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Overview of the Difference between the U.S. and Canadian Entity Classification Systems

Entity classification refers to a set of rules used in the U.S. tax system to classify entities for the purposes of the Internal Revenue Code. Once classified, the entity will either be subject to the Code rules for corporations or the Code rules for partnerships.[1]

The Canadian tax system, on the other hand, does not have entity classification rules. Instead, the Canadian tax system simply categorizes entities for tax purposes based on their classification under commercial law. Commercial law recognizes corporations, partnerships and trusts, and the tax system has separate regimes that apply to each.[2] Where these rules apply to human beings, the tax system refers to them as "individuals".

There are two primary reasons why the Canadian tax system has not developed entity classification rules. The first reason is conceptual. The Canadian tax system defers to form over economic substance much more than the U.S. system. As a result, the system views the form of the entity as being determinative. The second reason is that one of the fundamental policies informing the Canadian tax system is that of "integration".

Integration, in the Canadian tax system, is a strategy that tax authorities employ to ensure that the total tax burden remains the same, regardless of the form of business ownership. For example, this means that the income tax burden on income earned by a corporation and distributed to an individual should be roughly equal to the tax burden on the same income if it was earned directly by the individual. The integration policy is implemented primarily through two aspects of the system. First, some of the tax paid by a corporation is refunded to the corporation when it pays a dividend. Second, the individual receives a tax credit to the extent that the dividend income has been subject to tax at the corporate level.[3]

The U.S. has a blatant double tax system for income earned through a corporation. As a result, the need to avoid corporate level tax in the U.S. is a primary motivation for the entity classification system. The integration system in Canada does not give rise to a similar motivation.

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[1] In cases where entities are fiscally transparent, their fiscal results are combined with those of their owners.

[2] The system does not have a separate regime for joint ventures. They are treated in a manner similar to co-ownership arrangements. The CRA does have several publications on how to distinguish between and joint venture and a partnership.

[3] The integration system, and in particular the dividend tax credit calculation, is much more complex than described in this article. Second, a separate set of rules applies to integrate capital gains earned through a corporation with capital gains earned by an individual.

Given the wider implications for international tax planning, the differences between entity classifications in Canada and the U.S. remain an important consideration for the various affected entities in Canada. The most common of these entities is a Canadian unlimited liability corporation (ULC). These entities may be created pursuant to the laws of three provinces: British Columbia, Alberta and Nova Scotia. ULCs have a separate legal personality and therefore are considered corporations. However, as the name suggests, a ULC's shareholders have unlimited liability and, as a result, are disregarded in the U.S. where a ULC has one shareholder. When a ULC has more than one shareholder it is considered to be a partnership. ULCs are commonly used by U.S. businesses expanding into Canada because they combine the advantages of having an entity in Canada with the advantages of fiscal consolidation in the U.S. The fiscal consolidation usually simplifies the application of the U.S. foreign tax credit system.[4] Note that due to the lack of liability protection, a liability blocker between the ULC and its U.S. parent entity is often needed to isolate liabilities from carrying on business in Canada.

Another entity that is commonly used by U.S businesses in Canada is an S-Corp. Canada taxes an S-Corp as a corporation, whereas the U.S. classifies an S-Corp as a partnership. While the use of an S-Corp to carry on business in Canada produces the same result for the U.S. business, the S-Corp provides its own measure of liability protection. Given that Canadian corporate tax rates are low in comparison to the relevant U.S. tax rate, the use of a single purpose S-Corp in Canada is often very efficient.

The ability to elect an entity classification in the U.S. also has its advantages. A Canadian partnership can elect to be taxed as a corporation for U.S. purposes. This is a useful structure since, where the partnership has incidental income, this effectively becomes connection income and Canadian partners continue to benefit from fiscal transparency in Canadian business activities. However, the partnership is able to file a single U.S. tax return as a result of the effectively connected income and shield the partners from the obligation to do so. Most Canadians see value in staying "off the radar" in the U.S.

The above is not meant to be a comprehensive analysis of the entity classification system in Canada. Instead, it provides an overview of the implications of the differences between the U.S. and Canadian entity classification systems and a couple examples of structures that play on these differences.

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[4] Depending on the province in which the business is located, Canadian corporate tax rates are typically less than 30%. Currently, in B.C., the corporate tax rate is 26.5%. These rates typically compare favourably with the U.S.

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