10 tips for U.S. entities seeking to incorporate a Canadian subsidiary

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Canada has a number of unique features when it comes to private law and regulatory law, and U.S. entities need to be mindful when looking to incorporate a Canadian subsidiary. This article provides an overview of commonly asked questions that arise in connection with the establishment of a new Canadian subsidiary.

1. Relevant entities

When expanding into Canada, parties typically consider using corporations and partnerships. Canada does not have a C-Corp vs. S-Corp distinction and the concept of a limited liability company (LLC) does not exist in Canada.

That said, unlimited liability corporations (ULCs) under the laws of Nova Scotia, British Columbia and Alberta are sometimes used since they are deemed to be flow-through entities for U.S. purposes by the IRS and viewed as ordinary corporations for Canadian income tax purposes. In some cases, flow-through status from a U.S. perspective can ease IRS reporting obligations and allow for a better application of Canadian income tax as a foreign tax credit against US income tax.

Therefore, oftentimes a key gating item is to consult with the parent's tax advisors to determine which type of entity is most appropriate under the circumstances.

2. Jurisdiction of incorporation

Once the type of entity is confirmed, parties need to consider under which laws to incorporate, which typically involves choosing either to incorporate federally under the Canada Business Corporations Act (CBCA) or under the laws of a particular Canadian province or territory.

While CBCA corporations are frequently used within Canada, one significant drawback is the CBCA's requirement that at least one director be a Canadian resident. As a result, the choice for subsidiaries for foreign parents is often driven by the lack of director residency requirements and provinces with no such requirement include British Columbia, Alberta, Ontario, Québec, New Brunswick and Nova Scotia.

3. Appreciating the impact of local law

Each of Canada's provinces and territories have their own legal system and regulatory framework, with Canadian federal law being applicable in all provinces and territories. The nature of the Canadian subsidiary's business will inform the overall approach to compliance at the federal, provincial and sometimes local levels.

However, irrespective of industry, each province requires that entities from other jurisdictions register in such province if it is carrying on business or employing personnel there. Furthermore, where Newco has employees on the ground, it is often required to register with the applicable provincial worker's compensation regime.

4. Tax numbers

Upon incorporation, the Canada Revenue Agency (the CRA, Canada's version of the IRS) will assign the new entity a business number, however, most operating businesses will need to take further steps to obtain numbers for payroll taxes (called deductions at source) and Goods and Services Tax (GST) and, as applicable, its local equivalents. These tax numbers are obtained relatively rapidly and at low cost.

It should be noted that Québec has its own version of the CRA called Revenu Québec, whose function is almost identical to the CRA and subsidiaries incorporated in Québec or doing business in Québec need to file tax returns with both the CRA and Revenu Québec.

5. Bank accounts and service providers

Opening up bank accounts can be time consuming due to the Canadian banks' robust know your client and anti-money laundering processes. This is particularly the case if Newco does not have any directors that reside in Canada.

In order to ensure account opening runs as quickly and smoothly as possible, it is helpful to ensure that you are working with bank personnel with cross-border experience and that you respond to their various enquiries in full and on an expedited basis, particularly on matters such as beneficial ownership.

Newco will also require accounting and day-to-day tax administrative support, particularly since it will require its own, non-consolidated financial statements for tax purposes. Further, managing Canadian goods and services tax (GST) and its local equivalents typically requires considerable attention.

Finally, Newco will often require outside assistance with insurance and benefits, which can sometimes be offered by its US providers, though sometimes local options can be more suitable.

6. Employment contracts, stock options and PEOs

Employment agreements and related confidentiality and intellectual property assignment agreements tend to be governed by the laws of the province where the employee ordinarily resides. While employment agreements in Canada's 9 common law provinces are substantially similar, Québec employment agreements are distinct in a number of respects.

When seeking to grant stock options to employees, it should be noted that the taxation of employee stock options in Canada is complex. Please see BLG's previous article for a more in-depth summary on the taxation of equity compensation in Canada, which provides helpful background on equity compensation plans. Of note, Professional Employer Organizations (PEOs) continue to gain traction as a common way for companies to test the waters in Canada.

In our experience, one of the most appealing services a PEO will provide is that of employer of record (EOR). PEOs enter into an employment agreement with employees, in theory taking on the legal responsibility for the employment relationship. For businesses not wanting to establish a presence in Canada, this can be a valuable and convenient service. That said, it should be noted that a PEO cannot be used to circumvent an employer's legal obligations in common law provinces or the province of Quebec. Another technical challenge that may arise with a PEO surrounds the issuance of stock options, particularly where the PEO has been retained as the EOR. When Newco wishes to offer or grant stock options to an employee, it must consider the fact that it cannot do so through the PEO. Notwithstanding some of these technical issues, the use of PEOs can be beneficial under certain circumstances.

Please see BLG's article about engaging a PEO in Canada.

7. CCPC status and SRED credits

A Canadian-controlled private corporation (CCPC) is a private corporation resident of Canada who is not controlled in any way, directly or indirectly, by one or more non-resident person or public corporation. CCPC status is a prerequisite for many special incentives such as a refundable scientific research and experimental development (SRED) investment tax credit (ITC) of 35 per cent on up to $3 million of qualifying expenditures.

Non-CCPC can expect SRED ITC at a basic rate of 15 per cent on qualified SRED expenditures. However, the tax credit will not be refundable, which means that it will have to be applied against Canadian tax payable.

8. Debt to equity ratios and other intercompany arrangements

Thin-capitalization rules restrict the ability of Canadian corporations to deduct interest expense on debt owing to certain related non-residents. Interest deduction will be limited proportionally if a debtor's outstanding debts to related non-residents exceed 1.5 times the debtor's equity in the Canadian corporation.

Furthermore, a new excessive interest and financing expenses limitation (EIFEL) regime will limit the amount of net interest and financing expenses that certain taxpayers may deduct in computing their taxable income, based on a fixed percentage of EBITDA.

Canada also has transfer pricing rules, which require that transactions occur under arm's length terms and conditions.

9. Doing business in Québec

Each of Canada’s provinces and territories have their own legal system and regulatory framework, with Canadian federal law being applicable in all provinces and territories.

Of the 10 provinces north of the border, nine have legal systems rooted in the English common law tradition and one province, Québec, whose private laws are set out in a Civil Code with French Napoleonic roots.

When expanding into Québec, U.S. companies need to be mindful of the province’s unique linguistic, cultural and legal environment, particularly since Québecers represent approximately 22% of the Canadian population.

10. *Investment Canada Act* filing

An often-overlooked formality when incorporating a new foreign-controlled business is the “new business establishment” filing under the *Investment Canada Act*, which is required within 30 days after the business has achieved all of the following:

a. has a place of business in Canada (including employees working from home offices);
b. has an individual employed (or self-employed) in Canada; and
c. has assets in Canada used in carrying on the business.

Key takeaway

While there is no substitute for retaining experienced Canadian counsel to delve into the particulars of each situation, this primer is intended to give U.S. entities a sense of some of the key issues that they may encounter when setting up a Canadian subsidiary.

For more information on how BLG's Mergers & Acquisitions team can help you, please reach out to Neil Ezra Hazan: NHazan@blg.com or 1.514.954.2511.

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