Tax Issues Facing Canadian Companies Expanding into the U.S.

By
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A FORMER ATTORNEY WITH THE IRS CHIEF COUNSEL (INTERNATIONAL), ROBERT MISEY, EVALUATES THE FORMS OF OPERATION AVAILABLE TO CANADIAN COMPANIES CONSIDERING CROSS-BORDER EXPANSION INTO THE U.S.

Due to the Canadian-U.S. dollar exchange rate, many Canadian companies are viewing the U.S. as an attractive market for their products. As these Canadian companies cross the U.S. border, they will face some new tax issues. This article surveys the U.S. rules of international taxation encompassing these tax issues, which will often involve looking at the Canada-United States Income Tax Convention of 1980 as amended ("the treaty").[1]

Let us assume that a Canadian manufacturer, CanCo, has nominal exports to the U.S., but wants to expand U.S. sales. The U.S. expansion will replicate CanCo's Canadian distribution centre, which includes a sales office. CanCo will periodically detail a few Canadian sales persons and quality control specialists for approximately six months to ensure the proper functioning of CanCo's unique distribution software used at the U.S. distribution centre. When the U.S. operations become profitable, CanCo expects to repatriate cash.

CanCo will have to deal with the following major issues:

- Should CanCo structure its expansion into the U.S. through a branch or a subsidiary?
- What kind of exposure does CanCo have to state taxes?
- What are the U.S. tax consequences to the Canadian employees working in the U.S.?

Structure in the U.S.

CanCo has the choice of operating the distribution centre as a U.S. subsidiary ("USSub") or as a branch of CanCo in the U.S. There are several differences between the two types of organizations. Even if CanCo forms a limited liability company ("LLC") in the U.S., CanCo will have to choose whether it will treat LLC as a USSub or branch for tax pur-

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poses under the entity classification regulations.[2]

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A USSub of CanCo would incur corporate income tax at rates ranging from 15 to 35 percent.[3] CanCo and USSub must allocate a proportional basis of CanCo's general and administrative expenses to reduce USSub's income. USSub can deduct payments to CanCo for royalties and interest, which are subject to a 10 percent withholding tax,[4] and management fees, which do not incur a withholding tax.[5]

USSub should incur a five percent withholding tax when repatriating a cash dividend to CanCo.[6] CanCo should treat any dividend received as a return of excess surplus in Canada that should not generate any additional Canadian tax liability or foreign tax credits.[7]

Because USSub is subject to U.S. taxation, CanCo will want to place all U.S. activities in USSub to avoid inadvertent treatment of CanCo as a U.S. permanent establishment. A permanent establishment that earns effectively connected income in the U.S. would incur U.S. tax in addition to the U.S. tax that USSub would already be paying.

Under the treaty, a permanent establishment is a fixed place of business through which a foreign business conducts its local operations.[8] If CanCo were to operate the distribution centre and sales office as a branch, CanCo would obviously have a permanent establishment due to its fixed place of business, which this article will discuss later.

But if CanCo operates in the U.S. through a USSub, a permanent establishment may inadvertently result from the activities of CanCo employees in the U.S. For example, because the treaty states that an office constitutes a permanent establishment, CanCo will want to avoid having any of its employees use the sales office at the U.S. distribution centre.[9] The treaty does exempt a mere warehouse, without any other type of activities, from treatment as a permanent establishment.[10]

An inadvertent permanent establishment may also result from CanCo giving its CanCo employees operating in the U.S. the contracting authority of an agent.[11] Under the agency test, a dependent agent of CanCo may constitute a permanent establishment if the agent has the authority to contract on behalf of CanCo in the U.S. and the agent habitually exercises that authority. Although the treaty does not define habitual exercise, the exercise of authority to negotiate and enter into contracts once or twice is probably habitual. The more the employee exercises this authority, the more likely the IRS would deem it habitual.

CanCo should not have an inadvertent permanent establishment from its employees' involvement in the construction of the U.S. distribution centre provided that the construction activity lasts less than one year.[12]

In addition to avoiding an inadvertent permanent establishment, CanCo should ensure that USSub does not have any transfer pricing exposure.[13] Transfer pricing refers to the price that related corporations charge each other for tangible property, intangible property, services and loans. Transfer pricing receives substantial scrutiny from the IRS's international examiners, who may impose additional tax and a 20 to 40 percent penalty if the prices are not at arm's length.[14] The best way to avoid a transfer pricing adjustment when audited and to avoid a penalty is to document the pricing practices as required by the regulations[15] or to enter into an advance pricing agreement.[16] In our hypothetical situation, intercompany transactions could arise from the sale of goods, the transfer of technology, the provision of services or constructive loans based on generous payment terms.[17]

THE BEST WAY TO AVOID A TRANSFER PRICING ADJUSTMENT WHEN AUDITED AND TO AVOID A PENALTY IS TO DOCUMENT THE PRICING PRACTICES AS REQUIRED BY THE REGULATIONS OR TO ENTER INTO AN ADVANCE PRICING AGREEMENT.

BRANCH

Assuming that the operations of CanCo's U.S. branch constitute a permanent establishment, the effectively connected income[18] generated would similarly incur federal tax at rates ranging from 15 to 35 percent.[19] The branch can take deductions appropriate to the taxed activities, which include general and administrative expenses calculated on a proportional basis between the branch and its CanCo headquarters, assuming that the branch can show it has benefited from these expenditures.[20] A dis-

advantage is that the branch, as a non-corporate entity, cannot deduct payments for royalties, management fees or interest to its CanCo headquarters.

In lieu of withholding on a dividend, the IRS imposes a complex system of branch taxation on three separate tax bases:

1. Profits from CanCo's branch operations that are deemed repatriated from the U.S. under the branch profits tax rules;[21]
2. Interest deemed paid by the branch to foreign lenders;[22] and
3. Excess interest that is apportionable to effectively connected income of CanCo but not deemed paid by the branch.[23]

The IRS imposes the branch profits tax, the most relevant of the three, on a branch's U.S. earnings that are deemed repatriated to Canada. The branch profits tax is designed to approximate the U.S. withholding tax imposed on a U.S. subsidiary for dividends to its foreign shareholders. Because the repatriation of branch profits does not involve actual remittances, CanCo would have to segregate its U.S. branch's earnings from other earnings.

More specifically, the branch profits tax applies to after-tax earnings that are effectively connected to CanCo's U.S. operations to the extent CanCo does not reinvest those earnings in the U.S. The IRS imposes the branch profits tax at a five percent treaty rate[24] and is in addition to the regular U.S. corporate income tax on the effectively connected income. The treaty further provides for an exclusion from branch profit tax on the first $500,000 (Canadian) of a branch's effectively connected income.

Although CanCo's branch will incur both U.S. taxes on the branch's effectively connected income and Canadian tax, Revenue Canada permits a foreign tax credit to reduce a portion of the Canadian tax.[25]

If CanCo expects the U.S. operations to lose money the first few years, a branch would permit the U.S. losses to reduce CanCo's Canadian taxable income.

State Tax Issues

Because states, counties and municipalities are not parties to the treaty, some states do not respect the treaty. As a result, CanCo may be exempt from U.S. federal tax pursuant to various treaty provisions, but subject to various state taxes. Although a review of each state's respect of the treaty is beyond the scope of this article, CanCo should know it may have some state tax exposure.

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STATE INCOME TAX

The state of USSub's incorporation can tax USSub even if USSub does not conduct any business there. If USSub has activities in most states, the tax professional should consider the states of Nevada or Delaware due to their minimal reporting requirements and tax. USSub can incorporate in either state even if USSub organizes its distribution centre elsewhere (*i.e.*, distribution centre is in Wisconsin).

When a corporation earns income from business activities sourced in states outside the state of incorporation, the source states will use their apportionment factors to tax a portion of the corporation's income. However, there must be a sufficient contact or nexus with a particular state before the state can impose a tax. USSub would still have to file tax returns in the state where the distribution centre is located because the distribution centre would likely constitute nexus.

In addition to a state income tax, many states have a franchise (or capital-based) tax that applies if the corporation has royalties in the state.

STATE SALES AND USE TAX

Generally imposed on the ultimate consumer, state sales tax applies to the transfer of property (goods) and/or selected services at retail. The burden of proving that the tax does not apply lies with the seller unless the seller receives a certificate of exemption from the purchaser. The most common exemption is for non-retail sales because the policy of the sales tax is to tax the ultimate consumer on a retail sale. When goods are sold and the purchaser intends to resell the property, the sale is an exempt resale sale and not a retail sale.

A state may impose sales tax on intrastate sales and not interstate sales. All states that levy a sales tax also levy a use tax, which is an excise tax imposed on using, storing or consuming goods in a state. The primary purpose of the use tax is to protect in-state merchants from the competition of out-of-state sellers whose sales do not bear sales tax. Although sellers pass-on

the sales and use tax to the ultimate consumer, the sellers usually collect and remit the tax.

As with state income taxation, an out-of-state company must have nexus to incur liability for a state's sales or use tax. If a business does not have nexus with a state, then the responsibility for collecting and remitting the sales or use tax reverts to the purchaser. However, if the business has nexus, which varies by state, the business must collect and remit sales tax.

U.S. Taxation of Canadian Individuals in the U.S.

The Canadian individuals who work for CanCo will be concerned about any exposure to a U.S. federal tax liability from their assignment to the U.S. distribution centre. A Canadian individual's U.S. federal tax liability depends on two levels of inquiry. First, is the individual a U.S. citizen or resident? Second, if the individual is a nonresident alien in the U.S., does the treaty exempt the individual from taxation?

The U.S. taxes its U.S. citizens or residents on their worldwide income.[26] Assuming that the Canadian individuals are not U.S. citizens, U.S. taxation on worldwide income will still occur if they are residents under both the Internal Revenue Code[27] and the treaty.[28]

Nonresident aliens are individuals that are not U.S. citizens and have failed to meet the residency requirements.[29] If the individuals are nonresident aliens, the treaty determines their tax exposure.

Under Article XV of the treaty, salaries, wages and other similar remuneration earned by the Canadians for services performed in the U.S. do not incur U.S. tax if one of the following occurs:

1. the compensation paid in the calendar year is less than U.S. $10,000, or
2. the employee is present in the U.S. for less than 183 days during the year and the compensation is not borne by a U.S. employer (a U.S. subsidiary or branch).

If the individual meets one of these alternatives, no U.S. tax is due on the compensation. Although the first alternative (the $10,000 alternative) is simple, the second alternative merits further discussion.

Under the second alternative, if the Canadians are in the U.S. for less than 183 days,[30] their U.S. taxation depends on whether they are employees of either a U.S. employer (USSub or branch) or of CanCo. If the Canadians are employees of CanCo, they do not have a U.S. tax liability and should file a Form 1040NR that discloses the treaty position and reports the excluded amount.[31] But if the Canadians are employees of either USSub or branch, they have a U.S. tax liability, which requires withholding of 30 percent of their compensation,[32] the filing of a Form 1040NR with limited deductions and exemptions[33] and possible liability for the U.S.'s social security system.

THE U.S. HAS A TOTALIZATION AGREEMENT WITH CANADA THAT CAN ELIMINATE THE U.S. SOCIAL SECURITY TAX FOR THE FIRST FIVE YEARS A CANADIAN WORKS IN THE U.S.

U.S. Employers must withhold and remit the employee portion of the social security tax ("FICA") on all remuneration paid. In addition, the employer must pay their portion of the social security tax. For 1999, a rate of 6.2 percent applies to the first $72,600 of compensation for the old-age, survivors and disability insurance portion ("OASDI") for both employee and employer. The Medicare rate of 2.9 percent applies to all compensation.[34]

The U.S. has a totalization agreement with Canada that can eliminate the U.S. social security tax for the first five years a Canadian works in the U.S.[35] To obtain the exemption, the employer must transfer the employee to a U.S. location and receive a certificate of coverage from Revenue Canada. Because the Canadian social insurance rates are not as high as the U.S.'s, this exemption could save the employer a substantial amount of tax.

Please note that the federal tax treatment of CanCo's U.S. operations and these Canadian individuals are at odds. If the Canadian individuals are employees of either USSub or branch, CanCo avoids any inadvertent permanent establishment status as described above. But for the individuals to avoid U.S. tax, CanCo must employ them, which may result in CanCo having an inadvertent permanent establishment that the U.S. can tax.

The Canadian employees also may be liable for state income taxes depending on the respect the various states provide the treaty.

Conclusion

When expanding into the U.S., CanCo faces several key tax issues. First, CanCo must decide whether to operate as a subsidiary or a branch. Second, CanCo will try to minimize the burden of a variety of state taxes. Finally, CanCo will want to minimize the tax burden on its Canadian personnel in the U.S.

The federal tax impact of operating as a USSub or as a branch is fairly comparable. If the sales are purely U.S. sales, both will pay tax at marginal rates of 15 to 35 percent of their income while paying a five percent tax on repatriation through either the branch profits tax or withholding on dividends from USSub. A branch will result in several administrative inconveniences, such as accounting for all the branch taxes, while a subsidiary will require a review of transfer pricing.

With respect to state taxes, if CanCo decides to operate in the U.S. through a USSub, USSub will incur income tax in the state of incorporation. If USSub or CanCo has sufficient nexus in other states, those other states may impose tax based on their apportionment rules. Most states have a sales and use tax for which the U.S. activities may create nexus, resulting in registration to collect and remit the tax, unless a specific exemption applies.

Assuming that the Canadian employees are nonresident aliens in the U.S., they will incur tax on their U.S. source income unless the employees are in the U.S. for less than 183 days and CanCo bears the cost. The U.S.-Canada totalization agreement on social security may exempt the Canadian employees from any U.S. social security tax.

Despite the presence of these new issues, prudent planning will enable the tax professional to provide for an efficient U.S. operation.

ENDNOTES

1 Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital (1980), as amended by protocols.
2 Reg. §301.7701-1 through -3.
3 Code Sec. 11.
4 Treaty, Art. XII (Royalties); Art. XI (Interest).
5 Treaty, Art. VII.
6 Treaty, Art. X (Dividends).
7 Income Tax Act §113.
8 Treaty, Art. V (Permanent Establishment), par. 1.
9 Treaty, Art. V, par. 2.
10 Treaty, Art. V, par. 6.
11 Treaty, Art. V, par. 5.
12 Treaty, Art. V, par. 3.
13 Code Sec. 482; Reg. §1.482.
14 Code Sec. 6662.
15 Reg. §1.6662-6(d)(2)(iii).
16 Rev. Proc. 96-53, 1996-2 CB 375.
17 Reg. §1.482-2 through -4.
18 The only way that CanCo could avoid permanent establishment status for its branch would be to hire an independent warehouser and not have any CanCo employees visit, which is impractical from a business standpoint.
19 Code Sec. 11.
20 Code Sec. 882(c).
21 Code Sec. 884(b).
22 Code Sec. 884(f)(1)(A).
23 Code Sec. 884(f)(1)(B).
24 Treaty, Art. X (Dividends).
25 Income Tax Act §126.
26 *Cook v. Tait*, 265 US 47 (1924).
27 Code Sec. 7701(b); Reg. §301.7701.
28 Treaty, Art. IV (Residence).
29 Code Sec. 7701(b); Reg. §301.7701.
30 Even though physical presence in the U.S. for more than 183 days would qualify the individual as a U.S. resident under the substantial presence test, the treaty tie-breaker provisions may still deem the individual a Canadian resident and, therefore, a U.S. nonresident alien.
31 Code Sec. 6114.
32 10 percent for the first $5,000. Treaty, Art. XVII (Withholding of Taxes in Respect of Personal Services). Code Sec. 1441.
33 Code Secs. 871 through 874.
34 Code Sec. 3101.
35 The Social Security Administration Totalization Agreement with Canada of 1984, as amended (1996).