Provincial Sales Tax

Both Ontario and British Columbia impose retail sales tax. Every vendor in the business of selling taxable goods or providing taxable services is required to obtain a vendor’s permit.
The current retail sales tax rate in Ontario is 8%. This rate is applied to the retail sale price of goods and specified services at the time of purchase or import into Ontario and is payable by the consumer or user. If property is purchased in or imported into Ontario for subsequent resale, the retail sales tax is imposed not on the original purchase or importation but on the resale. For sales in Ontario, this tax is collected by the vendor as agent for the provincial tax authorities and remitted by the vendor.

British Columbia imposes a retail sales tax, called the Social Services Tax (SST), in the amount of 7% of the amount paid on leases or purchases of tangible personal property for use or consumption. The SST is therefore designed only to apply to the end user of such tangible personal property. “Tangible personal property” is defined broadly by statute to include property that can be “seen, weighed, measured, felt or touched”. Certain other specific transactions, including the lease/sale of computer software, telecommunications services and electricity, are also subject to the SST.
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