

# The U.S. TAXFAX

**TOPIC: SELF EMPLOYED INDIVIDUALS  
PERFORMING SERVICES IN THE U.S.**

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This edition of the U.S. TAXFAX discusses the taxation of self employed consultants working periodically in the United States.

Over the past several years we have noticed an increasing number of self employed professionals such as lawyers, accountants, engineers and computer analysts performing services in the United States. The U.S. income tax requirements are often ignored, or not addressed in enough detail, and the consultants find themselves in hot water with the IRS or State tax authorities. Negotiating with these bureaucracies after the fact can be very costly, not to mention extremely frustrating.

The first item to consider when establishing the U.S. tax consequences, if any, of operating in the U.S. is the residency status of the consultant. If the consultant is a U.S. citizen, or deemed a U.S. resident, he/she is taxable in the U.S. on worldwide income. If the consultant is a non resident of the U.S., he/she is only taxable on U.S. source income. This edition of the U.S. TAXFAX will only discuss the requirements relating to non residents of the U.S. working in the United States on a periodic basis.

The Internal Revenue Code (Code) provides certain tests that establish an individuals residency such as the green card and physical presence tests. The Canada-U.S. tax treaty (Treaty) provides tie breaker rules which can override the Code in cases where both

jurisdictions consider the individual a resident. A detailed analysis of the various rules will be saved for a later edition of the U.S. TAXFAX; However, a consultant will generally not be taxed as a U.S. resident if he/she:

- has a closer connection (both socially as well as economic) to Canada,
- is present in the U.S. less than 183 days, and
- is taxed as a resident in Canada.

If the consultant is not deemed a U.S. resident, it is necessary to determine whether he or she is subject to U.S. taxation. Without the benefit of the Treaty, any U.S. source business profits would be taxed in the U.S. pursuant to the Code. However, Articles V and XIV of the treaty override the Code provisions and generally provide that a self employed consultant is taxable in the U.S. only on business profits attributable to a permanent establishment in the United States.

Article V of the treaty provides a partial list of what constitutes a permanent establishment such as a fixed office, branch or workshop. This article states that the consultant is deemed to have a permanent establishment if he, or another person acting on his behalf (other than an independent agent), concludes contracts in the United States. It also gives examples of certain cases that are deemed not to be permanent establishments. Unfortunately, the treaty does not provide a comprehensive definition and, as a result, it is often a question of fact whether a permanent establishment exists.

In order to make a determination as to whether a consultant has a U.S. permanent establishment, it is essential to analyse the manner in which the consultant operates. A permanent establishment can often be avoided by making simple modifications to the way in which business is conducted.

Once the permanent establishment issue is resolved, it becomes necessary to determine the correct tax filing requirement(s). Regardless of whether a permanent establishment exists, the code requires the filing of Form 1040NR, U.S. Non Resident Alien Income Tax Return. If the consultant has a fixed place of business or an office in the U.S., Form 1040NR is due on or before April 15th of the year following the calendar year the income was earned. If there is no office or fixed place of business, the return is due on or before June 15 following the calendar year the income was earned.

If a permanent establishment exists, it is necessary to report the income and related expenses earned through this permanent establishment on Form 1040NR. The consultant will be liable for tax at the graduated individual tax rates if net income from the consulting business exceeds the personal exemptions. Tax paid to the United States may be claimed as a foreign tax credit on the consultant's Canadian tax return.

The penalty for not filing a return in this situation can be the denial of deductions and credits otherwise allowed to the taxpayer (e.g.: business expenses). Penalties may be waived by the district director upon the showing of good cause in "rare and unusual circumstances".

If the consultant takes the position that there is not a U.S. permanent establishment, he/she must file Form 1040NR together with a "Treaty Based Return Position Disclosure" statement. The information required by the disclosure statement includes the Code sections overridden, the Treaty articles relied upon, and a summary of the facts providing the basis for

taxation and the related exemption. A separate disclosure position must be filed for each exemption claimed. Failure to file the disclosure positions may result in a \$1,000 penalty for each such failure to disclose.

### **Miscellaneous Topic:**

#### **State Taxation:**

Many consultants address Federal filing requirements but ignore the State requirements. All but seven States have an income tax system. The State tax systems generally follow the Federal income tax system with slight modifications. Only the income and expenses allocated to a particular State are taxable in that State. State tax rates can range from 3% to 12% and any taxes paid are deductible on the Federal return. It should be noted that many states do not recognise the Treaty, and thus it is possible for a consultant to have a State liability while being exempt from Federal tax.

Some States have other taxes besides, or instead of, income taxes. These can include sales and excise taxes on goods sold or services performed within a State. It is important that consultants have a general understanding of a State's tax structure, as this can affect the overall profitability of a particular venture.

Related issues that will be discussed in future U.S.TAXFAX's include alternative business structures and U.S. social security taxes.

Please remember that 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 therein.