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CANADIAN BUSINESS: US PE?

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The Canada-US treaty and protocols generally set out rules governing which jurisdiction has the authority to tax certain types of income. Under the treaty, if a Canadian "carries on" a business in the United States, the business profits are subject to US tax to the extent that they are attributable to a PE. Any Canadian resident that carries on business in the United States or sends employees to perform services in the United States on its behalf should be mindful of when a US PE is established.

A PE, defined in treaty article V, generally means a fixed place of business, such as a place of management; a branch; an office; a factory; a workshop; and a mine, well, or any other place of extraction of natural resources. A PE does not include, however, a fixed place of business for the use of facilities for the purpose of storing, display, or delivery of goods or merchandise; the maintenance of a stock of goods or merchandise for the purpose of storage display or delivery; or similar uses. Thus, a Canco that has an office in the United States has a PE in the United States.

A PE may also be deemed to exist on the basis of the activities of Canadian employees in the United States. Thus, a PE may be created because employees have, and habitually exercise in the United States, an authority to conclude contracts in the name of the Canadian resident. If a Canadian contracts with a third party in the United States to perform services, it is essential to analyze the relationship to determine whether the third party is an independent or a dependent agent. A PE may also arise (1) if the services are provided in the United States by an individual who is present in the United States for a period or periods aggregating 183 days or more in any 12-month period, and during that period or periods more than 50 percent of the gross active business revenues of the enterprise consist of income derived from the services performed in the United States by that individual; or (2) if the services are provided in the United States for an aggregate of 183 days or more in any 12-month period with respect to the same or a connected project for customers who are either residents of the United States or who maintain a PE there, and the services are provided in respect of that PE.

For these purposes, "gross active business revenues" (which are defined in the US Treasury's technical explanation to the fifth protocol) are not restricted to the activities related to the provision of services and are not affected by when the actual billing occurs or by domestic law concerning when the revenue should be taken into account for tax purposes. The term "gross active business revenues" does not include income from passive investment activities. In addition, for the purposes of determining whether the time threshold has been met, projects are connected if they constitute a coherent whole, commercially and geographically. Whether projects are connected is determined from the point of view of the enterprise (not of the customer), and it depends on the facts and circumstances of each situation. Furthermore, non-working days are counted in the total number of days for the purposes of the first condition cited in the paragraph above, but they do not count for the purposes of the second condition; days spent on preparatory or auxiliary activities are not counted for either purpose.

If a Canadian business has a PE in the United States, the PE is taxed as a branch in the United States. Thus, the branch's taxable income is subject to US corporate income tax at graduated rates ranging from 15 to 35 percent, and it must file an annual US tax return. Moreover, the US branch's profits that are not reinvested in the branch are deemed distributed to the Canco and subject to a treaty withholding tax rate of 5 percent. Both the treaty and US domestic law provide an exclusion from the additional withholding tax for the first Cdn$500,000 of US-branch income. However, US states do not necessarily follow the treatment prescribed in the treaty, and a Canadian resident doing business in the United States should thus also be mindful of potential state-tax exposure.

A Canadian resident must also comply with all US tax-filing requirements, including state tax-filing requirements. For instance, if a Canco carries on business in the United States but does not have a PE there, the Canadian resident must still file treaty-based return disclosures. Thus, for example, IRS form 8833 ("Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)") must be attached to a US tax return (form 1120-F, "U.S. Income Tax Return of a Foreign Corporation," for a Canadian corporation).