

Proper Tax Structuring can Bring You Closer to US Customers

Reference: Tax Bulletin – March 29, 2008, *Tax Consequences for Canadians Doing Business in the US*, <http://www.bdo.ca/library/publications/tax/taxbulletins/112005.cfm>

With the US economy struggling, Canadian entrepreneurs are challenged to become more competitive to build business south of the border. Many are finding that getting business requires getting closer – literally -- to their US customers. At the same time, US income tax and filing requirements necessitate a careful approach, because one way of getting closer to the customer can be significantly more expensive than another.

Take ABC Co. for example. This computer hardware reseller wanted to establish a US branch to acquire a local presence, gain better access to suppliers, inventory, and achieve more favorable credit terms from US vendors.

While establishing a branch creates US federal tax filing obligations, under the Canada-US income tax treaty, a company may operate a purchasing center without incurring federal income tax in the US. Generally, a Canadian entity owes tax in the US on income derived from a “permanent establishment” (PE), a “fixed place of business through which the business of a resident is wholly or partly carried on.” However, by establishing a branch whose primary purpose is to purchase merchandise from US businesses, ABC Co. should not owe any US federal income tax. This may make the company’s foray into the United States financially palatable.

If you want your Canadian company to get closer to your prospects and customers across the border, there are numerous ways to structure your business dealings to achieve favourable tax treatment. Following are some of the basic rules to keep in mind.

Under US domestic tax law, a Canadian non-resident corporation is subject to US federal tax if it has income that is “effectively connected with the conduct of a trade or business within the United States.” Whether or not your company meets this test depends upon the level of its involvement with US customers. For example, your business may be considered to have a US trade or business and would be subject to US tax if:

- it ships goods to the US and title to the items passes in that country;
- its employees or agents travel regularly to the US to make sales calls or are marketing, demonstrating goods, or soliciting orders there;
- its employees perform personal services, such as consulting, in the US; or
- Its technicians generate income for your company when they travel to the US on a regular basis to help clients with installations, training, or servicing products.

If your company is engaged in such US trade or business, it will be taxed at graduated rates on a net basis on income that is “effectively connected” with that US trade or business. Effectively connected income generally includes business income and fees that can be attributed to services performed in the US.

Under the Canada-US treaty, however, Canadian corporations are only taxable in the United States on their US business profits if they carry on business in that country through a permanent establishment. This is essentially a fixed place of business such as an office, branch, factory, place of management, etc.

At the same time, certain other fixed places of business are not considered a PE, such as facilities that:

- store, display or deliver goods;
- maintain inventories of goods for storage, display, delivery or processing;
- collect information;
- advertise or supply information or research when those activities are secondary to the business;
- or, like ABC Co., purchase goods.

As well, if your company uses a US broker, general commission agent or other independent agent, it is not generally considered to have a US permanent establishment.

When your business has income that is effectively connected with a US trade or business, a US federal filing requirement exists with or without a permanent establishment.

There are also US state income tax issues to consider. You could be liable for state income taxes even if you don't have a PE for federal income tax purposes. The states are not bound by the Canada-US tax treaty and most impose tax on companies that carry on business in their jurisdiction. The basis of this taxation varies; some states base it on US federal taxable income, others base the tax on the balance sheet. New York State for example, requires a branch having nexus to file returns and pay tax on the portion of the company's worldwide taxable income that is allocated to New York State. Thus, along with choosing the appropriate business structure, selecting the appropriate state for your business dealings can make a big difference to your tax situation.

Go ahead. Fire up that competitive spirit. Just be sure to get reliable advice regarding the best ways to structure your transactions in the US so you simplify business with your US customers while avoiding costly tax complications.

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