Canadian Business Expansion into the U.S.

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Business Expansion into U.S.

- U.S. and Canadian tax considerations
  - Business
  - Employees
- Structuring
• Do I have a taxable presence in the U.S.?
• What type of legal entity should I use?
• In what state should I base my operations?
• How do I finance my U.S. operations?
• What do I need to consider when transferring employees to the U.S.?
• What are some other common issues?
U.S. Taxable Presence

- Non-U.S. entities will be subject to U.S. taxation on their operations if they are deemed to be “conducting a trade or business within the U.S.”
- Threshold for U.S. trade or business is low:
  - Personal services
  - Trading in securities and commodities
  - Selling of products through an agent
  - Export of goods from the U.S. and associated operations
  - Partner in a partnership doing business in the U.S.
  - Ownership and transactions involving U.S. real property
  - Other examples based on facts and circumstances of particular case
Article V (Permanent Establishment) of the Canada-U.S. Tax Treaty has higher threshold for level of activities giving rise to a taxable U.S. presence.

The Treaty trumps U.S. domestic tax law in determination of taxable presence – so if no PE, no tax on business profits.

Under Article V, PE generally includes: place of management, branch, factory, office, workshop, mines, construction site/project lasting more than 12 months, use of agent, etc.

Article V also provides specific guidance for when physical presence while performing services constitutes a PE.

Most U.S. states do not follow the Treaty, so taxable presence at state level ("nexus") can be earlier than at federal level.
Deemed PE - Services

- Change to the Treaty starting 2010
- A “temporal” rather than physical approach to “permanent”
- Applies to service businesses
- Deemed to provide services through PE if either:
  a) Services provided by an individual who is present for a period or periods exceeding 183 days in any 12 month period and during those periods more than 50% of gross revenue is from the services provided in the U.S. by that individual, or
  b) Services provided in the U.S. for 183 days or more in any 12 month period with respect to the same or connected project for customers who are U.S. residents or have a PE in the U.S. (and services related to that PE)
Does the Treaty Apply?

• Corporations with a foreign parent (other than U.S. or Canada) must review the availability of treaty exemptions due to the *Limitation on Benefits* rules in the changes to the Treaty.

• May lose key treaty benefits, for example:
  • Carrying on business in the other country but not through a permanent establishment
  • Reductions in withholding tax rates
  • Capital gains exemptions
States do not necessarily respect the Treaty

In addition to federal tax laws, 50 U.S. states exist each with their own set of local income, franchise, sales and property tax laws. Commonalities exist.

States are hungry for revenues and, therefore, aggressive in tax enforcement

Tax rates:

- Income/franchise tax rates generally from 0% to 12%
- Sales tax rates generally 4% to 9%
- Property tax rates vary from county to county

Generally, state taxable income is computed as:

\[
\text{State taxable income} = \text{Federal taxable income} + \text{State law adjustments (e.g. depreciation)} \times \text{State apportionment factor (sales, payroll, property)}
\]

State allocable income

State taxable income
• In some cases, may lack taxable presence for federal purposes (PE) but have a taxable presence for state purposes (nexus)

• Example: Canadian business sells widgets into the U.S., ships them to San Francisco where they are repackaged by an independent agent (no title transfer), then stores and distributes them to all 50 states

• In general, PE can be avoided at the federal level if careful not to cross Treaty thresholds

• For California, presence of inventory and sales in the state will be enough to create a taxable presence there. Compliance with both income and sales/use tax filings will be required.
• Delaware? Nevada? Where to locate company and operations?

• The adoption of unitary and combined filing by most states make the choice less important from an income/franchise tax perspective

• Unitary and combined filing generally causes its U.S. operations to be considered as a whole (regardless of legal entities) in computing state income/franchise taxes. Then state taxable income calculated based on activity in the state (sales, property, and payroll).

• Local incentives: Where a physical facility will be setup and jobs created, tax incentives may be obtained from the local authorities interested in attracting the company
U.S. Legal Entities

- Legal entities formed at state level, not federal

- Most common types of business **LEGAL** entities:
  - Corporation
  - Partnership, general and limited
  - Limited Liability Company (LLC)
  - Limited Liability Partnership

- Most common types of business **TAX** entities:
  - C-Corporation
  - S-Corporation (flow-through entity)
  - Partnership (flow-through entity)
  - Sole proprietorship
What’s a flow-through entity?
- An entity that is not subject to income taxes directly
- Entity is deemed to make a distribution of all its profits each year and the partners/members report those on their tax returns
- Partners/members are taxed on their share of the profits

Why do your U.S. business partners insist on a flow-through entity?
- Avoids double taxation on their share of the profits
- C-Corporations get taxed twice on their profits:
  - Corporate income tax on yearly profits, and
  - Tax on dividend paid by the C-Corporation
Corporations & Partnerships

• C-Corporation:
  • Federal income tax rate: 34%
  • State income/franchise taxes apply
  • Dividends taxable to recipients
  • Required for public companies
  • Ability to file consolidated returns

• S-Corporation:
  • Cannot have non-U.S. owners or corporate owners

• Partnership:
  • Income taxes deemed distributed yearly to partners who are responsible for the tax
  • Flexibility in different allocations of income, losses and capital for partners
• Legal liability advantages of a corporation, with more flexibility in ownership structure and also on tax treatment

• Tax treatments possible:
  • Partnership: The default tax treatment
  • C-Corporation: The LLC may elect under “check-the-box” rules to be treated as a C-Corporation
  • Disregarded entity: A partnership requires at least two partners. Single member LLCs will be disregarded for federal income tax purposes.
  • S-Corporation: If the LLC elects to be treated as a C-Corporation, and then makes an election to be taxed as an S-Corporation
Canadian Issues for LLC

- Pitfalls of using an LLC to carry on your U.S. business
- LLC is a corporation for Canadian purposes; generally not for U.S. purposes – timing and sourcing issues
  - No foreign tax credit available to Canadian parent
  - Can give rise to FAPI in Canadian parent, with no underlying foreign accrual tax
  - Loss of 5% treaty rate on U.S. branch tax – result 30% branch tax
  - Might be treaty surprises going from Canada to U.S.
Structure Alternatives

Canadian Individual

A

U.S. Business

Canadian Trust

Taxable or flow-through

A

U.S. Business
Structure Alternatives

Canco

U.S. Sub-Individual

U.S. Sub-Corp

A

Canco

U.S. Sub

U.S. Business

A

U.S. Sub

U.S. Business

A

Canco

U.S. Sub

U.S. Business
Structure Alternatives

LLC - Individual

LLC - Corp

U.S. Business

Canco

LLC
Layers of U.S. and Canadian Tax

U.S. Branch

- Personal tax on Canco dividend
- Canadian tax on business profits
- U.S. Branch profits tax 5% or 30%

U.S. Sub

- Personal tax on Canco dividend
- Canadian tax on U.S. dividend
- Dividend withholding 5%, 15% or 30%

U.S. tax on U.S. business profits
## Active Business Income Tax Rates

### Tax Rate Comparison - Active Income

Business Located in California

<table>
<thead>
<tr>
<th>Structure</th>
<th>Low income</th>
<th>High income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual or Trust</td>
<td>43.70%</td>
<td>48.90%</td>
</tr>
<tr>
<td>Canco</td>
<td>45.37%</td>
<td>57.58%</td>
</tr>
<tr>
<td>US Sub - Individual</td>
<td>56.38%</td>
<td>66.13%</td>
</tr>
<tr>
<td>US Sub - Corp</td>
<td>45.37%</td>
<td>57.58%</td>
</tr>
<tr>
<td>LLC - Individual*</td>
<td>53.27%</td>
<td>62.79%</td>
</tr>
<tr>
<td>LLC - Corp</td>
<td>59.74%</td>
<td>68.74%</td>
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</tbody>
</table>

* Overall tax is higher if income isn't immediately distributed
## Corporate Deferral

### Tax Rate Comparison - Profits Retained in Corp vs. Dividend
Business Located in California

#### ACTIVE INCOME Structure

<table>
<thead>
<tr>
<th>Structure</th>
<th>Low income</th>
<th>High income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canco</td>
<td>26.39%</td>
<td>42.84%</td>
</tr>
<tr>
<td>US Sub - Individual</td>
<td>22.51%</td>
<td>39.83%</td>
</tr>
<tr>
<td>US Sub - Corp</td>
<td>26.39%</td>
<td>42.84%</td>
</tr>
<tr>
<td>LLC - Corp</td>
<td>45.76%</td>
<td>57.88%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Distributed by Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canco</td>
</tr>
<tr>
<td>US Sub - Individual</td>
</tr>
<tr>
<td>US Sub - Corp</td>
</tr>
<tr>
<td>LLC - Corp</td>
</tr>
</tbody>
</table>
What Works, What Doesn’t?

- Individuals and trust
  - Commercial issues
  - U.S. estate tax exposure

- Canadian corporation

- Canadian corporation with US subsidiary
  - Tax deferral benefit if funds left in the corporation

- Beware the LLC
Modification to LLC

A

Canco

B

LLC

A

Canco

U.S. Sub

B

LLC
Where Do You Want Your Profits Taxed?

• 2012 corporate tax rates:
  • B.C. (combined) 25.0%
  • U.S. (federal only) 34.0%
  • U.S. state and local taxes could be another 10.0%

• Shift profits home to the extent supportable:
  • Interest, management fees, royalties, reimbursements
  • Transfer pricing review could help find opportunities
  • Transfer pricing documentation or full-blown report should be used to support
Consideration for Canadian Parent Company

- Consider the impact of U.S. expansion on the “Small Business Corporation” status of the Canadian corporation:
  - $750,000 lifetime capital gains exemption
  - Exemption from corporate attribution rules
  - Allowable business investment losses
- Consider a sister corporation as the Canadian holding company
Canadian Issues

- **Lifetime capital gains exemption**
- Don’t want shares and loans to U.S. Subco to exceed 90% of FMV of parent’s total assets
Sisterco Alternative

- **Lifetime capital gains exemption**
- **Opco satisfies the 90% of FMV test**
Personal Tax Rates

- **2012 personal tax rates:**
  - B.C. (combined) 43.7%
  - U.S. (federal only) 35.0% (highest income tax bracket)
  - U.S. state and local taxes could be additional 10.0%

- U.S. social security tax (4.2%) and Medicare (1.45%) withheld from employee would be additional costs

- For 2013, U.S. individual income tax rates are expected to go back to pre-2002 levels. Highest individual tax bracket will be 39.6% unless new administration and Congress act to maintain the current rate brackets.
Canadian Tax Developments

- Overseas employment tax credit
- Thin capitalization rules
Overseas Employment Tax Credit (OETC)

- Tax credit available to Canadian resident individuals working abroad for six months or more in a resource, construction, installation, agricultural or engineering project
  - Federal tax payable on 80% of qualifying foreign employment income (max of $100,000)
- Phased out over next 4 years
  - Currently – 80%
  - 2013 – 60%
  - 2014 – 40%
  - 2015 – 20%
  - After 2015 – 0%
Overseas Employment Tax Credit (OETC)

IMPACT:
• Increased cost of overseas assignments
• Impact on foreign tax credits claimed
• Employers should review employment contracts
Thin Capitalization - Subsection 18(4)

- Proposed reduction in debt-to-equity ratio from 2:1 to 1.5:1
  - Applies to taxation years that begin after 2012
- Extended application to loans to partnerships
  - Applies to debts of a partnership o/s at any during taxation year that begins on or after March 29, 2012
- Disallowed interest deemed to be a dividend subject to W/H tax
  - Applies to taxation years that end on or after March 29, 2012
- Prevent double taxation on debt from foreign affiliates
  - Applies to taxation years that end on or after March 29, 2012
Thin Capitalization - Subsection 18(4)

IMPACT:
• Additional capitalization in advance of 2013 year-end, if necessary
• Review debt/equity ratio, as the deemed dividend rule applies now
• Preparation of NR4 slips and remittance of W/H tax
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