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US – Canada Update
HLB North American Tax Conference

Cancun, Mexico
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US-Canada Update

Agenda – Case Studies

- Performing Services in Canada
- Canada-US Tax Traps for LLCs
- GST/HST

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PERFORMING SERVICES IN CANADA

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Overview

Tax implications for:

- (a) services performed in Canada by non-resident employees and subcontractors; and
- (b) deemed PE's:
  - Regulation 102 ("Reg 102") addresses wages paid to employees.
  - International social security agreements
  - Secondment of employees
  - Regulation 105 ("Reg 105") addresses payments for services to non-residents
  - Permanent establishment – Deemed PE rules

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Case Study 1 - Scenario 1

- Mr. Barak, a U.S. resident employed by Obama Co, a U.S. company, is sent to Canada to provide services to the Canadian PE of Obama Co.
- Mr. Barak is in Canada for 182 days and is paid CDN$10,000 for the services performed in Canada.
- The Canadian PE pays for the wages and deducts the amount to arrive at taxable income (Employee secondment).

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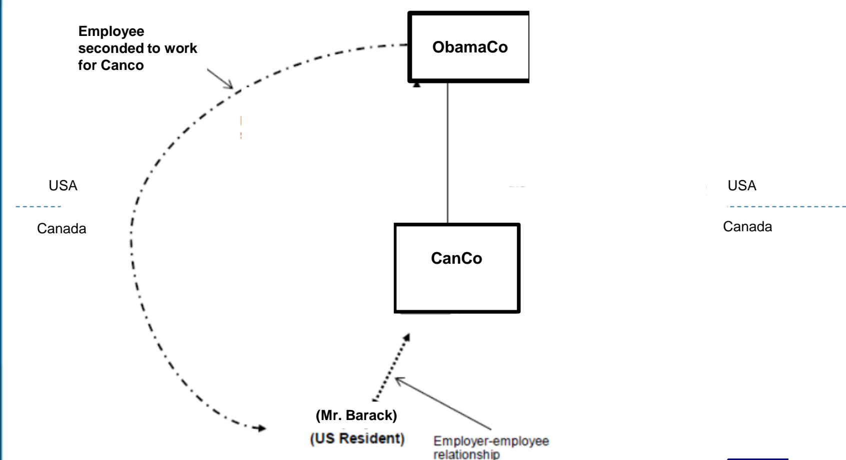
Case Study 1 - Scenario 1



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Regulation 102

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Issues:

- With limited exceptions, a payer must withhold income tax and social security (CPP & EI) where non-resident employees performs services in Canada.
  - Reg 102 applies to benefits which are taxable pursuant to Canadian tax legislation
    - Not required where employment is not regular and continuous. “Regular and continuous” is not defined in the Tax Act but CRA has a VERY broad interpretation
  - Employer must complete a BN# application and request a payroll account

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Reg 102 (cont’d)

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Issues:

- Reg 102 Waiver to exempt employee from withholding if annual earnings less than CDN$10,000 for U.S. residents ($5K for others) **or**,
- the employee performs services for less than 183 days (parallels the treaty) **and**;
- Remuneration must not be borne by a Canadian resident or employer with a PE in Canada.
- Waivers should be approved by CRA 30 days prior to commencement of work in Canada.

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Regulation 102 (cont'd)

Issues:

- Tax withheld by the employer is not a final tax and may be recoverable by filing a tax return.
- Treaty protection is available for the employee to file a personal tax return and recover income tax withheld where:
  - A) Remuneration is less than Cdn$10,000 or
  - B) Employee is present in Canada less than 183 days in any 12 month period *beginning or ending* in the fiscal year concerned and wages not paid or borne by or on behalf of a resident of Canada and is not borne by a PE in Canada.
- Employee must obtain Tax ID# and file a personal tax return claiming treaty exemption to claim refund of income taxes withheld.

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Social Security

- Certificate of coverage for social security is possible if conditions of Total Harmonization Agreement met.
- Withholding of EI is not required if the unemployment insurance laws of the U.S. require premiums to be paid for that employment.

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Secondments

- Secondment means the temporary assignment of an employee from an entity (lending employer) in a foreign country to an entity (receiving employer) carrying on business in Canada
  - Supported by the existence of an employer/employee relationship between the individual and the receiving employer
- A secondment may exist whether or not an employee remains on the payroll of the lending employer or is transferred to the payroll of the receiving employer
- Reg 105 withholding arise when non-resident employees remain on the lending employer's payroll and the lending employer charges the the receiving employer for amounts relating to the employee plus a markup. (if only reimbursement no Reg 105.)

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Secondment (Cont'd)

- Best practice to have a secondment agreement between lending employer and receiving employer.
- Agreement to include legal terms of the secondment, i.e. duration, responsibilities, job description, pay, and any other benefits.
- The receiving employer is responsible for the employee's salary and benefits.
- No element of profit should be included in the charge-back to the receiving employer by the lending employer.

Secondment (Cont'd)

- Regulation 102 continues to apply for the seconded employee.
- Seconded employee to file Canadian income tax return.
- Care must be given to ensure the work performed by the employee is related to the secondment location and will not be considered by CRA to be in respect of the carrying on of the foreign employer's business.

Case Study 1 - Scenario 1

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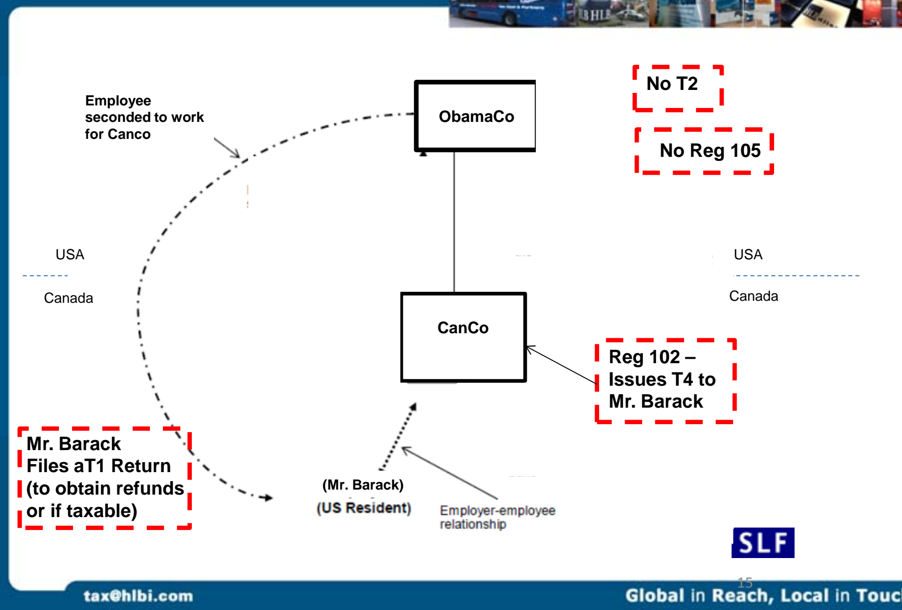

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Case Study 1 – Solution

Scenario 1

1. Wages do not exceed threshold (Article XV paragraph 2(a));
2. Mr. Barack is present in Canada less than 183 days (Article XV (2)(b)), but;
3. Wages borne by employer with a PE in Canada
   A. wages not exempt from Canadian tax;
   B. Regulation 102 withholdings apply;

Result

Employee should file a Canadian personal tax return and claim the Canadian income tax paid as an FTC on their 1040.

Canadian PE to file Canadian tax return and obligation to pay tax

May require transfer pricing study to minimize tax in Canada (consider 26.5% vs. 36% corporate tax rate in Canada vs. US).

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Case Study 1 - Scenario 2

- Same as Scenario 1, except salary paid by head office of Obama Co in the U.S. and charges a mark-up.

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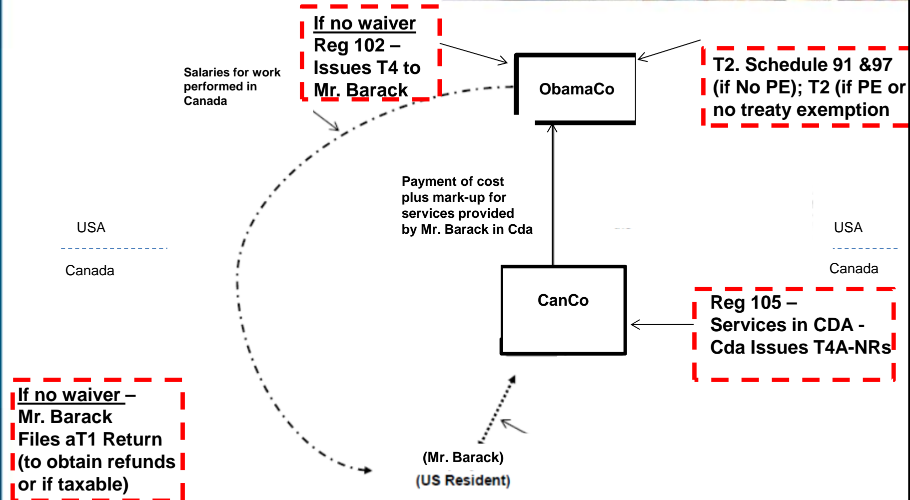
Case Study 1 - Scenario 2



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Case Study 1 - Solution

Scenario 2

1. Wages do not exceed threshold (Article XV (2)(a));
2. Mr. Barack is present in Canada less than 183 days (Article XV (2)(b), but;
3. Wages are not borne by an employer with a PE in Canada

Result

File Reg 102 waiver to avoid withholding taxes and social security amounts

No requirement for Mr. Barak to file a Canadian tax return (only if waiver not received).

Treaty based T2 required.

Case Study 2 - Scenario 1

- In an effort to prop up the Canadian dollar and encourage passing of the Keystone Pipeline bill in the United States, Obama Co. accepts an engagement from Stephen Harper Ltd. ("SH Ltd.") to perform services in Canada.
- Obama Co. has no other revenue.
- Engagement divided into three separate contacts.
  1. Contract One - installation of an "off the shelf" computer system which Obama Co will purchase then sell to SH Ltd.
  2. Contract two - modifications to tailor the system to SH Ltd.'s specific operations.
  3. Contract three - train employees of SH Ltd. on the use of the company's newly acquired donut making machine purchased from Dunkin Donuts.
- Completion time for each contract is 95 days (donut dispensing is difficult to master and requires much time and practice).

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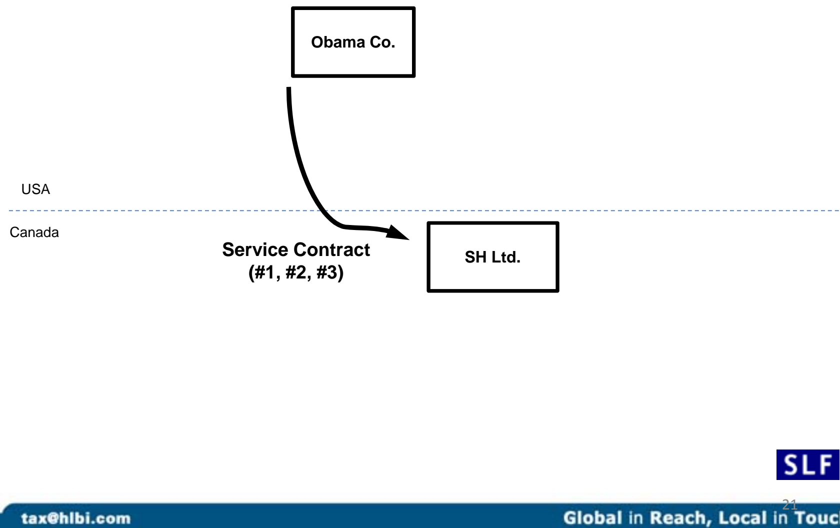
Regulation 105 Requirements



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Reg 105

Issues:

- Canadian tax legislation requires all payers to withhold taxes on fees, commissions, and other amounts paid to non-residents of Canada (other than employees) for services rendered in Canada. The rate of withholding is 15% of the gross amount.
- Annual reporting on a calendar year basis to CRA is mandatory (T4A-NR).
- Reg 105 waiver may be available to reduce or eliminate withholding but requirements for waiver are very limited and must be filed in advance of payment to non-resident. Waiver application is onerous and requires submission of financial data.
- The tax withheld is not a final tax but rather is reported as a credited on the tax return filing and may be refunded.
- A corporate income tax return is mandatory whether or not tax was withheld.

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Reg 105 (Cont'd)

Issues:

- U.S. resident utilizing a non-resident subcontractor to perform services in Canada have an obligation to withhold under Regulation 105, remit withholding, and issue Form T4A-NR.
- Withholding taxes must be remitted by the 15th of the month following the month in which the amounts were paid for services performed in Canada. Penalties are assessed on late or unremitted withholding taxes and filings.
- Subcontractors have a filing obligation for income earned in Canada (either Treaty based or if PE, T2).

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Art V(9) - Deemed PE's

Issues:

- Paragraph 9 of Article V of the Canada – U.S. deems a PE to exist where:
  - A. the services are performed by a person present in Canada for 183 days or more in any 12 month period and Canadian source gross business income is more than 50% of the total income
  - B. the services are provided in Canada for 183 days or more in any 12 month with respect to the same or "connected" projects for Canadian customers with a PE in Canada.

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Art V(9) - Deemed PE's

Issues:

- Art V(9)(a) - All days or part days , including weekends and holidays are counted.
- Art V(9)(b) - Only days or part days that you are performing services are counted.
- Art V(9)(b) - "Connected" refers to projects being a coherent whole (both geographically and commercially) even though there may be more than one contract.
  - Example: The same project with a series of contracts relating to receipt, delivery, assembly, installation, supervision of employees, training etc.

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Case Study 2 - Scenario 1

- In an effort to prop up the Canadian dollar and encourage passing of the Keystone Pipeline bill in the United States, Obama Co. accepts an engagement from Stephen Harper Ltd. ("SH Ltd.") to perform services in Canada.
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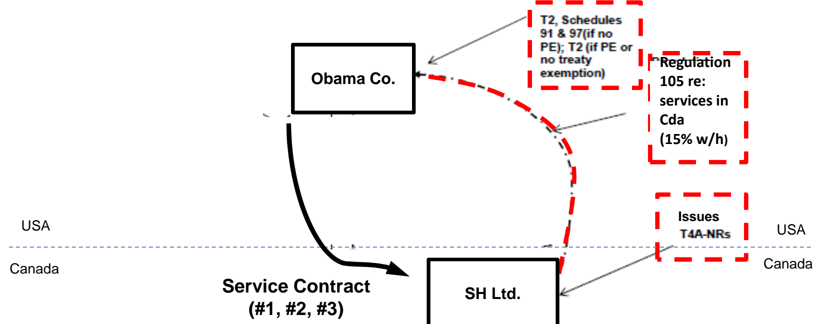
- Completion time for each contract is 95 days (donut dispensing is difficult to master and requires much time and practice).

Regulation 105 Requirements



Note: Reg 102 issues - see Case Study 1

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Case Study 2 - Solutions

Scenario 1

1. Article V(9)(b) - contracts 1 and 2 will be deemed to be commercially coherent based on a contract term of 95 X 2 = 190 days.
2. Article V(9)(a) - Services are provided for 183 days or more and more than 50% of revenue attributable to the Canada.

Therefore, no exemption from Canadian tax as both criteria of Article V, Paragraph 9 (a) and (b) are met, thus a Canadian PE is deemed to exist.

The third contract will be part of the income of the "enterprise" since there is a deemed PE by virtue of contracts 1 and 2.

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Case Study 2 - Scenario 2

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Same as scenario 1 except each contract is 90 days.

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Case Study 2 - Solution

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Scenario 2

No deemed PE:

- Combined days of contracts 1 and 2 are less than 183 days so first criteria of Art. V(9)(a) is not met. Even though 2nd criteria is met (i.e. gross revenue criteria), both criteria must be met to deem a PE to exist.
- The third contract is “stand alone” and unconnected to contracts 1 and 2, therefore not taxable as Art. V(9)(b) is not met.

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Non Resident Penalties

1. Failure to deduct at source – 10% of amount not withheld (20% where gross negligence is alleged).
2. Failure to file T4/T4 Summary return (similar to W-2 filings) – based on # of slips late filed (administrative relief currently reduces penalty)
3. Failure to file a Treaty based return - $2,500 penalty per year.
4. CRA assesses interest on any unpaid amount.

Note: Issues such as work visas/permits are not addressed in this presentation.

CANADA-US TRAPS FOR LLC'S

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Canada US Traps for LLCs

- An LLC is not deemed to be a US resident because the US LLC is not itself liable for tax in the US.
  - US-CAN Art IV(3) provides that if a company is resident of both Contracting States it will be deemed to be a resident based on its place of country of incorporation.
  - The term "company" means any corporate body or any entity which is treated as a corporate body for tax purposes.
- Article IV(6) provides only limited relief from Canadian tax on payments made to an LLC.

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Canada US Traps for LLCs

1) An LLC that has a Canadian manager may be deemed to be a Canadian resident and be taxed in Canada on it’s worldwide income.
   – Canada may deem the LLC to be a Canadian resident if it is centrally managed and controlled in Canada

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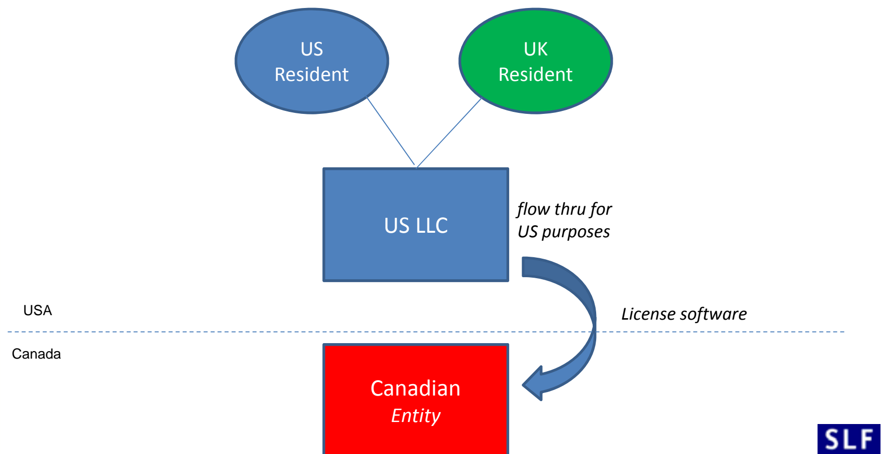
Canada US Traps for LLCs – Example #2



Canada US Traps for LLCs

2) Assume a US & UK resident form an LLC to license computer software to Canadian clients.
   - US-CAN Art IV(6) provides relief for Canadian withholding on US residents only.
   - US-CAN Art XII withholding tax does not apply to license payments to a US resident.
   - UK-CAN withholding tax does not apply to license payments to a UK resident.
   - But since the payment is made to the LLC, the pro rata portion allocable to the US resident is exempt from Canadian withholding tax but the portion allocable to the UK resident is subject to 25% withholding tax.

The UK resident is penalized for investing through an LLC rather than directly from the UK

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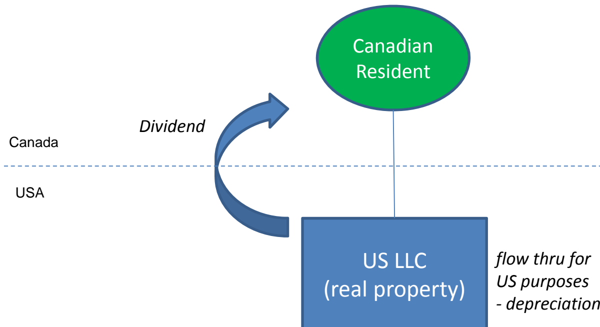
Canada US Traps for LLCs – Example #3

Facts: Canadian resident forms an LLC to invest in US real estate - rental property



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Canada US Traps for LLCs

3) Assume a Canadian resident forms an LLC to invest in a US real estate - rental property
   - Even though the LLC is treated as partnership for US tax purposes, it is considered a foreign corporation for Canadian tax purposes.
   - CCA (depreciation) claimed at the partnership level does not shelter income distributions to the Canadian members from Canadian tax.
   - Even if the CCA claimed creates a loss, all the distributions to the Canadian member are regarded as dividends and individual recipients may pay Canadian tax at the top rates.

Alternate structures such as limited partnerships should be considered for these types of investments. This structure allows CCA to be claimed and to offset the net rental income at the partnership level and allow a tax-free distribution to the partners.

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Canada US Traps for LLCs – Example #4

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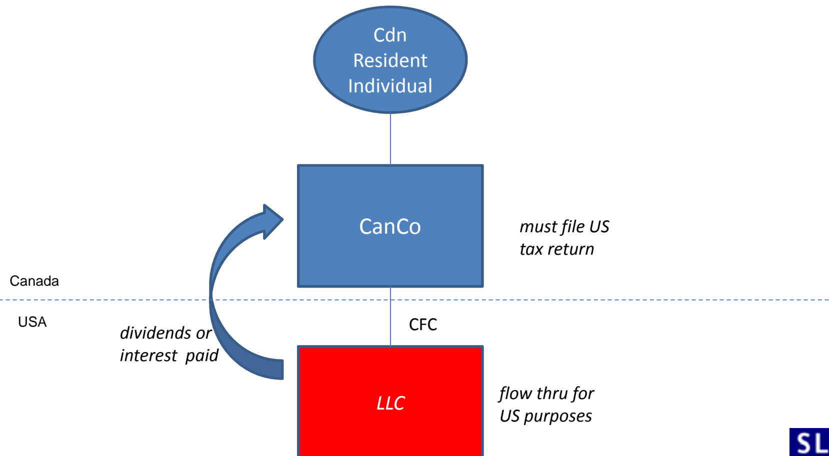
Facts: Canco expands into the US and forms an LLC



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Canada US Traps for LLCs

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4) Canco expands into the US and forms an LLC.

- LLC is regarded as a controlled foreign affiliate for Canadian tax. For US tax purposes, the LLC is disregarded and Canco is subject to US Corporate tax and to a 30% US branch tax.
- The branch tax reduction in the treaty does not apply, both because of US domestic law and US-CAN Art IV(7)(a).

If Canco carried on the business directly in the US, the US branch tax will be reduced to 5% and may apply the $500,000 branch tax exemption.

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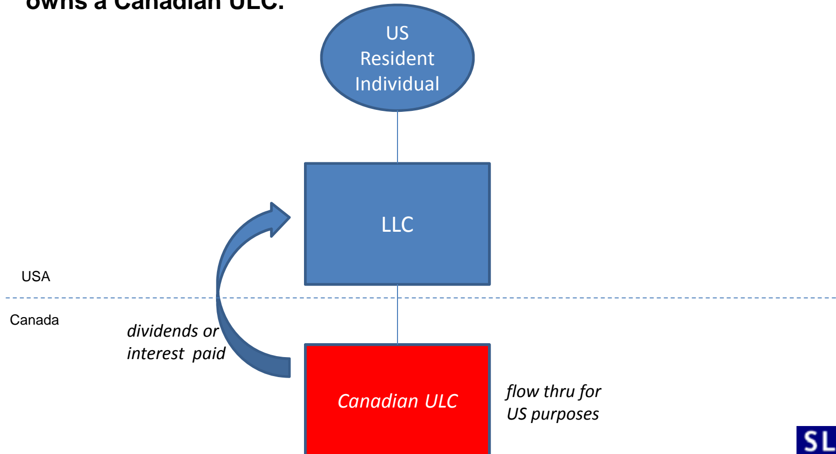
Canada US Traps for LLCs – Example #5

Facts: An American investing in Canada through a US LLC that owns a Canadian ULC.



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Canada US Traps for LLCs

5) An American investing in Canada through a US LLC that owns a Canadian ULC.
   - Art IV(7)(b) denied all treaty relief.
   - Dividends paid by the ULC to an LLC are subject to 25% withholding tax
   - Administratively, if have PUC increase which is treated as a deemed dividend, it will reduce withholding tax to 5%.

If US Co carried on the business directly in the US, the US branch tax will be reduced to 5% and may apply the $500,000 branch tax exemption.

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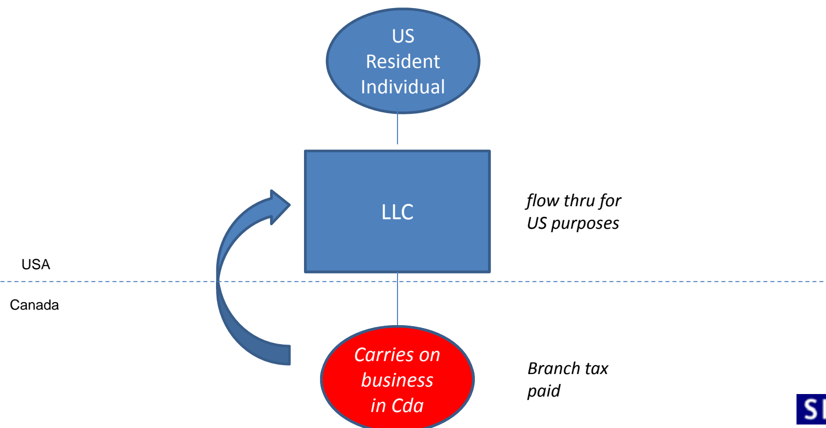
Canada US Traps for LLCs – Example #6

Facts: Assume an LLC is owned by a US resident individual and carries on business in Canada through a PE.



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Canada US Traps for LLCs

6) Assume an LLC is owned by a US resident individual and carries on business in Canada through a PE.
   – Canada regards the LLC as a foreign corporation that must pay Canadian corporate and branch tax.
   – The Canadian branch tax reduction to 5% is not available if the LLC is owned by individuals.

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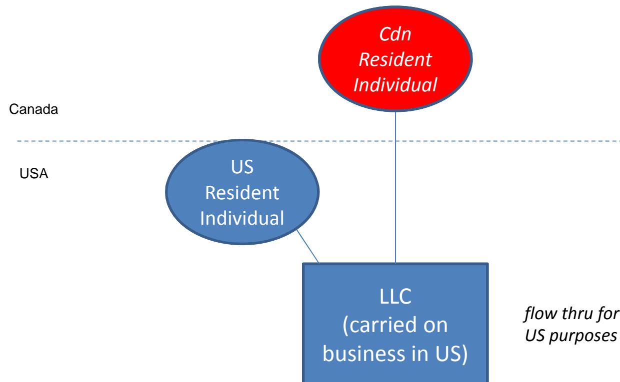
Canada US Traps for LLCs – Example #7

Facts: A Canadian resident individual is a member of an LLC that carries on a trade or business in the US.



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Canada US Traps for LLCs

7) A Canadian resident individual is a member of an LLC that carries on a trade or business in the US.

- The LLC is treated as a partnership in the US and a 35% withholding tax applies to income allocable to a non-resident.
- The Canadian resident's eligibility for a foreign tax credit or deduction for US withholding tax is limited to his foreign source income. If the LLC does not distribute income to the Canadian individual in the same calendar year that the US tax arises there is a mismatch and double taxation may arise.
- Only 15% of the US withholding tax is creditable and the balance is only deductible, therefore, there is always some double taxation regardless of the level of foreign source income.

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GST/HST

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Case Study 1 – GST/HST

Facts:

- America Computer Co. ("ACC") is a U.S. based manufacturer of computer software.
- ACC is considering entering the Canadian market place using a branch office.
- The Canadian office will be in Ontario. However, the Canadian customer base is currently located in Ontario, Alberta and BC and the intention is to expand that customer base to other provinces.

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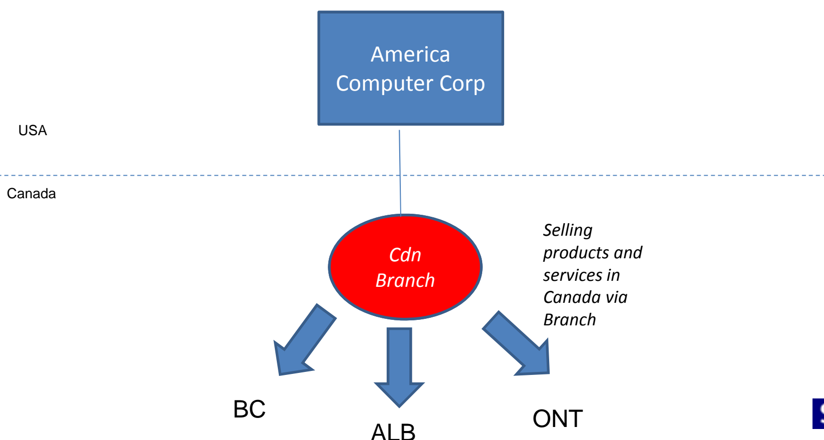
Case Study 1 – GST/HST



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Case Study 1 - Issues

- The U.S. controller of ACC has asked for assistance related to:
  - GST, HST and Provincial Sales Tax (PST).
  - Place of Supply Rules
  - Application of Provincial Sales Tax

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Case Study 1 - Analysis

- The branch must register for GST/HST as a foreign company. As a non-resident corporation it will be required to post a GST/HST bond. (If use a Cdn Co. no bond will be required)

Place of Supply for Goods:

- Takes place in the province in which the vendor delivers it or makes it available to the purchaser.

Case Study 1 - Analysis

Place of Supply for Service:

- You must determine where the recipient of the service is located and what is the address most closely related to the service?
- Customer 1 is located in Ontario which is a province with HST. Therefore, the customer will be billed for the software plus 13% HST.
- Customer 2 is located in B.C. which is no longer an HST province. Therefore, the customer will be billed 5% GST.

Case Study 1 - Analysis

BC Provincial Sales Tax (PST)

- If, the ordinary course of your business, you sell or provide taxable software in BC, you must register for PST.
- If you are registered or are required to be registered and you sell taxable software, you must charge and collect PST on that sale. The sale of custom **software is exempt** from PST. (The determination of whether you are selling custom software or non-custom software can be problematic)

Case Study 1 - Analysis

B.C. Provincial Sales Tax (PST)

- **Software** means a software program that is delivered or accessed by any means, or the right, whether exercised or not, to use a software program that is delivered or accessed by any means. Examples of software include application software and system software.
- You do not charge PST on services for software, including services to test, install, configure, modify, repair or restore software. However, services to hardware are subject to PST, including services to repair computers and peripherals.

Case Study 1 - Solution

Summary:

- Each non-harmonized province has its own statutes and rules for Provincial Sales Tax purposes, as to what constitutes taxable software and taxable computer services. Therefore, companies who operate in Canada should become familiar with the applicable provincial statutes applied to those provinces. The concern is similar to the U.S. issue of Nexus and U.S. State retail sales tax.

Case Study 2 – Scenario 1- GST/HST

Facts:

- Petco U.S. is a U.S. based wholesaler of pet food.
- Petco U.S. also sells to Canadian retailers currently located in the province of Ontario.
- Up to this point in time all shipments for Petco were made from the U.S. warehouse with title passing in the U.S. because the Canadian wholesale customer was the "importer of record" for customs and GST/HST purposes.

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Case Study 2 – Scenario 1- GST/HST

Facts (Cont'd)

- One of Petco's large customers in Canada (Big Pet Can Co) has approached the company about the possibility of Petco U.S. acting as the "importer of record" and bringing the goods to Canada.
- Not wanting to lose the customer Petco is looking for help to deal with the issue.
- Petco does not have a PE in Canada.

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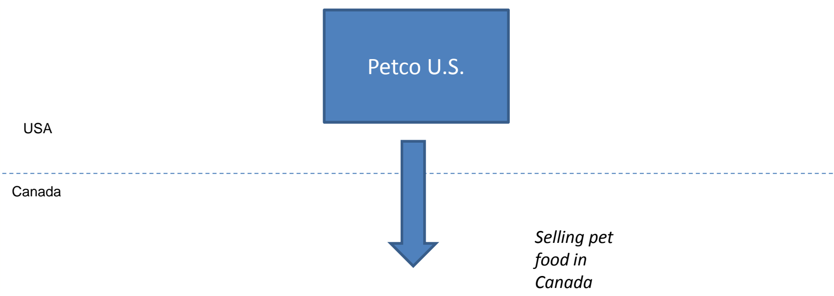
Case Study 2 – Scenario 1- GST/HST



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HLB TAX Case Study - Analysis

- Petco U.S. could apply for a Canadian importer license and import their product into Canada.
  - Petco U.S. would hire a Canadian custom broker to clear the goods into Canada on their behalf and shipment would be made to the Canadian customer's warehouse.
  - In addition to paying any shipping and duty that is applicable on importation, Petco U. S. would also pay any GST/HST that was payable on importation.

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HLB TAX Case Study 2 - Analysis

- In order to recover this GST/HST, Petco U.S. would have to register for GST/HST in Canada.
- This would require them to collect GST/HST on the sale price of any goods sold to Big Pet Can Co. based on the selling price in Canadian dollars and the GST/HST rate applicable to that province (13% in Ontario)
- Petco U.S. would be entitled to claim input tax credits to recover any GST/HST costs they incurred for the product they imported.

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Case Study 2 - Solution

Summary:

- With the assistance of its Canadian customs broker and by using its GST/HST and importer licenses, Petco U.S. will be able to accommodate Big Pet Can Co.
- As a non resident GST/HST registrant Petco U.S. will be required to post a bond equal to 50% of the estimated net tax (minimum $5,000, maximum $1,000,000)
- As a condition of obtaining their GST/HST license they will be responsible for filing GST/HST tax returns as well as a treaty based income tax return.
- Petco should adjust its accounting system to account for GST/HST recovery and collection and remittance. Petco will have to reconsider its pricing to Big Pet Can Co. to compensate for any duty, shipping or other costs.

Case Study 2 – Scenario 2- GST/HST

Facts:

- 2 years later Petco U.S. runs into some financial difficulty and the CFO and most of the accounting department leave the company.
- New accounting staff are hired, however the transition does not go well and the new staff are left with little or no backup or instructions as to how the GST/HST should be handled.
- Over the next few years GST returns are not filed on a timely basis nor are remittances made on a timely basis and the CRA decides to commence an audit.
- Petco hired a new controller last week and he is asking for help

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Case Study 2 – Scenario 2- GST/HST

The audit revealed the following issues:

- GST/HST returns were sometimes filed in Canadian dollars and other times in U.S. dollars.
- The Harmonized Sales Tax system in Canada is constantly changing i.e. in April of 2013 BC had opted out of the Harmonized GST system reverting to a 5% GST and 7% Provincial Sales tax.
- The province of Prince Edward Island adopted the Harmonized GST system effective April 1, 2013 at a rate of 14%.
- Petco U.S. ignored the notices from the CRA advising of the changes and had not kept up with the changes even though they were making sales into BC.

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Case Study 2 – Scenario 2- GST/HST

The audit revealed the following issues:

- Accounting staff did not always file GST/HST returns using the accrual method therefore, sales per the f/s did not match sales per the GST/HST returns. The resulting understatement of sales and under remittance of GST/HST resulted in the auditor applying HST at the highest HST rate based on f/s sales and also proposing to impose tax evasion penalties.
- The CRA proposed assessment based on the Canadian f/s of the company and included all sales, including those where the Canadian customer acted as “importer of record.”

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Case Study 2 - Analysis

1. GST/HST returns must be filed in Cdn $. This will result in FX issues that must be managed by the Co.
2. GST/HST return must be done on an accrual basis.
3. Petco U.S. must identify the shipping destination of its customers so as to categorize its customers for purpose of charging the correct amount of tax. CRA is not willing to offset Petco's erroneous over collection of tax against it's under collection of tax. CRA is expecting Petco U.S. to pay all under collections out of their own pocket. Petco U.S. could still attempt to recover the tax from their customers however the business cost of correcting this error would have to be assessed by management.

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Case Study 2 - Solution

- The auditor did his audit based on the Canadian f/s prepared by the company.
  - 60% of the Canadian sales were made to Canadian customers who took title to the goods in the U.S. and acted as the "importer of record" for Canadian purposes.
  - These sales were completed outside of Canada. Now the company must prove to the CRA, by providing documentary evidence, that the 60% of sales made outside Canada should be excluded for GST/HST purposes. (The problem was compounded by the fact that the company records were in a mess and shipping documents had been misplaced or destroyed.)

Case Study 2 - Solution

Summary:

- It is absolutely essential that companies that do business in Canada keep proper records that show where title passes in cross border transactions. The problem was time consuming however, through a combination of customer's cooperation and accumulation of documentary records CRA accepted the fact that 60% of the sales took place outside of Canada.

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CRA's Policy on Carrying on Business in Canada for GST/HST

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

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GST/HST Tax Rates

Harmonized	Jurisdiction	GST/HST Rate	Total Rate including Provincial Sales Tax	PST on GST	APPENDIX 6
	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 is no longer 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 cancelled its proposal to reduced the HST rate that was expected July 1, 2014.
Yes	Ontario	13%	13%	N/A	
	Manitoba	5%	13%	No	
Yes	PEI	14%	14%	N/A	
Yes Hybrid	Quebec	5%	14.975%	Yes	Must be registered in Quebec to collect QST.
	Saskatchewan	5%	10%	No	

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Questions?

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