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KOTLER VAN DEN BRINK & COMPANY
U.S. & CROSS-BORDER TAX CONSULTANTS

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**practicing as a professional corporation*

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The U.S. TAXFACTS

Kotler van den Brink & Company has been providing U.S. and cross-border (Canada-U.S.) tax consulting and compliance services to accounting and legal professionals since 1988.

TOPIC: CURRRENT EVENTS - CORPORATE

This edition of the U.S. TAXFACTS will discuss issues that we are regularly seeing with respect to corporate clients who are U.S. entities, or are Canadian companies receiving income from US sources.

PERMANENT ESTABLISHMENT

For Canadian corporations doing business in the U.S., one of the most important fundamental concepts of the Canada-U.S. income tax treaty is that of the permanent establishment (or "PE"). The Business Profits article of the Treaty provides that a resident of Canada will only be taxable in the U.S. to the extent that it carries on business through a U.S. PE.

The more intuitive idea of a PE is the typical "brick and mortar" fixed place of business. These include such places as an office, a place of management, a factory, a workshop or a place where natural resources are extracted such as a mine or oil well.

Less well known PE's will include those created by a construction or installation projects lasting more than 12 months, or a deemed "service" PE created where a Canadian resident provides services in U.S. for more than 183 days during a twelve month period (any twelve month period, not necessarily the entity's fiscal year) and earns more than 50% of its business revenue from those services during that period.

What does not create a PE however is a location used solely for the purpose of storing goods or merchandise, or for the display or delivery of goods.

Where a Canadian corporation does not have a U.S. PE, but has U.S. source income - for example where the title transfers in the U.S. on the sale of goods, it is important that this income be disclosed to the IRS and that an exemption from tax under the Treaty be properly claimed. Failing to properly disclose a treaty position (i.e. taking the position that US source income is not taxable but not filing a return to disclose this position) can result in a US$10,000 penalty per undisclosed treaty position.

STATE TAX - NEXUS UPDATE

It is important to note that the Treaty is a federal document that deals with Federal taxes and that states are under no obligation to adhere to it. Some states do; most do not.

While the Federal test for taxation is the PE, the threshold where a foreign entity can be taxed at the state level, generally referred to as "nexus" is much lower. Nexus is created where there is a sufficient level of business contact to the state such that the state is constitutionally allowed to tax the out of state vendor.

Nexus does not require a PE. Having inventory in a state, or employees, or any other physical contact, however brief, is generally enough to create Nexus.

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While it used to be that some form of physical contact with a state was required before the State could tax an out of state vendor, that is no longer the case. Many states have legislated the concept of "economic nexus". Economic nexus allows the state to tax an out of state vendor once a specified level of economic benefit is derived from that state. The threshold for economic nexus does vary by state, but will generally require a high volume of sales, or a certain proportion of total sales being made to a single state.

It is important to keep in mind that not only is it possible for a Canadian corporation to be taxable at the State level while exempt from tax at the Federal level, it is also possible for a Canadian corporation to face State taxation without any physical presence in the United States.

LIMITED LIABILITY COMPANIES (LLC)

LLC's continue to be a problem and should be avoided by Canadians investing in the U.S.. While LLCs provide an excellent business or investment vehicle for US residents they pose significant tax problems for Canadian residents.

For U.S. income tax purposes, the taxation of an LLC will vary depending on how many owners it has. A single owner LLC provides legal liability protection but will be disregarded as separate from its owner for U.S. income tax purposes. An LLC with multiple owners is generally treated as a partnership.

For Canadian income tax purposes an LLC will always be considered a foreign corporation. Thus while income will generally flow through and be recognized on a current basis for U.S. tax purposes, it is trapped at the LLC level for Canadian income tax purposes until distributed. Even when distributed this income will be treated as a foreign source dividend in Canada, with limited foreign tax credits allowed, despite being taxed as ordinary business or partnership income in the US.

To compound the problem, LLC's owned by Canadian resident corporations are generally not recognized under the Treaty and so are not afforded any treaty benefits.

A Canadian company operating in the U.S. through a LLC will very often face double taxation on its LLC earnings.

AUTOMATIC PENALTIES

In Canada the failure to file an information return will generally result in a $25 per day penalty to a maximum of $2,500. In the US, the failure to timely file an information return will generally result in a $10,000 penalty.

The requirement to timely file is key when it comes to information returns required by corporate entities as the IRS is now automatically assessing these penalties on late filed forms. When a form is filed late, the IRS computers will automatically send the penalty notice without any consideration of extenuating circumstances.

While the IRS will still forgive a penalty where reasonable cause exists, it is becoming much harder to make that argument. While first time offenders may be able to have the penalty abated, the IRS will generally not accept ignorance or the reliance on another (i.e. a professional advisor) as an acceptable reason to forgive a penalty. The IRS expects a business to exercise business prudence and be reasonably aware of its compliance requirements. Where a taxpayer is unable to demonstrate reasonable cause, the IRS will not forgive the penalty.

CHANGING DUE DATES

For year ends starting after December 31, 2015:

- U.S. corporate returns will initially be due 3.5 months after year end (not 2.5 months as in the past), except for corporations with a June year end, they will continue to be due September 15th (2.5 months) until 2025.
- U.S. partnership returns will be due 2.5 months after year end (not 3.5 months as in the past)
- Foreign Bank Account Reports (FBARs) will be due with the tax return and will no longer have a fixed June 30th due date.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained.