PERMANENT ESTABLISHMENT IN CANADA: BRANCH OR SUBSIDIARY?

Whether a Canadian permanent establishment exists depends on the facts. Generally, a permanent establishment is a fixed place of business through which the business of the non-resident is wholly or partly carried on. Tax treaties generally provide that a permanent establishment includes a place of management, a branch, an office, a factory or a workshop. As such, depending on the nature of its activities, a branch operation in Canada will often have a permanent establishment in Canada.

A permanent establishment can arise in many other circumstances as well. For example, having a server that connects to the Internet may be considered to be tangible property having a physical location that may constitute a place of business of a non-resident person. Agents and employees in Canada may constitute a permanent establishment in some circumstances. Having sales representatives in Canada might not constitute having a permanent establishment, provided the representatives do not have or habitually exercise authority to conclude contracts in the name of the non-resident.

A subsidiary is a separate corporation established in Canada and taxed as a Canadian resident on its world-wide income. A branch is the Canadian business activity of a foreign corporation which is only subject to Canadian tax on certain Canadian source income.

A number of issues should be considered in choosing whether to operate as a branch or a subsidiary. If the Canadian operation is expected to incur significant losses in its early years of operation, the foreign entity may wish to carry on business in Canada directly through a branch, in order to deduct these losses for foreign tax purposes, if possible. However, because a branch office is not a legally distinct entity from the parent company, the parent will be exposed to the debts, liabilities and obligations of the Canadian operation. For this reason, many foreign investors prefer to carry on business in Canada through a Canadian subsidiary. The use of a Canadian subsidiary is also more convenient for administrative purposes.

A foreign corporation may conduct business within Canada through a branch operation after obtaining a licence or registering in the province(s) where it carries on business. A corporation may be found to be carrying on business in Canada if it has a resident agent, representative, warehouse, office or place where it carries on its business in a province or if it holds an interest in real property located in a province other than by way of security.

The two important concepts on which Canada's tax laws are based are residency and source. In Canada, income earned by Canadian residents and income earned by non -residents sourced in Canada are subject to Canadian income tax. Under the Income Tax Act, Canadian residents are taxed on their world-wide income, whereas non -residents are taxed on Canadian source income which generally includes income that arises from employment in Canada, a business carried on in Canada, or the disposition of "taxable Canadian property". Generally, however, Canada's tax treaties provide that a corporation's business profits will only be subject to Canadian income tax to the extent that they are attributable to a Canadian permanent establishment. Furthermore, non-residents may also be subject to Canadian withholding tax on certain types of passive income, including interest, dividends, rents, and royalties.

In addition to Canadian federal and provincial income tax, a non-resident corporation carrying on business in Canada through a Canadian branch operation is subject to a branch tax (to replace dividend withholding taxes that would be paid by a subsidiary). Where the rate of withholding tax on dividends is reduced by tax treaty, the rate of the branch tax is often reduced to the same rate.

The ITA generally provides that branch tax is levied on the after-tax Canadian earnings of the business carried on in Canada less any amounts that are reinvested in the Canadian business. A tax treaty may modify the method of calculating the earnings for branch tax purposes. In addition, a tax treaty may exempt the first $500,000 of a non-resident corporation's income from branch tax.

Whether a branch or a subsidiary, the business is required to maintain books and records in Canada and to file corporate tax returns within six months of the fiscal year end. The corporate tax rate is the same for a branch as for a foreign-controlled corporation.