TaxTalk

U.S. FEDERAL TAX CONSEQUENCES FOR CANADIAN BUSINESSES WITH U.S. OPERATIONS

Canadian businesses are expanding their operations into the United States for many reasons, some of which include, lower corporate tax rates due to the 2017 Tax Reform, a stable economy and proximity to Canada. While these are all good reasons to expand into the U.S., Canadian businesses must be aware of the U.S. federal and state tax implications of carrying on a trade or business in the U.S.

Note that this article will only address the federal tax issues that Canadian businesses may face when doing business in the U.S. Further note that state tax is different for each state and for each type of tax i.e. income, sales, etc. Please contact us to discuss your specific state tax issues.

What does it mean by "Carrying on a Trade or Business in the U.S."?

If you operate a business in Canada that is selling or has activities with U.S. customers, you may be considered to be carrying on business in the U.S. Whether or not this is the case will depend on the facts and circumstances of your dealings with U.S. customers.

If yes, your company will be subject to U.S. federal tax if you have income that is "effectively connected" (see below) with a trade or business in the U.S.

Generally, a trade or business is any activity conducted for the purpose of generating income. The level of activity required for 'trade or business" in the U.S. is fairly low. As such, a Canadian company could be considered to be carrying on a trade or business in the U.S. when it has regular, continuous, and its dealings with U.S. customers are a material factor in the realization of that income.

The following are some situations where you might be deemed to be carrying on a trade or business and be subject to tax in the U.S.:

- Sales of products in the U.S. market directly or through agents;
- If you ship goods to the U.S. and title to the goods passes in the U.S., you will likely be considered to have a U.S. trade or business;
- The activities of your employees or agents may cause you to have a U.S. trade or business.

Effectively Connected Income

Generally, when a Canadian company engages in a U.S. trade or business, all income associated with that trade or business is considered Effectively Connected Income ("ECI").

Under U.S. domestic law, Canadian companies are required to pay U.S. federal (and maybe state) income tax on ECI on a net basis (i.e. income less expenses to earn ECI) however, the Canada-U.S. Income Tax Convention (the "Treaty") may provide relief from this tax burden. (See relief described below). Note that the Treaty relief is with respect to income that is not attributable to a U.S. P.E.

For purposes of the Treaty, Canadian companies are required to pay U.S. federal income tax if they carry on business through a U.S. permanent establishment ("P.E.").

What is a P.E.?

A P.E. is defined as a fixed place of business in the U.S. through which a non-resident (i.e. Canadian company) carries on business. Some examples of a P.E. include:

- A physical place of business,
- A branch,
- An office,
- A factory or workshop,
- A place of extraction of natural resources, such as a mine,
- A building, construction or installation project lasting more than 12 months.

Your Canadian business will also be considered to have a U.S. P.E. if a person acting on your behalf in the U.S. regularly has the authority to conclude contracts in your company's name and habitually exercises such authority while in the U.S.

For example, if an employee of a Canadian company travels to a U.S. trade show and actually makes or authorized to make sales there, the Canadian company could be considered to have a U.S. P.E. by virtue of the employee's general authority to conclude contacts at the annual trade show.

Service P.E.

Effective January 1, 2010, the service P.E. provisions of the Treaty came into force to deem a Canadian service provider to have a P.E. in the U.S. if certain conditions are met where the provision of the services would not otherwise create a fixed place of business.

The term "services' can include a broad range of activities, therefore, it is important that all businesses involved in cross-border trade between Canada and the U.S. be aware of the service P.E. provisions of the Treaty. The consequences of having a service P.E. in the U.S. could be significant. For example, a Canadian service provider will be deemed to have a P.E. in the U.S. if services are performed by its employee who is present in the U.S. for 183 days or more, in any 12-month period, and during that period, more than 50% of the company's "gross active business revenue" consists of income derived from the services performed by that employee in the U.S.

Activities that do not give Rise to a U.S. P.E.

Under the Treaty, the following are some activities that do not give rise to a U.S. P.E.:

- The use of facilities for storage, display or delivery of goods,
- The maintenance of a stock of goods for storage, display, and or delivery,
- The purchase of goods in the U.S,
- The collection of information in the U.S., and
- Advertising, supply information or scientific research done in the U.S. that is preparatory or secondary to the business.

U.S. Filing Requirements

Treaty-Based Filing Positions

Canadian companies with income that is effectively connected with a U.S. trade or business must file U.S. federal income tax returns. Note that states are not party to the Treaty and their tax filings are based on nexus for state income tax purposes. The nexus rules are different for each state.

A Canadian business with U.S. ECI that is not attributable to U.S. P.E. must file U.S. Federal Form 1120-F, U.S. Income Tax return of a Foreign Corporation, together with Form 8833 Treaty-Based Return Disclosure (Treaty-Based Return) to claim relief from U.S. federal tax pursuant to the Treaty.

Canadian companies with U.S. ECI attributable to a U.S. P.E. cannot claim the Treaty exemption and must file a Form 1120-F to report the U.S. source income and expenses (e.g. a branch of Canadian company). The regular tax rate is a flat 21% of taxable income.

In addition to the regular tax, a branch will be subject to an additional 5% (30% reduced to 5% under Treaty) tax on branch profits.

Note that if you are not certain if you have income from carrying on business in the U.S., you should consider filing a U.S. return along with a Treaty-Based Disclosure (Form 8833) to protect yourself form penalties for failure to file and disclose a Treaty-based filing position. In this regard, the Treaty return is a "Protective Filing".

Filing Deadlines

The filing due date for a Canadian company with income attributable to a U.S. P.E. is the 15th of the 4th month following the end of the fiscal year of the business if their books and records are kept in the U.S.

The filing due date for a Treaty-based return for Canadian companies that do not maintain an office or place of business in the U.S. is the 15th day of the 6th month following the end of the fiscal year of the business. For example, for calendar year businesses, the deadline would be June 15th of the following year.

If the books and records of the Canadian company with income attributable to a U.S. P.E. (or a U.S. branch) are kept in Canada, then, the filing due date for the return is the 15th of the 6th month following the fiscal year end.

Recent IRS Activity with U.S. P.E. Positions under the Treaty

The IRS stepped up scrutiny of Treaty-based filings with the formation in 2019 of a practice unit in its compliance division to examine whether foreign corporations (including Canadian companies) have a U.S. P.E. as a result of an agent concluding **contracts in the U.S. on its behalf.**

Also, they set up a second practice unit to focus on whether an activity had a preparatory or auxiliary character in order to determine the existence of a U.S. P.E. For example, an office solely for the purpose of advertising, supplying information, servicing a patent, scientific research, or similar activities.

Note that the IRS has instructed its agents in these practice units to look at a variety of sources including financial statements, websites, and the foreign corporation's invoices in order to determine whether a U.S. P.E. exists.

Penalties

If a Treaty return is not filed or is filed late, the IRS may impose a non-disclosure penalty of U.S. $10,000 for each item of income not reported and the Canadian company may be taxed on a gross basis (i.e. no deductions) on its U.S. source gross business.

In light of the IRS's new focus on P.E. positions, it is advisable for Canadian companies that are taking the positions that they have no U.S. P.E. to timely file their Treaty-based return (Form 1120F), including extensions.

Summary

Canadian companies with operations in the U.S. may have federal income tax filing obligations and taxes payable if the business are conducted through a U.S. P.E. The company may also be subject to U.S. state tax depending on the state laws in which it operates.

If you have business operations in the U.S. or are thinking of expanding to the U.S., contact Basil Punit of McCarney Group, LLP to discuss your U.S. tax obligations.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

Offices: First Canadian Place
100 King Street West, Suite 5700
Toronto, Ontario M5X 1C7
Phone: 416-362-0515

1900 Minnesota Court, Suite 116
Mississauga, Ontario L5N 3C9
Phone: 905-451-4788
Fax: 905-451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com). Please visit our web site at www.mgca.com.