

# The U.S. TAXFAX

**TOPIC: CANADIAN COMPANIES DOING  
BUSINESS IN THE UNITED STATES**

**Date of Issue: January of 1997**

In this issue we look at the U.S. tax consequences of U.S. business activities carried on through a Canadian controlled private corporation. We will assume that the shareholders are not U.S. citizens.

**Federal Taxation**

Pursuant to the Internal Revenue Code, a foreign corporation engaged in a U.S. trade or business is taxable on income effectively connected with that trade or business. Article VII of the Canada U.S. Tax Treaty (Treaty) overrides the code to provide U.S. taxation only where the business profits are earned through a U.S. permanent establishment. It is often difficult to determine precisely when a corporation first has a permanent establishment in the United States (Note: please refer to a previous issue of the U.S. TAXFAX for a discussion of the permanent establishment issue)

A Canadian corporation must file Form 1120F, U.S. Income Tax Return of a Foreign Corporation, if it is engaged in a U.S. trade or business. If the company does not have a U.S. permanent establishment, Form 8833 (Treaty Disclosure Statement) must be filed as an attachment to Form 1120F. Form 8833 provides the IRS with information relating to the exemption from U.S. tax. Many accountants rely on their interpretation that a company does not have a U.S. permanent establishment, thus no basis for taxation, yet fail to make the required disclosure with the IRS.

Filing the treaty disclosure statement is important for three reasons. The first is that the IRS can deny deductions and tax the company on gross U.S. source income if they determine that a permanent establishment does exist. Secondly, the statute of limitations in the U.S. is three years from the date the return is filed. When returns are not filed, the IRS can assess taxes beyond the three year limit. If a company is assessed taxes beyond the three year limit, and the Canadian statute of limitations has expired, these taxes may not be creditable in Canada, resulting in double taxation. The third reason is that failure to make the disclosure may result in a \$10,000 penalty annually for each treaty position not disclosed.

A corporation that earns trade or business income through a U.S. permanent establishment must file Form 1120F and report effectively connected revenues and expenses. Expenses may include a reasonable allocation of general and administrative costs incurred in Canada. Foreign corporations operating in the U.S. are liable for Federal tax on their taxable income at the same rates as U.S. domestic corporations. The tax rates are as follows;

<u>Taxable Income</u>	<u>Tax Rate</u>
\$0. - \$50,000.	15%
\$50,001 - \$75,000.	25%
\$75,001 - \$10 MM.	34%

In addition, taxable income between \$100,000 and \$335,000 is subject to an additional 5% tax. This additional 5% tax serves to eliminate the two lower rate brackets. Once \$335,000 of taxable

income is achieved, all income is taxed at a 34% rate until reaching the \$10 million dollar range.

Other federal taxes that foreign corporations can be subject to are the branch profits tax, the excess interest tax, the accumulated earnings tax, and/or the alternative minimum tax. A more detailed discussion of these various types of taxes will be saved for later editions of the U.S. TAXFAX but suffice it to say that planning can usually be undertaken to avoid or minimize these taxes.

### **State Taxation**

Foreign corporations conducting business in the United States may also be subject to taxation in one or more States. A very minimal level of business activity within a State may create a nexus or presence in that particular State. Once this presence is established, the company is required to conform to that State's taxation laws and file returns.

Some States, such as Nevada and Washington, do not have state corporate income tax systems. Nevada receives tax dollars from gaming whereas Washington imposes a Business and Occupation (B&O) Tax on services and products delivered or consumed within the state. The B&O Tax is an excise tax levied on gross revenues at a rate between .5 - 2.5% depending upon the particular type of industry. Oregon imposes county and city taxes in addition to State corporate taxes. State tax rates range from 0% to 12% with some States charging a minimum tax regardless of profitability.

States are not obligated to honour the terms of international tax treaties entered into between the United States and foreign countries. Consequently, a corporation may be exempt from U.S. Federal income tax pursuant to the provisions of a tax treaty, yet subject to tax in one or more states.

The starting point for the calculation of state income taxes is generally Federal taxable income. This income is then adjusted for differences between federal and state law. The state tax rate

is applied to the state taxable income amount to determine the state tax liability, which is deductible on the Federal corporate return.

When a corporation is taxable in more than one state, allocation of Federal taxable income is required. Federal taxable income must be allocated to each state based upon a three factor formula of sales, labour and fixed assets located within the state as a percentage of total sales, labour and fixed assets. This requires that accounting records for these factors be maintained on a state by state basis.

California is one of several states that imposes a unitary tax. Corporations under common control, generally considered to be 50% common interests, are considered to be members of a unitary group. California includes the profits of all members of the unitary group and then applies the three factor formula to determine California taxable income. This requires that each member of the unitary group (even foreign corporations) maintain financial records in U.S. dollars and in accordance with California tax provisions. This presents a substantial record keeping burden on most corporations. There are elections available to reduce the complexity of filing on a unitary basis.

State filing requirements should be reviewed annually to ensure that the corporation is meeting its compliance requirements. State taxation may also affect where a corporation locates an office or warehouse facility, or which state it chooses to incorporate in.

The next U.S. TAXFAX will discuss the Income Tax issues and requirements of U.S. persons living in Canada.

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.