Doris Dennee
Baker Newman & Noyes, LLC
100 Middle Street PO Box 507
Portland, ME 04112
(800) 244-7444
FAX (207) 774-1793
ddenneebnncpa.com – www.bnncpa.com

Income Tax Implications of Doing Business in Canada

Do you ship goods to Canadian customers? Have you considered marketing your products in Canada? Do your employees occasionally cross the Canadian border to sell or to perform services for your business?

If you answered "yes" to any of these questions, it is important that you have a clear understanding of the tax implications of your Canadian business activities. While there are many similarities between Canadian and U.S. tax rules, there are also enough differences that you will want to consult your tax advisor for assistance in dealing with these issues.

Non-residents carrying on business in Canada generally are subject to income tax on the profits from their Canadian activities. For U.S. resident companies however, our income tax treaty with Canada provides some relief from these broad rules. Exporters that only sell cross-border and other businesses that have only a limited presence often can claim exemption from Canadian tax if they are careful to structure their Canadian activities to fall within the treaty provisions.

What is considered "carrying on a business in Canada?"
As Canada's Income Tax Act only imposes tax on the activities of non-residents if they carry on a business there, the first question to ask is whether you are considered to be "carrying on a business" in Canada. This is generally a matter of the specific facts and circumstances of each case.

The law identifies specific activities however that, when conducted by a non-resident, will be deemed to be carrying on business in Canada. Predictably, these include producing, growing, manufacturing, constructing, fabricating and packing. But they also include the soliciting of orders or offering anything for sale in Canada through an "agent or servant," whether the contract or transaction is to be completed inside or outside Canada. Carrying on business in Canada can also include providing services in Canada.

Note that *the mere solicitation of orders is enough to be carrying on a business in Canada*. If you offer something for sale in Canada through an employee who is a salesperson, you are carrying on business there. If, on the other hand, you sell to an independent contractor such as a Canadian-based retailer or wholesaler who then resells the item, and you have no other presence, you are probably not carrying on business there.

Qualifying for the Benefits of the Canadian Income Tax Treaty
If you *are* carrying on a business in Canada, you may still be able to claim exemption from Canadian tax if you can qualify for the benefits provided by the Canada-U.S. Income and Capital Tax Treaty.

As long as you avoid creating a "permanent establishment" as defined in the treaty, Canada will not tax you on the profits from your operations. A permanent establishment ("PE" for short) is a fixed place of business through which the business is wholly or partly carried on. For example, if you open a factory, an office, or have other permanent space available to you, you probably have a PE. A warehouse used only for purposes of storage, display or delivery of goods is specifically exempted. Construction projects lasting less than 12 months are also specifically exempted.

The treaty also permits you to carry on business *(e.g., sell)* through an independent broker or other independent agent, as long as that agent is acting in the ordinary course of his business.

As is the case in many countries, the treatment by Canada of internet-based commerce is not clear, and it is not addressed in the treaty. Your tax advisor can assist in assessing the facts and circumstances of your particular situation.

Even if you believe that you do not have a PE, it is important to note that you are not automatically protected by the Treaty. To claim the benefit, you must file a Canadian tax return providing details of your operations in Canada, and attach Schedule 91, "Information Concerning Claims for Treaty-based Exemptions." We recently have seen increased enforcement by the Canada Revenue Agency for businesses not previously filing returns, as well as increased audit activity based on the information provided in these non-resident returns.

Issues for Limited Liability Companies – Trap for the Unwary

Limited liability companies (LLCs) are a popular form of doing business in the United States, because of the tax and legal benefits they provide to small businesses. Unfortunately, the Canada Revenue Agency takes the position that an LLC is not entitled to protection under the treaty. Without the benefit of treaty protection, not only would a U.S. LLC be required to pay income taxes on its Canadian sourced profits, it would also be assessed a 25% "branch profits" tax on any profits that are repatriated (instead of the 5% branch tax allowed under the treaty for eligible entities.)

Therefore, *an LLC is not a suitable form for a U.S. venture that may be carrying on business in Canada.* For a small business that requires the protection of the corporate form, a Subchapter S corporation may be a more attractive form of doing business in this situation. Even though an S corporation elects flow-through status for U.S. tax purposes, it will still be eligible for Canadian treaty benefits, and can offer the legal protection of the corporate shield.

Providing Services in Canada

As a general rule, anyone who provides services in Canada will be subject to Canadian tax on the income earned from the performance of those services.

Again, the Canadian treaty offers some exemptions from this rule. A corporation that does not have a PE under the treaty is exempt if it properly files the claim for exemption. An individual who provides services as an independent contractor is exempt as long as he or she has no fixed base in Canada. An individual who performs services as an employee of a non-resident company without a PE is exempt as long as the employee is present in Canada for no more than 183 days during the calendar year, or the compensation does not exceed C$10,000.

Regardless of these treaty exemptions, Canadians who make payments to non-residents (other than employees) for income such as fees, commissions or other payments for services rendered in Canada are required to withhold a 15% tax on the gross amount paid. This is true regardless of whether the services are performed by a company or an individual, and regardless of whether the individual or business has a permanent establishment in Canada under the treaty.

This withholding tax is considered a payment on account of the overall tax liability. A non-resident who has been assessed the withholding tax can subsequently file a Canadian tax return computing the taxable income amount and relevant tax liability, claiming treaty protection if appropriate, and claim a refund for any overpayment. Recently, claims for refunds have taken up to two years to be cleared by the Canada Revenue Agency.

It is interesting to note that while a business may not have a PE in Canada, it may employ workers who are present in Canada for more than the 183 days allowed by the treaty. In this instance, it would be necessary for the employer to comply with all of the employment tax withholding and reporting rules applicable to Canadian employers. The employees in this case would be subject personally to Canadian income taxes. They would be required to file an individual income tax return and pay the applicable tax.

U.S. Tax Implications of Canadian Business Activities

Regardless of how Canada views your cross-border activities, the U.S. will also include your Canadian business profits in your U.S. tax return if you have not set up a separate foreign corporation. The United States taxes its residents and citizens on their worldwide income, regardless of its source. The treaty does not change this.

If you do incur Canadian taxes on your Canadian income, in most cases you should be able to obtain relief from the double taxation on that income by claiming the foreign tax credit. As there are many restrictions on the availability of this credit, it is not a perfect mechanism for relief.

It is far better to minimize the incidence of Canadian taxation on your cross border activities by taking full advantage of the treaty provisions available, thus ensuring that you are paying the lowest overall income tax.