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EXPECT THE BEST

Many Canadian Companies in Position to Reduce Tax Burden

by Paul L. Schnier

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Paul Schnier chairs Blaney McMurtry's tax group. He restricts his practice to income tax law with emphasis on tax planning and implementation and advising as to the tax consequences of proposed transactions. He has advised a variety of public and private corporations on numerous domestic and international undertakings.

Paul can be reached at 416.593.3956 or pschnier@blaney.com.

Many Canadian companies don't know it, but they are in a position to reduce their tax burden substantially.

As Canadian businesses grow in international scope, the need to carry them on exclusively in Canada diminishes. When it is not necessary to carry on these businesses in Canada, an offshore structure can be a great benefit.

By way of background, if a business were carried on in Ontario through a Canadian corporation, it would be subject to tax of approximately 18% on its first $300,000 of annual income and approximately 36 % on the balance. Further tax would be paid when the shareholders withdrew the company's income, after corporate tax, in the form of dividends.

However, Canada has an international tax regime and treaty network that allows businesses to establish themselves in certain foreign countries (including so-called tax havens) in order to lower their overall rate of corporate tax.

These countries include Barbados, Cyprus, Luxembourg, The Netherlands and Switzerland. The Canadian policy that allows Canadian-owned businesses to operate in these jurisdictions at lower tax rates is a key part of Canada's effort to support the global competitiveness of Canadian multinationals.

Barbados offers one good example of a system that allows Canadian owned enterprises to operate at lower tax rates. The key instrument in Barbados is its International Business Corporation (IBC) legislation

The typical structure is for the Canadian company to carry on business through a corporation incorporated under the Barbados IBC legislation. The shareholder of the Barbados corporation is the Canadian corporation. The majority of the board of directors of the Barbados corporation would be residents of Barbados, as would its senior officers. As the sole shareholder of the Barbadian IBC, the Canadian corporation, through its directors, may set policy for the IBC but may not manage its day-to-day affairs. This management must be entrusted to the officers of the IBC, who are residents of Barbados.

The effect of this structure is that the income earned in Barbados by the IBC will be subject to corporate tax at a rate of about 1.5%. There will be no further tax when dividends are paid by the IBC to its Canadian corporate shareholder. Under the Canadian international tax system, these after-tax profits are not subject to further tax in the Canadian corporation. They are subject to Canadian tax only when the shareholders withdraw these profits in the form of dividends. The effect is a significant reduction in the overall rate of corporate tax as well as a deferral of virtually all tax until the money ultimately ends up in the hands of the shareholders.

As an example, if the annual income of the Barbadian IBC were $1,000,000, it would pay $15,000 in tax compared to the $306,000 that would be paid if the business were being carried on in Canada through a Canadian corporation.

If the balances were paid out to Canadian
owners in dividends taxed at an average rate of 30 per cent, those owners would be left with $689,500 in their pockets through the IBC vs. $485,800 through a Canadian corporation carrying on the business in Canada

There are two essential factors necessary for this structure to work:

1. The income must be earned by the Barbados IBC from activities conducted by the IBC in Barbados. In other words, even though clients may be international in scope, the business activities of the company must be conducted in Barbados; and

2. The management of these activities may not be attributed to Canada. Under the tax doctrine of "central management and control," if it were determined that the decision making for the IBC was taking place in Canada, the IBC would be deemed to be resident in Canada and subject to full Canadian corporate tax. It is essential therefore that the substance of the business activity follows the corporate form and that the structure is not merely a facade.

The planning for this type of structure, which many Canadian corporations employ successfully, is much more complicated than this article might suggest, but the benefits may be well worth it.