

Canada

Federal Taxation

Corporate Taxation

Introduction

Canada is a federation made up of ten provinces and three territories. In this commentary, a reference to a province includes the territories.

The federal and provincial governments each have taxing jurisdiction. Federal tax applies throughout Canada. Provincial taxes are imposed on activity within the province. Most provinces have entered into a collection agreement with the federal government, and accordingly, the federal government administers both the federal and the provincial corporate income tax systems. All taxes imposed by the province are remitted to the federal government. Corporations need file only a single corporate income tax return. The provinces of Quebec, Ontario and Alberta administer their own provincial corporate income tax systems, although Ontario has signed a tax collection agreement with the federal government. Under the agreement, businesses would make combined payments starting in 2008 and file a single return beginning in 2009 for taxation years ending after 31 December 2008.

Corporations are subject to Canadian federal income tax, federal goods and services tax (a VAT-style tax), social security taxes and capital taxes. The provinces also levy a range of taxes including income taxes, capital taxes, resources taxes, payroll taxes, health taxes, insurance premium taxes and tobacco taxes. Not all provinces levy all of these taxes.

The currency is the Canadian dollar (CAD).

1. Corporate Income Tax

1.1. Type of tax system

The Canadian corporate tax system attempts to achieve integration between corporations and their shareholders, meaning that income passing through a corporation should not attract any additional taxation than income received by an individual directly. As taxes are levied at both the individual and shareholder level, double taxation is partially eliminated through a modified imputation system. The system uses a notional dividend tax credit to provide tax relief in respect of domestic dividends paid to individuals. The dividend tax credit is provided at a fixed rate irrespective of the actual corporate tax rate that may have applied to the corporate income out of which the dividends were generated.

If an individual receives a dividend from a resident corporation, the individual grosses up the dividend by 25%. Federal income tax is then calculated by applying the appropriate federal tax rate to this grossed-up amount.

When calculating tax payable, the individual may claim a dividend tax credit equal to 13.3333% of the grossed-up amount. This is illustrated in the following example, which deals with an individual who pays tax at the top marginal rate of tax.

Example

actual dividend received	100.00
gross-up dividend amount by 25%	125.00
basic federal income tax payable (assume top rate of 29% applied to CAD 125)	36.25
deduct dividend tax credit (13.3333% of the grossed-up amount) from basic federal income tax payable	(16.67)
<i>equals</i> net federal income tax payable	19.58
add provincial tax (assume theoretical rate equal to 50% of net federal income tax)	9.79
<i>equals</i> combined federal and provincial tax on dividend	29.37

The above is a theoretical illustration only. Provincial tax rates vary, and the provinces provide their own dividend tax credit. Various federal and provincial surtaxes cause further distortions.

This dividend tax credit does not fully compensate for corporate tax paid in the case of other income. Such other income includes the following:

- active business income of a Canadian-controlled private corporation (CCPC) in excess of the annual limit, which is currently CAD 400,000;
- any income earned by a domestic corporation that has publicly traded shares; and
- any income earned by a corporation that is controlled by non-residents or by domestic corporations with publicly traded shares.

As a result, an enhanced gross-up and dividend tax credit was introduced to provide for better compensation for corporate tax paid. It applies to dividends paid after 2005 by public corporations (and other corporations that are not Canadian-controlled private corporations (CCPCs)) that are resident in Canada and subject to the general corporate income tax rate. In addition, CCPCs can qualify to the extent that their income (other than investment income) is subject to tax at the general corporate income tax rate. Dividends are grossed up by 45%. Federal income tax is then calculated by applying the appropriate federal tax rate to this grossed-up amount. When calculating tax payable, the individual may claim a dividend tax credit equal to 19%. The provinces are also in the process of introducing their own enhanced dividend tax credits.

Subject to certain exceptions, resident corporations may deduct dividends received from another resident corpora-

tion. As a result, no additional tax is imposed on dividends that are paid through a chain of resident corporations. In certain cases, private corporations must pay a refundable tax equal to one third of dividends received from taxable resident corporations; however, this tax is refunded when the recipient corporation in turn pays a dividend to its shareholders.

1.2. Taxable persons

Legal entities subject to corporate income tax include the following:

- all corporations resident in Canada; and
- non-resident corporations, but only to the extent of income from certain Canadian sources (see 6.2.).

This survey is restricted to public and private corporations resident in Canada as well as non-resident corporations.

A partnership is treated as a separate person for the purpose of computing the income of the partnership. Once the income of the partnership has been computed, that income is then allocated to the respective partners based on their respective interests in the partnership. A partner that is a corporation includes its share of partnership income in its own income and pays tax on such income as if the partner had earned the income directly.

A number of corporate entities are exempt from the corporate income tax. The more significant of such entities are as follows:

- subject to certain exceptions, corporations that are at least 90% owned by the federal, a provincial, or a municipal government;
- registered charities;
- non-profit corporations organized and operated exclusively for non-profit purposes. This includes a non-profit corporation constituted exclusively to carry on or promote scientific research and experimental development; and
- corporations incorporated and operated solely to administer a registered pension plan and accepted by the Canada Revenue Agency (CRA) as a funding medium in connection with the registration of the plan.

Special rules apply if a corporation becomes or ceases to be exempt from income tax. The tax year of the corporation is deemed to end at the time of the status change, a disposition of capital assets is deemed to occur, and loss carry-forwards may not be carried over for use after the changed status.

1.2.1. Residence

A corporation is deemed to be resident in Canada if it has been incorporated in Canada.

A corporation that has been incorporated outside Canada is considered resident in Canada if its central management and control is located in Canada. Factors that determine where a corporation is centrally managed or controlled include the place where:

- its directors live and hold their meetings;
- its shareholders live and hold their meetings;
- its managers live and hold their meetings; and

- the organization performs its principal business and operations, and keeps its books and records.

Central management and control may be divided between two places, in which case the corporation is considered to be resident in both places. Usually, central management and control of a corporation is exercised by the directors. If so, the corporation is resident where the directors meet.

1.3. Taxable income

1.3.1. General

Corporations resident in Canada are taxable on their worldwide income. Non-resident corporations are taxable only on certain types of Canadian-source income (see 6.2.).

For corporations, the income tax system recognizes three main types of income sources: business income, property income and capital gains. Property income consists of passive income, such as rent, interest, royalties and dividends, earned through investment (as opposed to business) activities.

A corporation must compute income from each source separately, although the various sources of income are aggregated before computing the taxable income of the corporation. For example, a corporation might carry on two different businesses. Each separate business constitutes a different source of income and the net income or loss must be computed separately for each. Both sources of income are then aggregated with all other sources of income before computing taxable income.

Business income is taxable at full rates. Property income is usually taxable at full rates, with exceptions for certain types of dividends. Capital gains are effectively subject to tax at reduced rates, as only 50% of a capital gain must be included in income.

1.3.2. Exempt income

Virtually all corporate income is subject to income tax, whether that income is received in money or in money's worth. The only important exceptions are as follows:

- certain intercorporate dividends are deductible in computing taxable income (see 2.2.); and
- in general, the death benefit paid under a life insurance policy is exempt from income tax. For example, a corporation might acquire a life insurance policy on a key employee to provide the corporation with funds to assist the corporation if the employee were to die unexpectedly.

1.3.3. Deductions

1.3.3.1. Deductible expenses

Income from a business or property is equal to the profit from that business or property. The Income Tax Act applies the following general principles in respect of the deduction of expenses:

- expenses are deductible only to the extent that they are incurred for the purpose of gaining or producing income;

- expenses are deductible only to the extent that they are reasonable in the circumstances;
- expenses incurred on capital account are deductible only to the extent that the deduction is expressly permitted by the Act (see 1.3.5.);
- expenses are not deductible to the extent that they are incurred for the purpose of gaining or producing exempt income; and
- expenses are not deductible if they are incurred solely for the purpose of realizing capital gains.

In general, an expenditure must have been incurred in the year in order to be deductible in that year. A prepaid expense is deductible only to the extent that the expense relates to the year in question.

In general, the following expenses may be deducted:

- intercorporate dividends (see 2.2.);
- royalties; and
- financing expenses (over a 5-year period, with 20% of the expense being deducted in each year).

Interest expense that is on capital account may be deducted only in accordance with specific statutory rules. Generally, these rules provide a current deduction for simple interest during the year in which it accrues (not the year in which it is paid). In contrast, compound interest is deductible only in the year of payment. In lieu of taking a current deduction for interest on money borrowed to acquire depreciable capital assets, a corporation may elect to capitalize the interest. This election does not apply to inventory.

1.3.3.2. Non-deductible expenses

Subject to specific exceptions, a corporation may deduct only 50% of entertainment expenses. This limitation does not apply to employee functions (for example a staff Christmas party) up to a maximum of six employee functions per year.

Fines and penalties in general are not deductible. Federal and provincial income taxes are not a deductible expense (they are not incurred for an income-earning purpose but are a result of the income-earning process). Other taxes are deductible if they meet the income-earning purpose requirement. For example, municipal property taxes paid in respect of real estate used in the business represent a cost of doing business and are deductible under this principle.

1.3.4. Valuation of inventory

Inventory is valued at the lower of cost or fair market value. Alternatively, one may elect to value all inventory at cost or all inventory at fair market value. The method chosen must be followed consistently from year to year. If it is not practical to determine cost by reference to specific inventory items, tax authorities accept an arbitrary cost selection method that presumes inventory is sold in an assumed order. Permissible methods include the average cost method and the FIFO method. In some circumstances, a standard cost method is acceptable. The LIFO method may not be used.

The rules applicable to the valuation of inventory do not apply to property that is the subject of an adventure in

the nature of trade (i.e. a one-time speculative venture that does not qualify as an ongoing business).

1.3.5. Depreciation and amortization

Taxpayers may depreciate or amortize the cost of most types of capital assets acquired for an income-earning purpose. The major exceptions are land and corporate shares.

Two different depreciation and amortization regimes apply. The capital cost allowance (CCA) system applies in respect of most types of tangible capital assets (buildings, furniture and equipment) as well as specific types of intangible assets (patents, franchises, concessions and licences provided they are of fixed duration). A separate eligible capital expenditure system applies in respect of other types of intangible assets used directly in a business (i.e. goodwill and patents, franchises, concessions and licences, for an unlimited period).

1.3.5.1. Capital cost allowance

The capital cost allowance system groups depreciable assets into various classes. Each class is depreciable at a specific rate, generally on a declining-balance basis.

Capital cost allowance is calculated on the basis of asset pools. Assets of the same class form the pool. For example, office furniture is a class 8 asset, depreciable at a rate of 20% per year on a declining-balance basis. In the year of acquisition, only half the normal depreciation rate may be claimed. The taxpayer may claim as much or as little capital cost allowance as the taxpayer chooses, subject to the maximum amount permitted.

A negative balance in a pool may arise if assets are sold for more than their depreciated cost. A negative balance is brought into income only if it exists at the end of the tax year. A taxpayer can avoid including the negative balance in income if the taxpayer acquires other assets of that same class prior to the end of the tax year and the combined cost of those other assets is at least equal to the amount of the negative balance that would otherwise arise.

If no assets are in the pool at the end of the tax year, the taxpayer may deduct the full amount of the remaining balance as a terminal loss. A terminal loss may not be claimed if any assets are brought back into the pool before the end of the tax year.

No capital cost allowance may be claimed before an asset is available for use. Various statutory criteria determine the date on which an asset is considered to be available for use; however, the maximum delay in claiming capital cost allowance is generally 2 years.

The following table sets out capital cost allowance rates for some of the more common items of tangible depreciable assets. All rates are on a declining-balance basis and are subject to the half-rate rule for the year of acquisition.