



# US – Canada Update

## HLB North American Tax Conference

LaJolla, California  
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## Agenda – Case Studies

- Employee vs. Independent Contractor
- Treaty Analysis & LLC's
- Real Estate Ownership
- GST/HST



# EMPLOYEE VS. INDEPENDENT CONTRACTOR

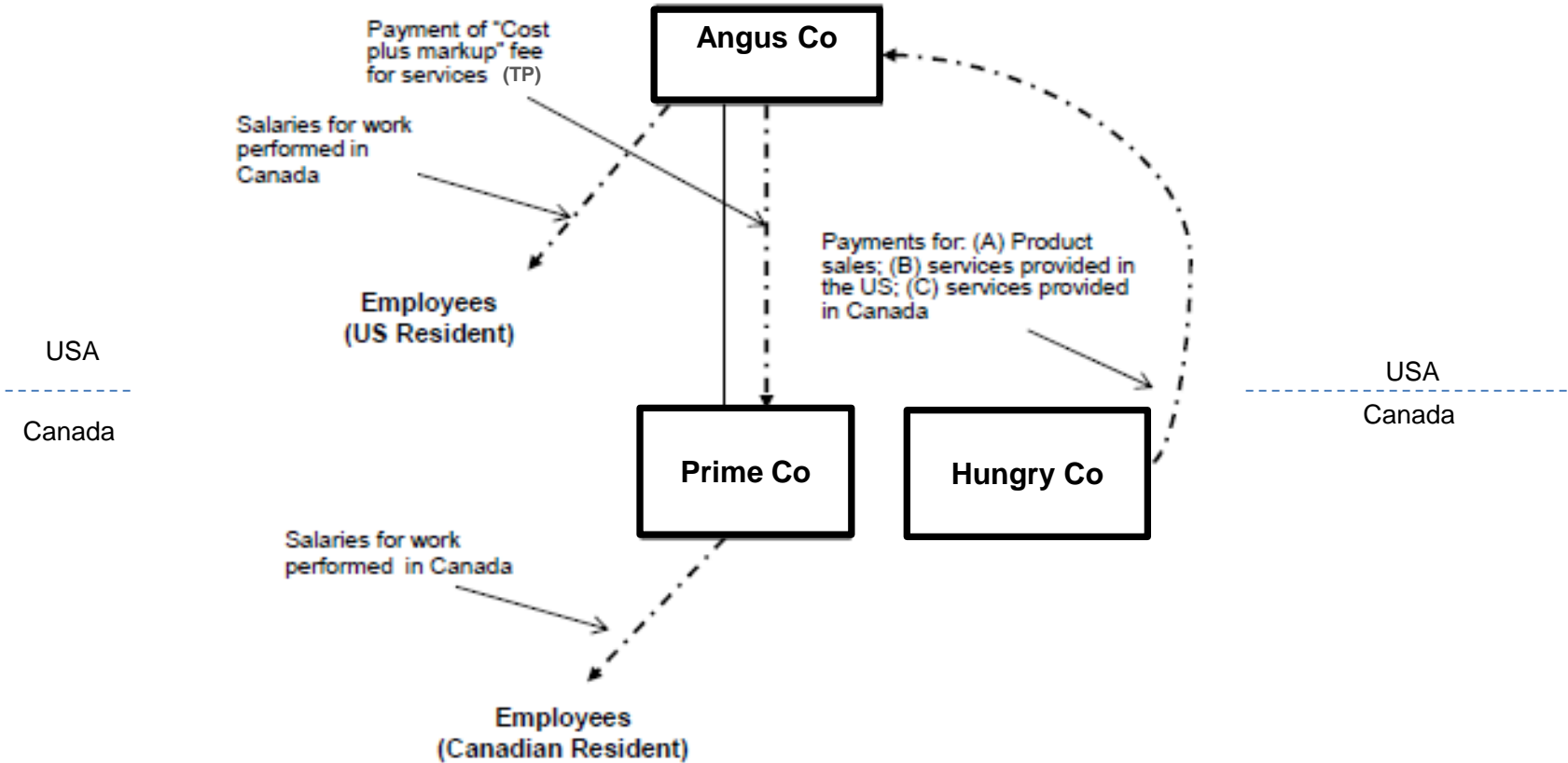


- We will look at cross border tax issues for businesses with inbound investment in Canada
- Application of Treaty provisions, *Income Tax Act* (Canada) (“ITA”) provisions and ITA Regulations.
  - Services as a Deemed Permanent Establishment – Article V, Paragraph 9
  - Regulation 105 withholding tax
  - Regulation 102 withholding tax
  - Income from Employment – Article XV of the Treaty



## FACTS:

- A Canadian company (Hungry Co) purchases Angus meat cutting machines from a US resident company (Angus Co).
- Hungry Co also requires Angus Co to perform installation and training services in Canada in respect of the cutting machine.
- Angus Co has a Canadian subsidiary (Prime Co) which it subcontracts to perform a portion of the services in Canada. A cost-plus fee is paid from US to Canada.
- Angus Co also sends its own employees to Canada to perform the other services.





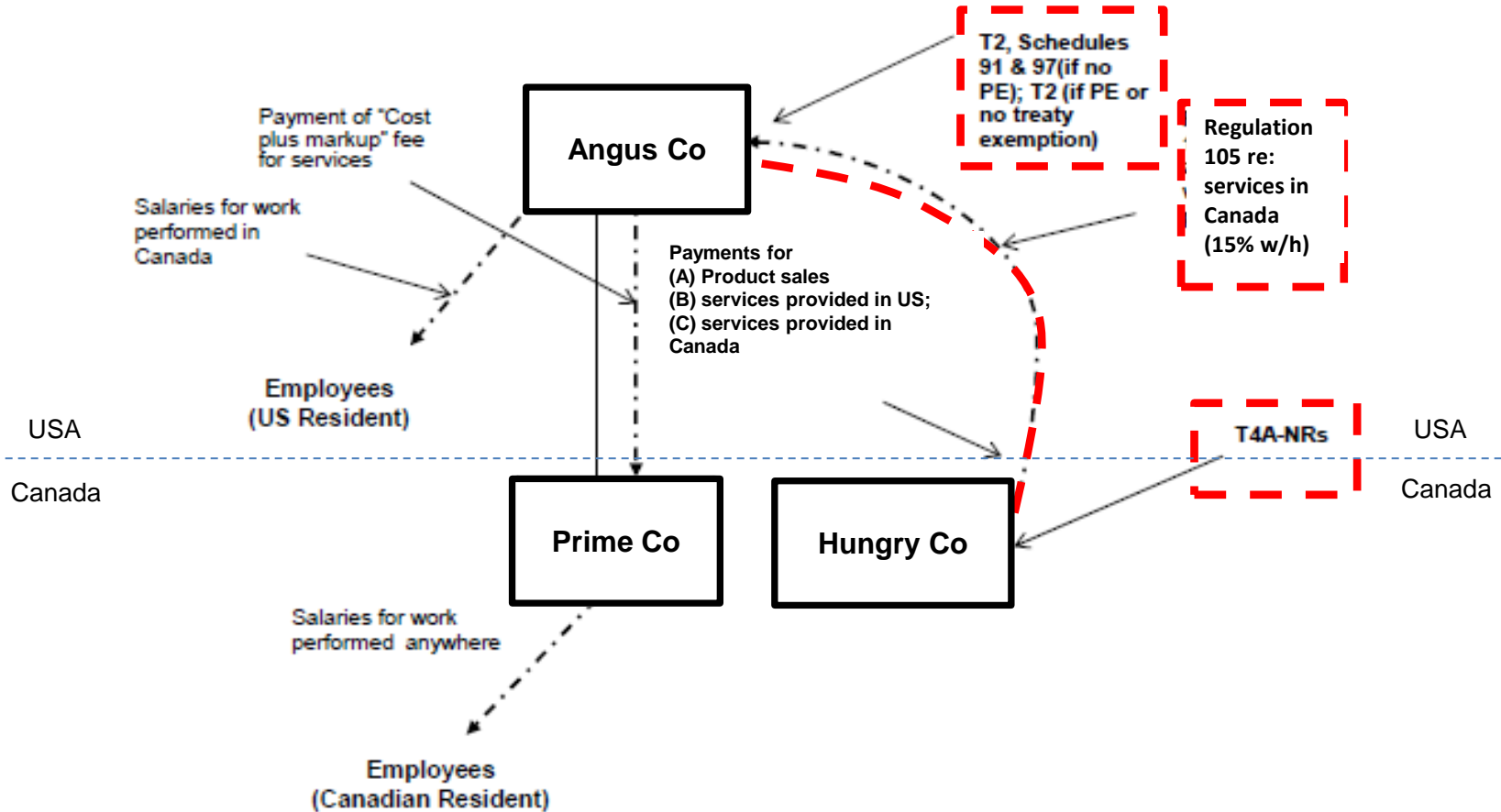
- Regulation 105 withholding tax
- Regulation 102 withholding tax
- Income from Employment – Article XV of the Treaty
- Transfer Pricing



- Fees in respect of services rendered by Angus Co to Hungry Co in Canada subject to 15% withholding tax on gross payment
- Canadian payer must remit on 15th day of month following month in which payment made
- If Angus Co retains an unrelated U.S. subcontractor to perform services in Canada, Reg. 105 withholding may still apply
- Reg. 105 waivers available under certain conditions:
  - No tax liability will result in Canada from the non-resident's exemption under a treaty (treaty-based waiver); or
  - Expected net income from services rendered in Canada will result in a tax liability that is less than 15% of the gross withholding (income and expense waiver)

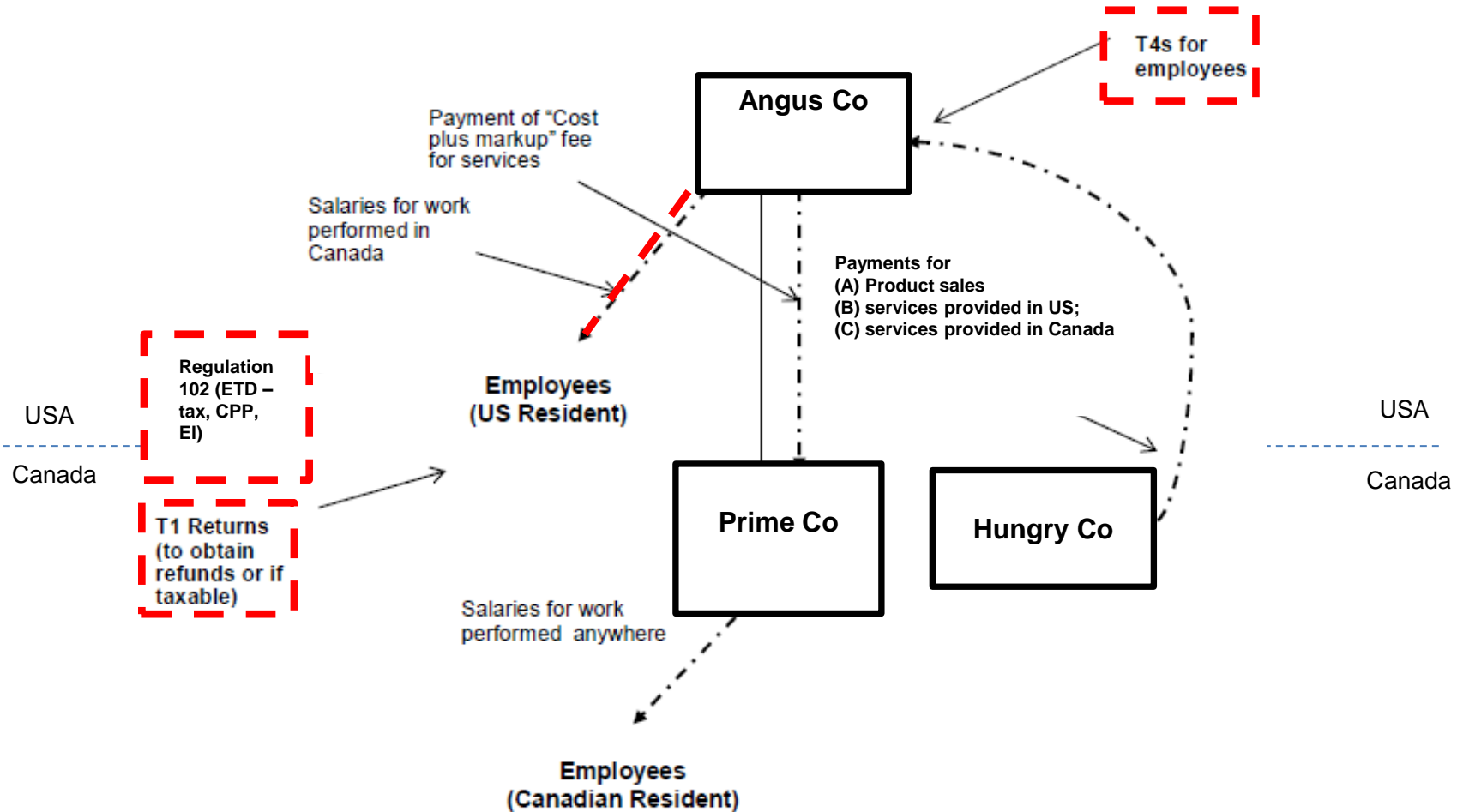


# Regulation 105 Requirements

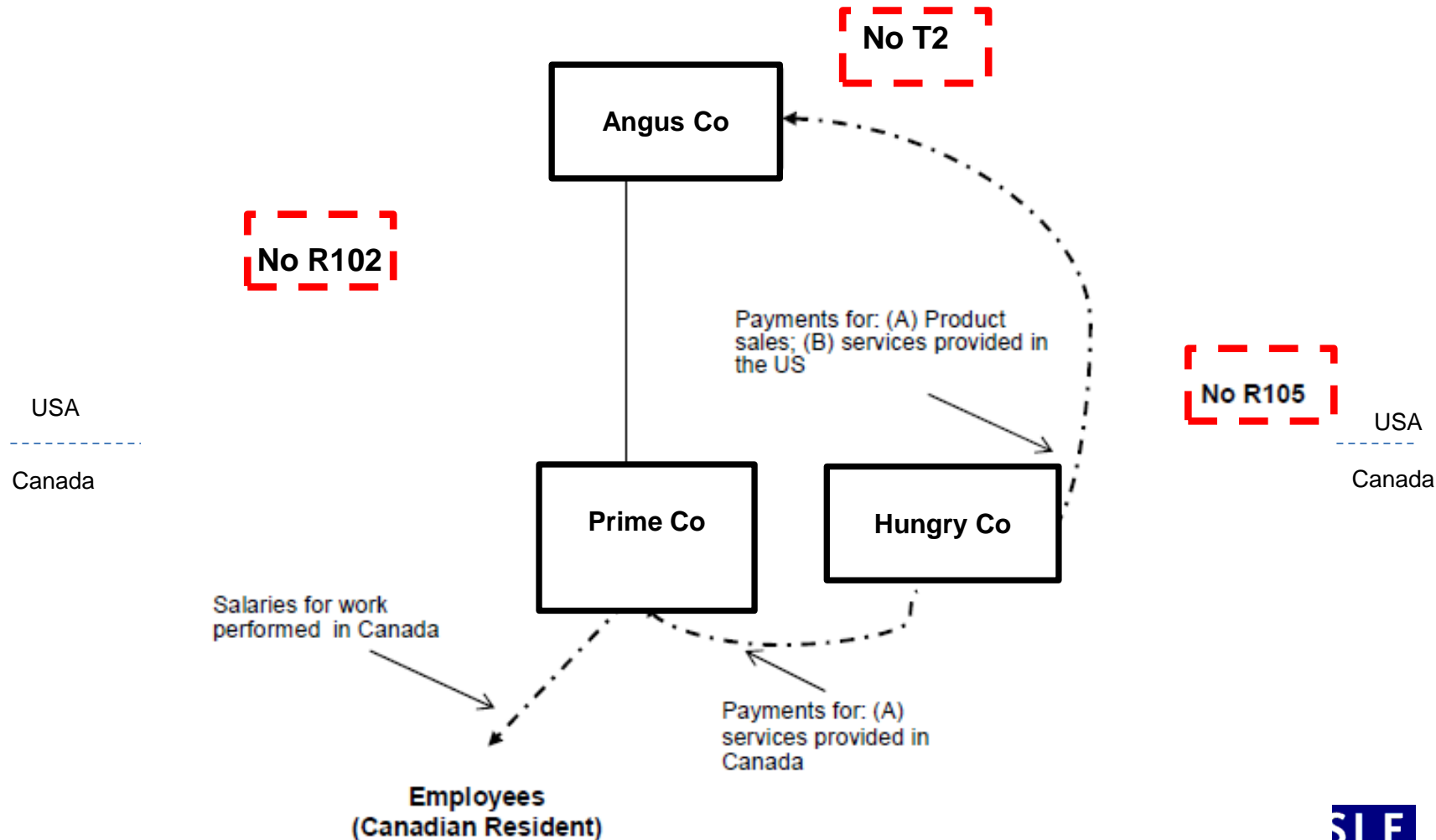




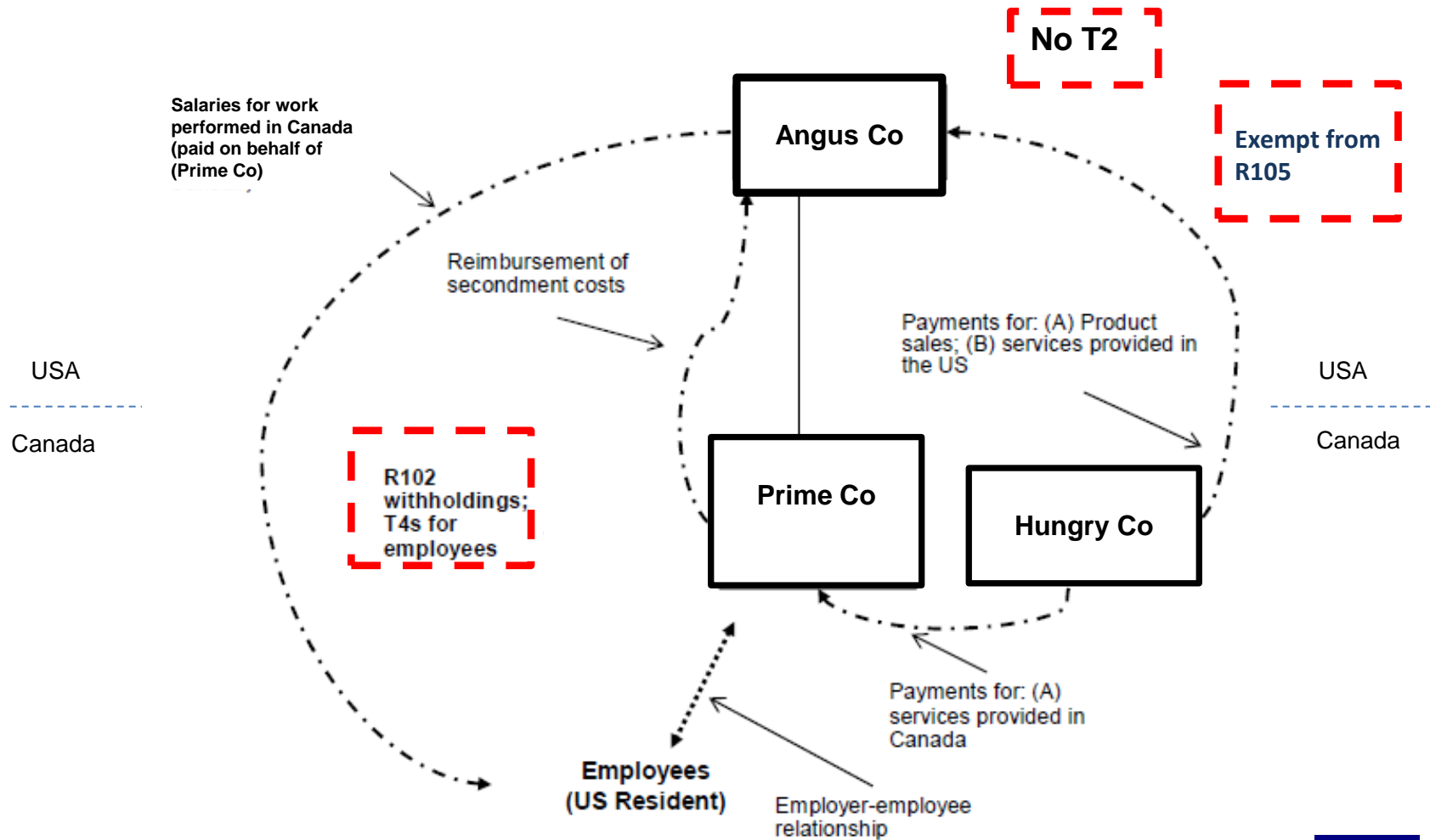
- Withholding on remuneration paid for employment services provided in Canada by non-resident employees
- Applies to both resident and non-resident employers and may include income tax, CPP and EI
- No de minimus position or threshold
- Employers have withholding, reporting and remitting obligations under the ITA when Reg. 102 is engaged
- Waivers may be available and must be filed 30 days before the start of services in Canada or the initial payment is made.



# Alternative #1 - Contract is split (US Services and CDN Services)



# Alternative #2 - Secondments





- Treaty now includes broadened provisions for a PE in Canada:
- Requirement for a “fixed” place of business is not necessary
- Article V, Paragraphs 9(a) and (b) of the Treaty – deemed PE in Canada if:
  - Services performed by an individual who is in Canada for more than 183 days in any 12 month period and 50% or more of enterprise’s revenue attributable to Canada; or
  - Services performed for more than 183 days in any twelve month period with respect to the same or connected project for Canadian-based customers



- **Reg. 105? No US Equivalent**
  - W-8BEN if no Permanent Establishment; W-8ECI if a Permanent Establishment
  - If no W-8 filed with payor, 30% tax may be withheld
  - 1120-F (Treaty-Based or not) should be filed annually
- **Reg 102? Payroll Tax**
  - Forms 940 / 941; Forms W-2 / W-3 (Federal)
  - State Payroll Taxes (income tax withholding, unemployment, disability)
  - Worker's Compensation
- **Employee vs. Independent Contractor**
  - Federal Rules: (formerly 20 Factor Test) "Categories-of-Evidence" Methodology: Behavioral Control, Financial Control, Type of Relationship
  - State Rules: e.g., NJ = "ABC" Test (A: Agent free from control/direction; B: Service outside usual course of employer's business; c: Agent customarily engaged in an independently established trade or business)



# TREATY ANALYSIS & LLC'S





- Facts
- Options / Alternatives
- Issues
- Implications



## FACTS:

- Dave is an individual resident in the U.S. and Arnold is a resident of Germany and they form an LLC.
- U.S. LLC intends expand business into Canada
- Operations to be from a permanent establishment
- Underlying assets not real property

What are the alternative structures and tax implications?



## OPTIONS/ALTERNATIVES

- Operate as a branch
- Incorporate Canadian subsidiary corporation
- Incorporate an Unlimited Liability Corporation (current allowed in the Provinces of Alberta, British Columbia and Nova Scotia)
- Instead of an LLC, use a “C” Corp to own the ULC



## ISSUES

- Treaty relief relating to:
  - Income tax on profits
  - Dividends
  - Interest
  - Royalties
  - Capital gains



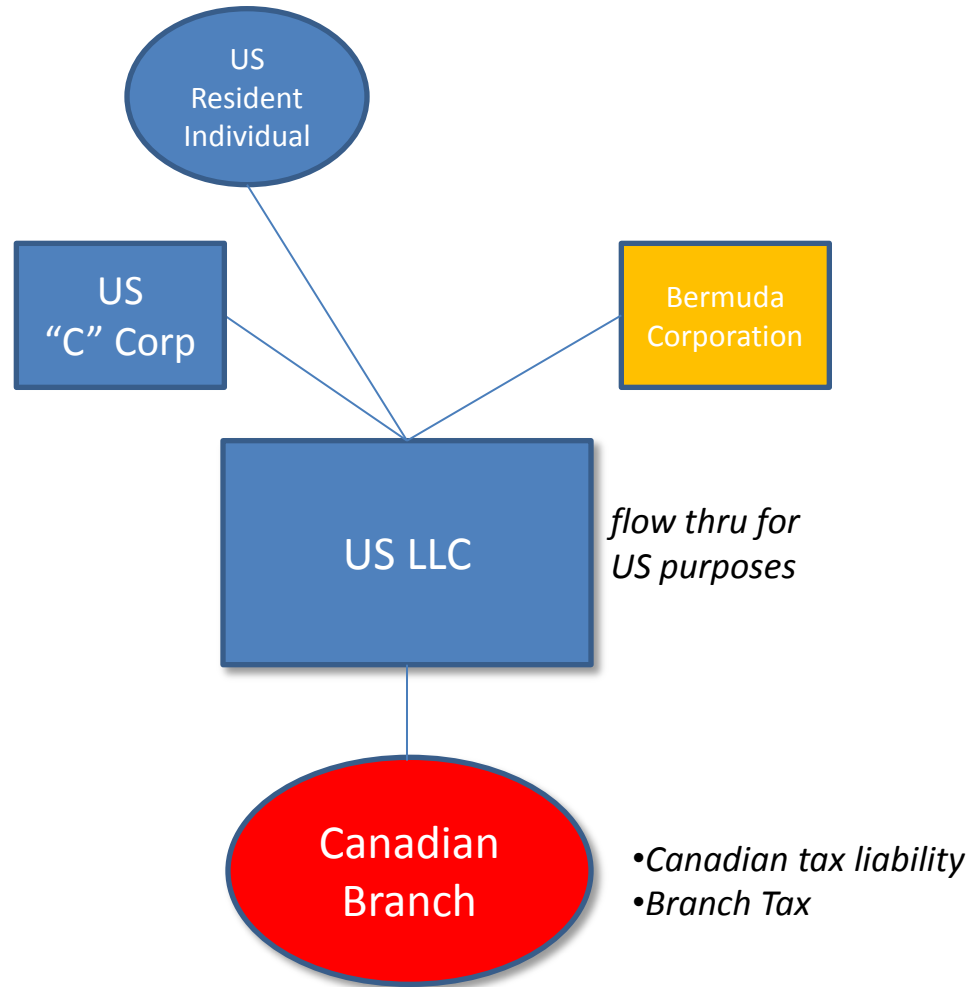
## ISSUES (CONT'D)

- Canadian registration required with CRA:
  - Corporate income taxes – 26.5%
  - Payroll withholdings
  - GST/HST
  - Excise Tax
- Withholding taxes (with the exception of ULC's)
  - Dividends: 5% under the fact scenario presented
  - Interest: 0%
  - Royalties: 10%
  - Capital gains (specific gains by U.S. residents are not taxable in Canada per Article XIII of the treaty)



## ISSUES (CONT'D)

- Additional possible filings
  - Form NR 303 “Declaration of Eligibility For Treaty Benefits” by hybrid entities disclosing residency and % ownership for each member
  - T106 to report non-arms length transactions with non-residents
- Branch Tax
  - Branches are subject to a branch tax on accumulated profits in excess of CDN \$500,000 (5% for U.S. branches) calculated and reported on the corporate income tax return

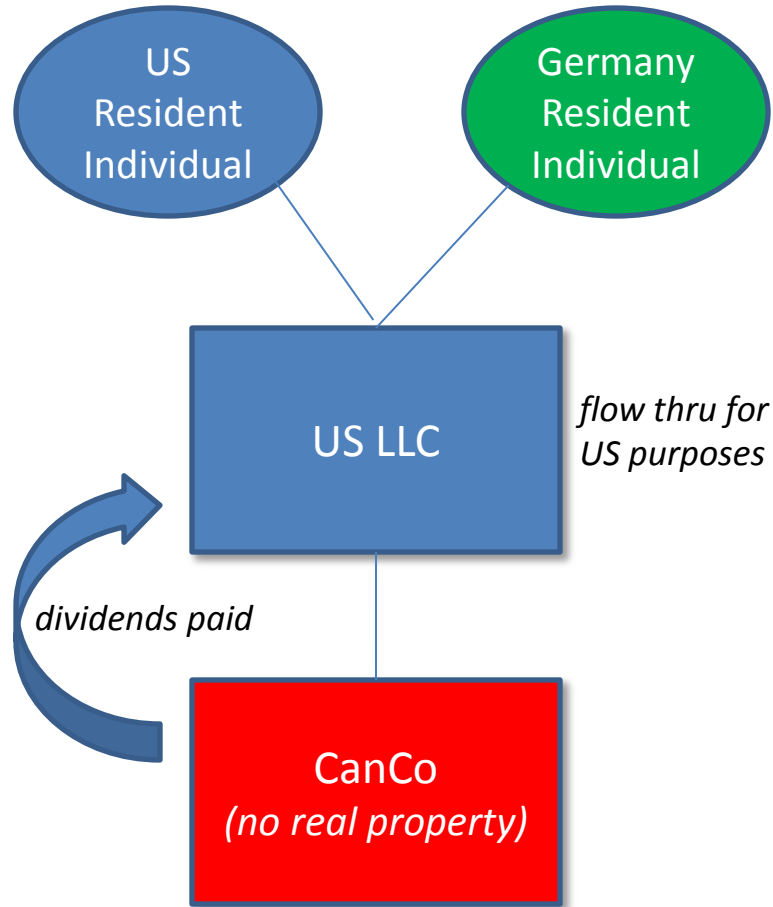




## TAX IMPLICATIONS FOR BRANCH

- Taxed on Canadian source income as a corporation
- Corporate tax return includes calculation of annual branch tax on profits whether actually repatriated or not (CDN \$500,000 exemption on a cumulative basis under Canada – U.S. treaty)

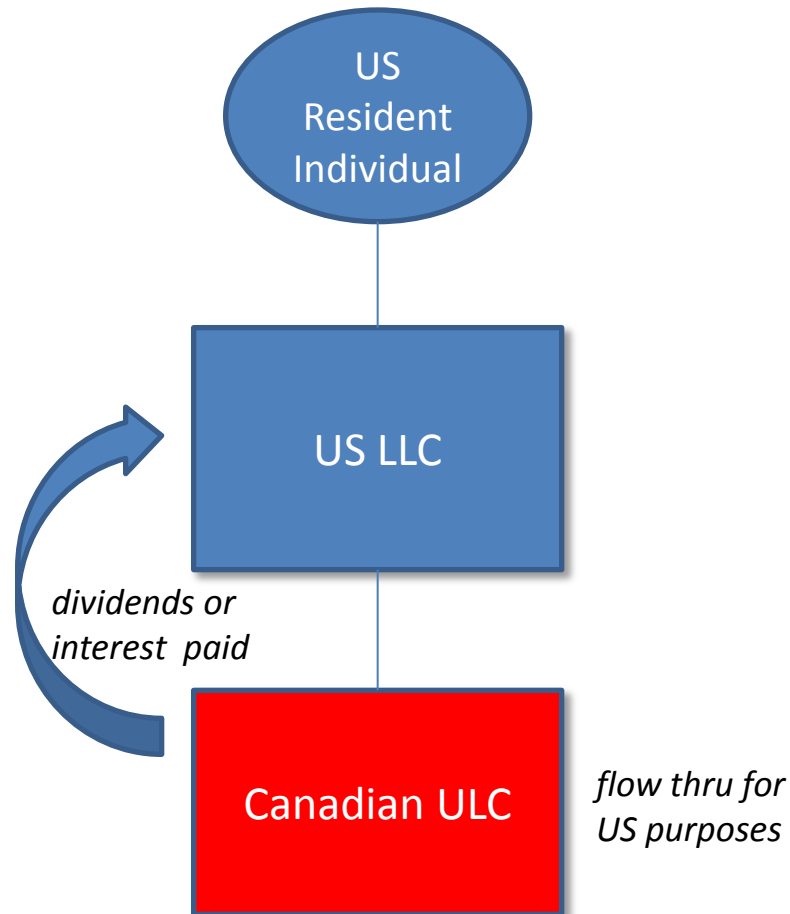






## TAX IMPLICATIONS - SUBSIDIARY

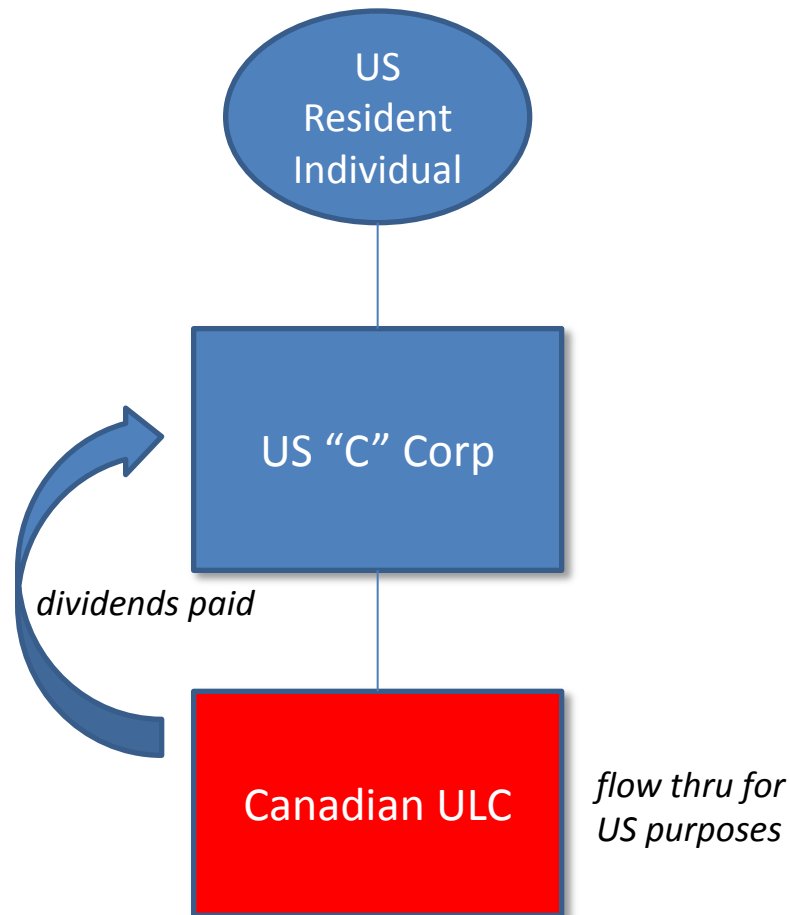
- W/H tax on dividends at 5% for US members, otherwise 25%.
- No withholding tax on sale of shares as sub is not “Taxable Canadian Property”
- Expect the unexpected (thin cap rules, deemed interest/dividend income inclusion on loans receivable from certain connected non-residents - ITA s. 214(3))





## TAX IMPLICATIONS – INCORPORATE CANADIAN ULC

- Taxed in Canada as subsidiary corporation
- HOWEVER;
- No treaty protection as Article IV (7)(b) of the treaty provides ULC's status in Canada is a corporation but under U.S. law the LLC is considered to be an FTE





## TAX IMPLICATION – USE “C” CORP TO OWN THE ULC

- Using a “C” Corp or interposing a “C” Corp between the LLC and the ULC eliminates some of the negatives
- Dividends by ULC to “C” corp do not get treaty protection but PUC increase to limit w/h tax to 5%
- No treaty protection on interest





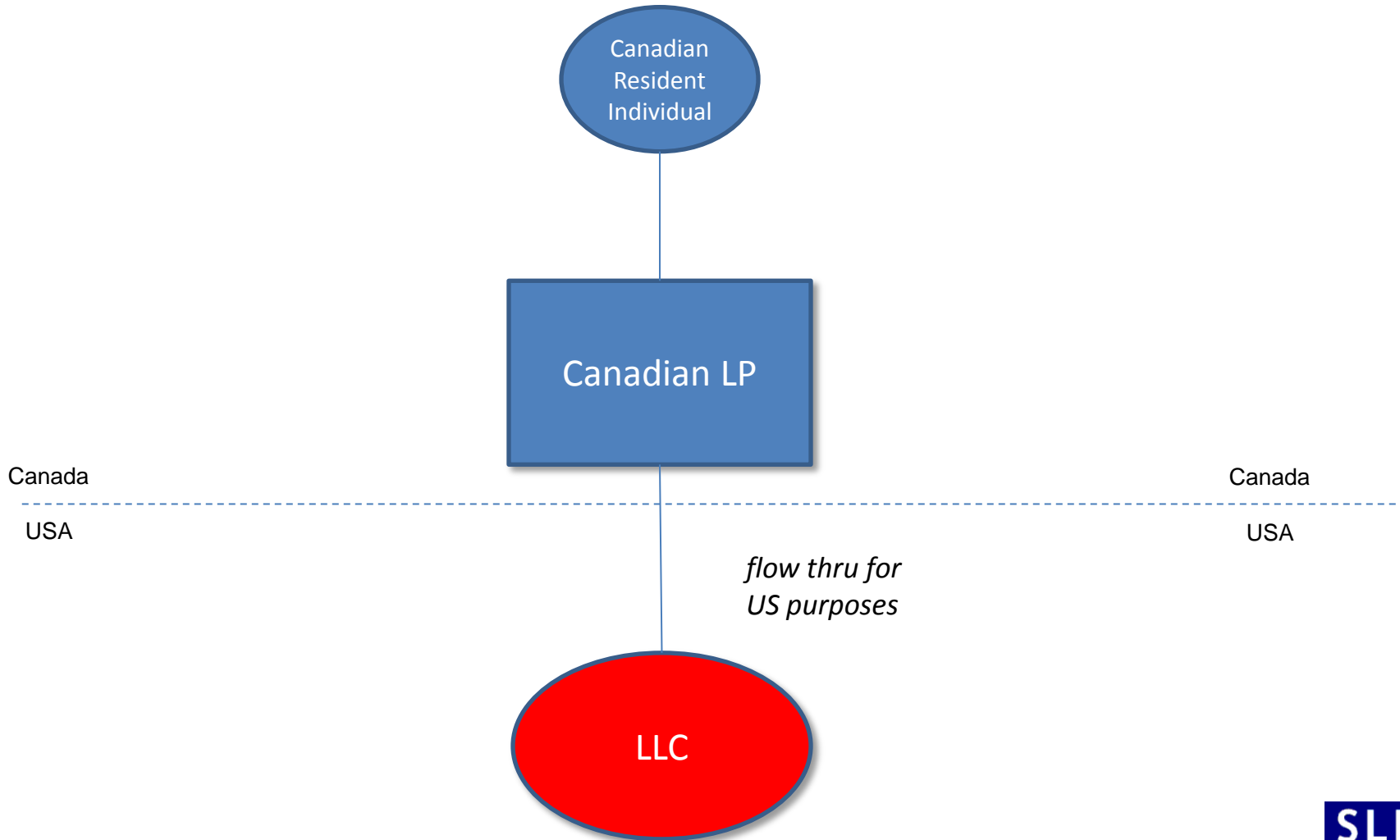
# REAL ESTATE OWNERSHIP & TAX RAMIFICATIONS





- Two Canadians walk into a bar and form a Canadian LP. The LP buys real estate in the US using an LLC which is disregarded for US purposes.
- One Canadian says to the other "you know our US assets may be subject to US estate tax at a rate of 40%--ouch."
- They order another round of ICE wine and decide to check the box treating the Canadian LP as a corporation for US purposes to avoid the estate exposure.
- So now they have an 1120 F and US branch taxes to wrestle with at rates of 35% and 5%, respectively.
- Is this a good structure or bad structure??

# Limited Liability Corporations





- Effective tax rate is 65% with the LLC structure

Taxable Income	\$100.00
U.S. Tax	(35.00) <b>(A)</b>
	-----
Cash available for distribution	65.00
5% W/H Tax	(3.25)
	-----
Sub-total after US Tax	61.75
Canadian Tax	(30.00) <b>(B)</b> (\$65.00 x 46.41%)
Tax Credit – W/H Tax	3.25
	-----
<b>Net after tax income</b>	<b>35.00</b>
<b>Effective tax rate (A) + (B)</b>	<b>65.0%</b>



- Use a Canadian Grantor trust to own US real estate.
- This structure avoids US estate tax and the effective tax rate is equal to what we would otherwise pay, i.e. 46.41%.



Investor:	← Canadian Corp →			
	Branch	US Corporation	US Partnership	Individual/Trust
US-Source Taxable Income	1,000,000	1,000,000	1,000,000	1,000,000
US Tax Thereon (35%; 39.6%)	350,000	350,000	350,000	396,000
Income available for repatriation	650,000	650,000	650,000	604,000
Branch Profits Tax (5%, exemption) *	32,500		32,500	
Dividend Withholding Tax - 5%		32,500		
Taxable Income in Canada	1,000,000	650,000	1,000,000	1,000,000
Canadian Tax - Corp (26.5%)/Individual (49.53%)	265,000	-	265,000	495,300
Less: Foreign Tax Credit	265,000	-	265,000	396,000
Net Canadian Tax	-	-	-	99,300
Net Cash Flow to CDN Parent/Individual	617,500	617,500	617,500	504,700
Effective Tax Rate prior to corp distrib'n	38.25%	38.25%	38.25%	49.53%
Dividend Tax on distrib'n from Parent Corp. (36.47%)	225,202	225,202	225,202	
Net Cash Flow to CDN Individual	392,298	392,298	392,298	504,700
Effective Tax Rate after dividends	60.77%	60.77%	60.77%	49.53%

\* \$500,000 one-time exemption not taken into account



# GST/HST



## FACTS

- The Porcelain Palace Inc. (German company) has a US wholly owned subsidiary “I Don’t Know Co?” (“? Co.”), the manufacturer of modular kitchens.
- (? Co.) has obtained it’s first Canadian customer, Canco.
- Canco is in the business of providing long term residential apartment rentals and is exempt from GST/HST.
- Canco will be the importer of record on the shipment of kitchens from (? Co.) into Canada.
- Canco pays GST and custom duties on the importation of the kitchen but is exempt from GST/HST and will not be entitled to recover the GST/HST paid.

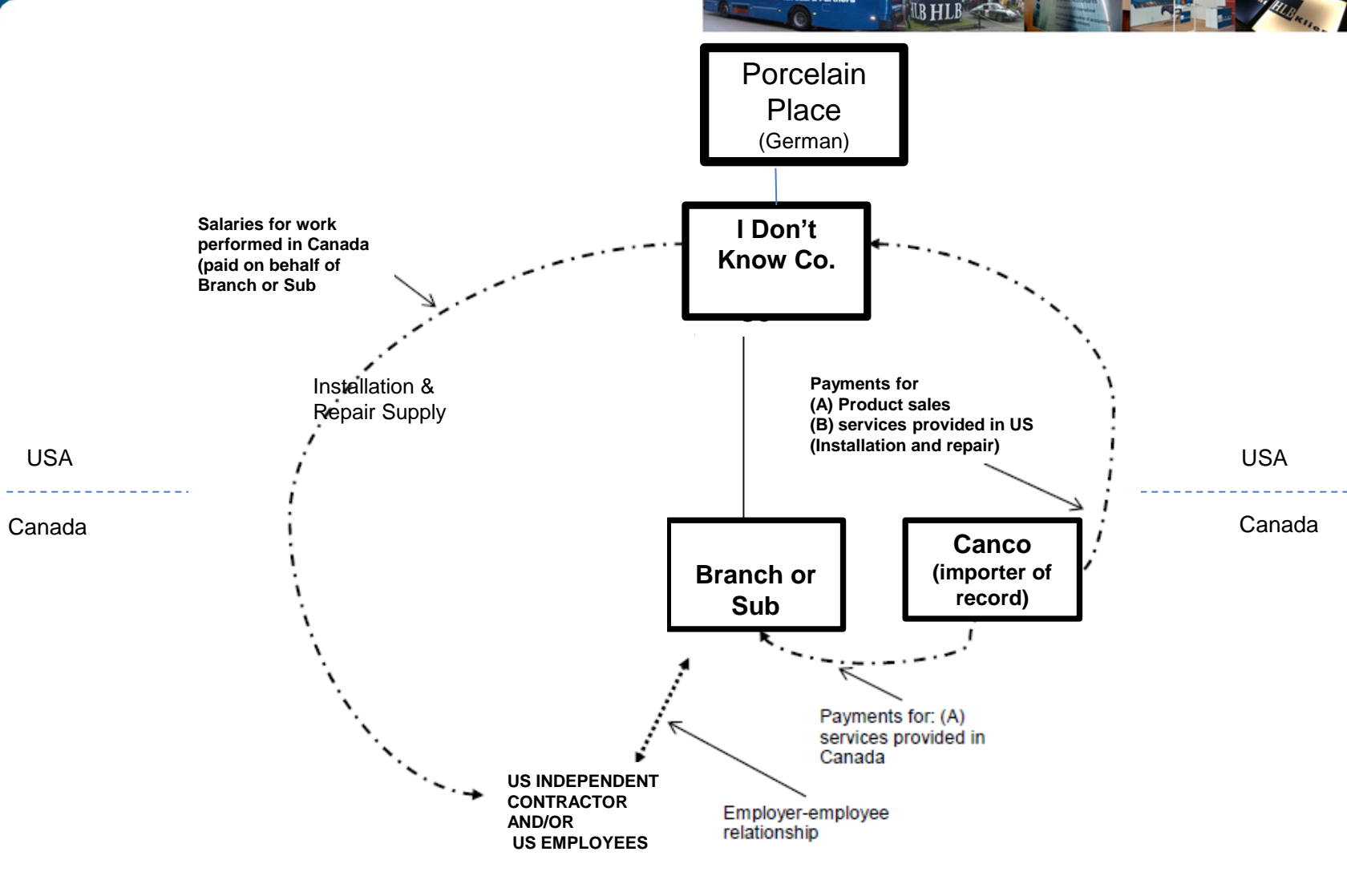


## FACTS (cont'd)

- Canco's auditors discovered an unrecorded liability for GST/HST. As an "importer of record" the 5% federal portion of the GST was paid at the time of importation.
- Canco was legally responsible for self-assessing the Ontario provincial portion of the HST, an additional 8%. Canco has decided to file a voluntary disclosure to avoid any penalties.



# Porcelain Palace





## FACTS (cont'd)

- Canco's management has decided to avoid being the importer of record and shift the importation responsibility to their supplier (? Co.).
- Canco's has advised (? Co.) that they will have to enter into an agreement to supply and install the kitchen as well as provide warranty and repair.

(? Co.) does not want to lose the business and are reconsidering their Canadian business alternatives.



- 1) Hiring an arms length Canadian contractor to do installation work in Canada. (No PE)
- 2) Sending its US employees to Canada to do the installation, warranty and repair work when required. (No PE)
- 3) Hiring Canadian employees to do the installation, warranty and repair work. These employees would also be responsible for soliciting additional sales in Canada.
- 4) Establishing a Canadian corporation for their Canadian operations.



## ALTERNATIVE 1 - Hire Canadian Arms Length Contractor

- The Canadian contractor will charge (? Co.) GST/HST on the services provided.
- (? Co.) is not registered for GST/HST and will not be able to recover the GST/HST.
- Canco also paid GST/HST on the supply and installation price and will not be entitled to recover the GST/HST paid because it is providing an exempt service.
- The result is double tax with respect to the GST/HST on the installation services
- Other issues: Canco does not really want to be the importer of record anymore. Therefore, (? Co.) could become the importer of record which would require GST/HST registration.



## ALTERNATIVE 2 – US Employees

- The employees in Canada may cause (? Co.) to be “carrying on business” for GST/HST. (See Appendix 1).
- If they ignore the GST/HST issues they could face penalties for non-collection of GST/HST.
- Double taxation could result if Canco paid tax as the “importer of record” and (? Co.) is assessed for tax on the entire contract on basis it failed to charge GST/HST.



### ALTERNATIVE 3 – Canadian Employees

- (? Co.) would register for GST/HST and also register as importer of record for the kitchens.
- GST and duty would be payable on the importation by (? Co.) and (? Co.) would charge GST/HST on the total supply and installation contract price to its customers based on the shipping destination of the kitchen.
- (? Co.) would claim back any GST/HST paid on the importation as well as any other GST/HST paid.



### ALTERNATIVE 3 – Canadian Employees ( cont'd)

- Canco will achieve the desired outcome of not being responsible for importing and self-assessing GST/HST and have the services carried out by (? Co.)
- The contract price to Canco will have to be adjusted for duty i.e. duty costs were previously borne by Canco on importation. They will now be borne by (? Co.) on importation. It will be necessary to build the customs cost into the total contract price.



- Transfer pricing will have to be considered
- GST/HST returns will have to be filed
- (? Co.) will have to become aware of their responsibilities as GST/HST registrant including filing returns and keeping up to date with GST/HST changes (see Appendix 3 and 4)
- The GST rate will vary depending on the province that the goods are ultimately shipped in accordance with the GST/HST and place of supply rules (see Appendix 5)
- The place of supply rules can be very complicated.
- If (? Co.) is a non-resident of Canada they will be required to post a bond with the Canada tax authority. (50% of tax minimum 5K)
- Other considerations (repair parts - domestic vs. foreign; split contracts, etc.)





## APPENDIX 1

Based on 12 factors:

1. The place where agents or employees of the non-resident are located;
2. The place of delivery;
3. The place of payment;
4. The place where purchases are made or assets are acquired;
5. The place from which transactions are solicited;
6. The location of assets or inventory of goods;
7. The place where business contracts are made;
8. The location of a bank account;
9. The place where the non-resident's name and business are listed in a directory;
10. The location of a branch or office;
11. The place where the service is performed; and
12. The place of manufacture or production



## APPENDIX 1

CRA provides little guidance on how to apply the factors, other than stating that the importance or relevance of a given factor in a specific circumstance will depend on the nature of the business activity under review and the facts and circumstances of each case.



## APPENDIX 2

- Taxpayers registered under GST/HST **do not** receive the same relief as those under income tax treaties
- Those who are not subject to income tax in Canada due to treaty relief may be still exposed to GST/HST under the Excise Tax Act



## APPENDIX 3

- Does your client have the ability to handle the changes?
  - New rules
  - Province of Prince Edward Island opted to accept Harmonization effective April 1, 2013
  - British Columbia decided to opt out of the HST effective March 31, 2013
  - Quebec has agreed to Harmonize its QST with the GST effective January 1, 2013



## APPENDIX 4

- The GST/HST rate varies between 5% - 15% depending upon the province and if it is harmonized
- GST/HST registrants are responsible for collecting taxes at the correct rate
- Registrants who erroneously undercharge their customer are responsible for the shortfall



Harmonized	Jurisdiction	GST/HST Rate	Total Rate including Provincial Sales Tax	PST on GST	APPENDIX 5
	Alberta	5% GST only	5% GST only	N/A	
	NWT	5% GST only	5% GST only	N/A	
	Nunavut	5% GST only	5% GST only	N/A	
	Yukon	5% GST only	5% GST only	N/A	
	BC	5%	12%	No	B.C will no longer be Harmonized effective April 1, 2013
Yes	New Brunswick	13%	13%	N/A	
Yes	Newfoundland/Labrador	13%	13%	N/A	
Yes	Nova Scotia	15%	15%	N/A	Nova Scotia HST is proposed to be reduced to 14% and 13% effective July 1, 2014 and 2015
Yes	Ontario	13%	13%	N/A	
	Manitoba	5%	13%	No	PST rate increased to 8% July 2013
Yes	PEI	14%	14%	N/A	
Yes Hybrid	Quebec	5%	14.975%	Yes	Quebec to be replaced with Harmonized QST effective July 1, 2013 (14.975)
	Saskatchewan	5%	10%	No	



# QUESTIONS??