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"Doing Business in Canada"

Key tax considerations to understand

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Discussion Outline

- Introduction
- Permanent Establishment
- Branch vs. Subsidiary
- Goods & Services Tax
- Services rendered in Canada by U.S. companies
- Questions?

Permanent Establishment under the U.S.-Canada Tax Treaty

Permanent Establishment

- Canadian business profits of a U.S. company are subject to Canadian income tax only if the U.S. company has a permanent establishment (“PE”) in Canada.
- PE is a term defined in the U.S.-Canada Tax Treaty.
- PE definition includes a traditional bricks and mortar office location as well as a variety of provisions that deem a PE to exist where there may be no physical office location.

Construction & installation sites

- A building site, construction or installation project constitutes a PE if it lasts more than 12 months.
- The term *installation project* is not restricted to construction projects.
- For example, a computer software project may constitute an installation project.

Employees & dependent agents

- An employee acting in Canada on behalf of a U.S. company is deemed to be PE if the person has, and habitually exercises, an authority to conclude contracts in the name of the U.S. company.
- Authority to conclude contracts does not, by itself, create a PE; the authority must be habitually exercised.
- A U.S. sales rep with signing authority may visit Canada without creating a PE as long as contracts are not concluded.
- Beware the appearance of U.S. head office rubber stamping of contracts negotiated in Canada.

Independent agents

- A U.S. company may carry on business in Canada through an independent agent.
- Contracts may be concluded in Canada by bona fide independent agents without creating a PE of the U.S. company.

Inventory in Canada

- U.S. company may use a public warehouse in Canada for storage or delivery of goods to customers.
- The limitation of “storage or delivery of goods” must be adhered to; for example, if a U.S. company stores parts at a Canadian warehouse and uses those parts to perform warranty repairs, the U.S. company may have a PE.

Deemed PE – 183-day rule #1

- PE is deemed to arise if:
  - services are performed in Canada by an individual who is present in Canada for 183 days or more in any twelve-month period, and, during that period, more than 50 percent of the gross active business revenues of the U.S. company consists of income derived from those services.
- 183 days includes all days the individual is present in Canada (work days, travel and vacation).

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Deemed PE – 183-day rule #2

- PE is deemed to arise if:
  - services are provided in Canada for an aggregate of 183 days or more in any twelve-month period with respect to the same project or connected projects.
- 183 days includes only days on which services were rendered in Canada.
- Multiple workers in Canada on the same day counts as only one day.

Deemed PE under the 183-day rules

- These 183-day rules for services were introduced in 2007.
- Intended to capture taxable revenue in the new information services age where physical offices no longer need to exist.
- The rules also respond to an earlier court case that CRA lost.
- Mr. Dudney was a U.S. independent contractor who spent 300 days in Canada in 1994 performing services for one client and worked entirely out of his client's Canadian office.
- CRA asserted unsuccessfully that the client's office was a PE of Mr. Dudney.
- Cross border service providers such as Mr. Dudney are now automatically deemed to have a PE in Canada under the 183-day rules.

Employee home office

- To reduce the risk that a Canadian employee's home office may create a PE, ensure that business cards, phone listings, email signatures, advertising, website information, social media accounts, tweets, news feeds, etc. do not refer to the employee's home address.
- Evidence of PE indicators are difficult to monitor in today's online world where so much company information is being streamed to the public.
- By the time CRA has contacted a company about a PE audit, CRA has normally already reviewed the company's online content.

Employee home office

- Employers should exercise caution if asked to sign Canadian tax form T2200 “Declaration of Conditions of Employment.”
- T2200 includes a statement indicating the employer requires the employee to have a home office.
- A employer-signed T2200 is relied on by CRA to support reassessments that an employee’s home office is U.S. company’s PE.

Combined Canadian federal and provincial corporate income tax rates

B.C	26%
Alberta	25%
Saskatchewan	27%
Manitoba	27%
Ontario	26.5%
Quebec	26.9%
New Brunswick	27%
Nova Scotia	31%
Prince Edward Island	31%
Newfoundland	29%

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Branch vs. Subsidiary

Canadian branch of U.S. company

ADVANTAGES:

- Flow through of foreign income and foreign tax to U.S. shareholder
- 5% branch profits tax and $500,000 branch profits tax exemption
- No requirement to report transactions, charges or cost allocations between Canadian branch and U.S. home office to CRA

Canadian branch of U.S. company

DISADVANTAGES:

- Need to annually determine the amount of taxable profit “reasonably attributable” to Canadian branch
- Often difficult to convince CRA auditors of reasonableness of “home office” charges to the Canadian branch
- CRA auditors seem to struggle with the concept of an overhead allocation to a branch
- Difficulties may arise obtaining commercial insurance, opening Canadian bank accounts, setting up Canadian employee benefits plans, etc.

Canadian subsidiary of U.S. parent

ADVANTAGES:

- 5% withholding tax on dividends
- Generally easy to set up tax registrations, business licenses, bank accounts, etc.
- Profits subject only to lower Canadian rates until such time as dividends are paid to the U.S. parent

Canadian subsidiary of U.S. parent

DISADVANTAGES:

- No flow through of foreign income and foreign tax to U.S. shareholder
- Query whether loss of flow through is an advantage due to substantial reductions in Canadian corporate income tax rates in the past decade
- May need one or more Canadian directors depending on jurisdiction of incorporation

Canadian ULC alternative

- Canadian "unlimited liability company" ("ULC") is taxed as a corporation by Canada but disregarded by the IRS.
- ULC can provide some of the advantages of both a branch and subsidiary.
- Main concern is that low treaty tax rates on various types of distributions by ULC may not be available.
- 5% withholding tax on dividends only if the dividend is structured as a capitalization of retained earnings into paid up capital.
- Management fees, interest payments, royalties paid to parent may be subject to 25% withholding tax.
- A ULC can be effective in the right circumstances; review pros and cons prior to setting up a ULC.

Branch vs. subsidiary decision factors

MAIN TAKEAWAYS:

- Flow through of foreign income and foreign tax to U.S. shareholder is an important, but not the only, consideration.
- For example, if a Canadian business is heavily debt financed, it may be preferable to set up a subsidiary and accelerate debt repayment with profits that have been taxed at lower Canadian rates.
- If a U.S. company partners 50/50 with a Canadian resident, the Canadian corporate tax rate will be very low (e.g., 15.5% in Ontario).
- Need to weigh the benefit of today's accelerated debt repayment with the cost of tomorrow's loss of foreign tax credit flow through.

Goods & Services Tax

Goods & Services Tax ("GST")

- GST is a value-added tax modeled on Europe's VAT.
- Under a traditional sales tax system, businesses pay sales tax on many supplies and pass the cost on to their customers.
- Double tax arises if the company's outputs are also subject to sales tax.
- GST (i) eliminates the incidence of double tax in business-to-business transactions, and (ii) taxes consumers more fairly by taxing all goods and services as opposed to just taxing the sale of goods.

Goods & Services Tax

- Generally and interchangeably referred to as "GST" or "GST/HST" or "HST."
- Technically, GST refers to the 5% federal portion of the tax and HST (harmonized sales tax) refers to the provincial portion of the tax.
- "GST" will be used in this presentation to refer to federal GST and provincial HST.

GST registration

When is GST registration by a U.S. company required?

- A U.S. company must register for GST if “carrying on business” in Canada.
- “Carrying on business in Canada” is a question of fact and generally requires the business activity in question is done regularly or continually.

GST registration

Factors CRA reviews in determining whether a U.S. company is carrying on business in Canada for GST purposes include:

- place where agents or employees of the non-resident are located
- place of delivery
- place of payment
- place where purchases are made or assets are acquired
- place from which transactions are solicited
- location of assets or inventory of goods
- place where business contracts are made
- location of a bank account
- place where the non-resident's name and business are listed in a directory
- location of a branch or office
- place where services are performed or goods manufactured

Posting security with CRA

- U.S. company that is registered for GST may be required to post security with CRA, ostensibly to prevent collecting and absconding with the GST.
- Minimum security is $5,000 and up to 50% of prior year net GST owing.
- Security can be in the form of cash, certified check, money order or insured bond.
- Security not required if the company has a PE in Canada.

Preparing GST returns

- Net GST owing (or refundable) is equal to GST collected on sales less GST paid on expenses.
- Cannot claim credit for GST incurred by another company.
- This issue often arises within a related group of companies.
- Most suppliers will revise invoices if it is later discovered the invoice was issued to the wrong company.

Goods imported into Canada by a U.S. company

- The Importer of Record pays 5% GST on the duty declared value of most commercial goods imported into Canada.
- U.S. company, if importer of record, can claim credit for the 5% GST paid on imports only if registered for GST.
- GST paid on imports by a non-GST registered U.S. company can be passed to the Canadian customer for credit, but in most cases the GST is unnecessarily absorbed as a cost of sales.

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Drop shipments in Canada

Typical drop shipment scenario: A non-GST registered U.S. company acquires goods from a supplier in Canada and sells those goods to a customer in Canada.

- U.S. company will usually direct its Canadian supplier to drop ship the goods directly to its Canadian customer.
- The sale of the goods by the supplier to the U.S. company is subject to GST because the goods were delivered in Canada.
- Since the U.S. company is not registered for GST, the GST charged by the supplier becomes an expense of the U.S. company that must be passed to the customer.
- This breaches the most basic tenet of GST – that GST is supposed to be consumer tax, not a business tax.

Drop shipment certificates

- A drop shipment certificate is given to the supplier by the Canadian recipient of the goods to relieve the supplier from having to charge GST to the U.S. company.
- Recipient represents that the goods are being acquired for use in the recipient's commercial activity and assumes liability for GST on the sale if the goods are not used in a commercial activity.

GST rates across Canada

	GST /HST	Provincial sales tax
B.C	5%	7%
Alberta	5%	
Saskatchewan	5%	5%
Manitoba	5%	8%
Ontario	13%	
Quebec	5%	9.975%
New Brunswick	13%	
Nova Scotia	15%	
Prince Edward Island	14%	
Newfoundland	13%	

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Services rendered in Canada by U.S. companies

Services rendered in Canada

- Payments to non-residents (other than employees) for services rendered in Canada are subject to 15% Canadian withholding.
- Often referred to as the “Reg 105” tax.
- No de minimus exemption from Reg 105 for small services contracts.
- Reg 105 applies even if a U.S. company performs services in Canada for one day.
- Reg 105 arguably causes more confusion, grief and compliance expense among U.S. companies than any other area of Canadian tax.

Services rendered in Canada

Services subject to Reg 105 are wide ranging and include:

- Construction projects
- Software installations
- Software training
- Consulting
- Legal and accounting services
- Engineering
- Lecturing, seminar and conference presentations

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U.S. companies hiring U.S. subcontractors

- Multi-tiered contracts
  - The obligation to withhold Reg 105 tax applies to all payers for services rendered in Canada, whether resident or non-resident of Canada.
  - Under a multi-tiered contract, a U.S. general contractor may engage one or more U.S. subcontractors to perform services in Canada.
  - Reg 105 tax becomes cascading since the Canadian customer must withhold from payments to the U.S. general contractor and the U.S. general contractor must withhold from payments to its U.S. subcontractors.

Payments for services and goods

- Bundled contracts
  - A bundled contract refers to a contract that includes payments for services rendered in Canada and payments for other amounts, such as the sale of goods.
  - Since only payments for services rendered in Canada are subject to Reg 105, the contract and invoicing should clearly allocate the amount of each payment attributable to services rendered in Canada.
  - Unless an allocation is made, CRA's position is that Reg 105 applies to the entire payment if any element of the payment includes payment for services rendered in Canada.

Recovering Reg 105 tax withheld

- Reg 105 is considered an estimated tax payment rather than a final withholding tax.
- U.S. company's income tax liability, if any, is determined by the filing of a Canadian tax return.
- Reg 105 tax is fully refundable if U.S. company has no PE in Canada.
- Three year deadline to claim a Reg 105 refund.

Applying for a waiver of Reg 105 tax

- CRA relinquishes its right to Reg 105 tax only through the issuance of a CRA-approved waiver.
- Full waiver of Reg 105 tax can be requested if the company can show it has no PE in Canada.
- Partial waiver can be requested based on estimated net Canadian income if the company has a PE in Canada.
- CRA recommends waiver requests be submitted at least 30 days before service begins or payment is to be made.

Issues with CRA's waiver program

- Waiver does not eliminate a U.S. company's requirement to file a Canadian tax return.
- Blanket waivers are not granted.
- Will CRA grant the waiver at all?
- Will CRA process the waiver in time?
- Generally far easier to recover Reg 105 tax by filing a Canadian tax return at the end of the year and claiming a treaty exemption from Canadian tax.
- CRA review of refund claims in tax returns is generally far less onerous than during a waiver review.
- Time value of money today is at an all-time low.

Issues with CRA's waiver program

- Volume of information requested by CRA is considered excessive; see the R105, R102-J and R102R waiver application forms.
- Form R102-J is an example of a "simplified form" created by CRA in response to industry complaints about waiver overkill involving employees earning less than $10,000 working in Canada.
- CRA demands complete documentation about the entire contract, identification of all parties involved, tax identification numbers for the U.S. company and all employees and subcontractors involved, payroll registrations, GST registration, written demands to file employee and employer tax returns mailed out, etc.

Reg 105 – is the end near?

- Recommendation 7.3 made by Advisory Panel on Canada's System of International Taxation report to Canada's Minister of Finance, December 10, 2008:

  "*that the federal government eliminate withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty.*"
- The advisory panel basically recommended Canada follow the simplified U.S. procedures involving forms W-9, W-8BEN, 8233, etc.
- Six years later, nothing has changed.

Reg 105 – is the end near?

- Since the Advisory Panel's recommendations in 2008, the Reg 105 situation seems to be getting worse, not better.
- Businesses are frustrated by having to bear administrative responsibility for another person's tax liability.
- Many Americans enter into the waiver program assuming the Canadian waiver process is as easy and straightforward as the U.S. system.
- By the time they realize the mess they are in, it's too late to get out.

U.S. Employees working in Canada

Employer obligations:

- Remuneration paid to U.S. employees working in Canada is subject to the same withholding, remitting, and reporting obligations that apply to domestic Canadian resident employers and employees.
- Obtaining a waiver from CRA is the only approved method for reducing or eliminating Canadian withholdings on an employee's remuneration.
- See earlier discussion about pitfalls of requesting a waiver.

U.S. Employees working in Canada

Treaty exempt employment income:

- Employment income earned by a U.S. resident working in Canada is exempt from Canadian tax under the treaty if:
  - Total Canadian remuneration for the year is less than CDN$10,000, or
  - Employee is present in Canada for 183 days or less <u>and</u> the employer does not have a PE in Canada

Questions?

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