



U.S. Business Activities

What are the Tax Implications?

Your Canadian business is doing well and you are looking at the U.S. market to increase sales and bolster your profits. You may even already have some U.S. clients. Have you considered the U.S. tax implications of these sales or contemplated expansion? They could be significant.

U.S. Taxation

The U.S. taxes non-resident corporations that carry on business in the U.S. The income which is subject to U.S. taxation is that which is "effectively connected with the conduct of a trade or business within the United States", as stated in the IRS code.

What constitutes income effectively connected with a business in the U.S? The level of U.S. activity which deems a business to be carrying on business is surprisingly low.

You may be considered to be conducting business in the U.S. if you:

- Establish an office in the U.S. through which you market your services or product.
- Send employees to the U.S. on contracts or to customer sites to provide services or sell products.
- Solicit business in the U.S. or send employees to make sales calls.
- Ship to the U.S. and the title to the goods transfers in the U.S.

Canada – U.S. Tax Convention

Even though under U.S. domestic law, a non-resident person carrying on business in the U.S. is subject to tax on U.S. source business income and must file an income tax return, U.S. taxes may be avoided by way of the Canada – U.S. Tax Convention.

Under the Convention, income earned in the U.S. is only subject to U.S. taxation if it is earned through a U.S. permanent establishment ("PE" for a corporation; "fixed base" for an individual). A U.S. PE is a fixed place of business, such as an office, branch, factory, or other location through which a business is carried on. A permanent establishment could also include a person acting on your behalf, if the person has, and habitually exercises authority to conclude contracts on your behalf. It could also include an employee that performs substantial services in the U.S.

For a number of Canadian businesses, the PE exemption is available for US tax purposes, given their U.S. activities. However, despite not being subject to U.S. taxes, businesses which have income effectively connected with the US must file a U.S. income tax return, and formally claim the treaty exemption on the business income earned.

In the case of a Canadian corporation, it must file Form 1120F and attach Form 8833 disclosing the tax treaty claim. In the case of individuals with businesses, a 1040NR should be filed with the attached 8833 form.

Many taxpayers are tempted to ignore these filing requirements as their taxes payable are nil due to the tax

Ottawa Office

301 Moodie Drive, Suite 400
Ottawa, Ontario K2H 9C4
T (613) 820-8010 F (613) 820-0465
ottawa@collinsbarrow.com

Manotick Office

1136 Clapp Lane
Manotick, Ontario K4M 1A3
T (613) 692-2553 F (613) 692-2995
manotick@collinsbarrow.com

Queensview Office

2725 Queensview Drive, Suite 500
Ottawa, Ontario K2B 0A1
T (613) 226-5661 F (613) 226-3141
queensview@collinsbarrow.com

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treaty exemption. However, significant penalties are in place for failure to disclose tax treaty filing positions to the IRS.

Corporations could be subject to a penalty of \$10,000 while individuals could be subject to a \$1,000 penalty. This penalty could apply to each U.S. sale.

State Taxation

Similarly to Canada's provinces, U.S. states impose taxes on income earned in their respective state. The basis of taxation for most states is the "nexus". A nexus is similar to a permanent establishment but normally has a much broader definition. The slightest connection to a state could create a nexus for state tax purposes.

It is important that Canadian companies be aware that even though there may be no taxation at the U.S. federal level due to a tax treaty filing position, there may still be state taxes to pay. Some states base their tax on federal taxable income whereas others tax companies according to the state's own income tax laws.

Other state taxes which should be considered include franchise taxes and sales taxes. Sales taxes in particular affect a number of Canadian companies. If your company is making sales to customers of a U.S. state, it may be liable for state sales taxes.

U.S. Expansion – Branch vs. Subsidiary

Many companies will pursue business opportunities in the U.S., looking to expand their market. The business structure chosen is often a key decision which may impact the success of the new foreign operations. The most common structures considered are normally a branch or a subsidiary.

Each structure offers its own advantages which can make them appealing, depending on the specifics of a company's U.S. expansion. The benefits normally associated with each structure are as follows:

Branch

- Losses can be used to reduce the parent company's profits.
- 5% branch tax only applies after \$500,000 in earnings.
- Not subject to the accumulated earnings tax.
- No setup costs other than separate accounting records.

Subsidiary

- Income tax computations are much simpler than for a U.S. branch.
- Can become part of a U.S. Federal consolidated group of companies, permitting an offset of losses with other members' earnings.
- Income earned is not subject to Canadian taxation.
- Separate U.S. legal entity, which can be a selling point in the U.S. market.

These are but a few of the benefits which should be considered in determining the structure which best suits your business needs. Discussions should be undertaken with your Collins Barrow tax advisor in order to consider the specifics of your business.

Limited Liability Company Is it Right for me?

The U.S. provides various corporate structures which are very different from those in Canada. The most commonly used is the limited liability corporation. From a U.S. standpoint, it is viewed as a flow through entity for tax purposes and yet provides limited liability to the shareholders.

Canadians are advised by U.S. advisors to use the LLC for their U.S. operations but one small element is often overlooked. From a Canadian tax standpoint, the LLC is treated as a corporation for tax purposes and not a flow through. This can result in a mismatch of foreign tax credits and really complicate a taxpayer's affairs. Therefore, before proceeding with an LLC, you should contact your Collins Barrow advisor to ensure it's right for you.

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Summary

Expansion into any new market is a high risk venture. There are many factors which need to be considered, including the income tax consequences of the expansion. These can be significant and sometimes underestimated by taxpayers.

Let your Collins Barrow advisor help make your expansion smoother by tackling these issues proactively prior to the finalization of any expansion plan.

Our Team Members are:

Ken Tammadge, CA, CPA (ILL.) is a Partner of the firm and brings over 30 years of professional expertise in providing services to entrepreneurial clients on a variety of tax issues in the areas of business succession, estate and retirement planning as well as cross-border tax issues.

Contact Ken at: ktammadge@collinsbarrow.com

Sylvain Campeau, CA, CPA (ILL) is a Senior Tax Manager in the firm and a specialist in income tax, commodity tax and complex cross border tax issues.

Contact Sylvain at: scampeau@collinsbarrow.com

Why Collins Barrow Ottawa LLP

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For more information on our approach, solutions for specific client groups, and the credentials of our experienced team, please visit:

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BAKER TILLY
INTERNATIONAL

Ottawa Office

301 Moodie Drive, Suite 400
Ottawa, Ontario K2H 9C4
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