TAX BULLETIN

TAX CONSEQUENCES FOR CANADIANS DOING BUSINESS IN THE U.S.

November 2020

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Has your Canadian business expanded into the U.S.? Do you have dealings with U.S. customers? If so, have you considered the U.S. tax implications? It's important that you do. Canadians — both individuals and corporations — can end up with a U.S. tax liability if they carry on a trade or business in the U.S. Even if there is no U.S. tax liability associated with carrying on a trade or business, there may be U.S. filing requirements, which may attract significant penalties if not met on a timely basis.

In this bulletin, we'll primarily discuss the U.S. federal income tax liability and filing requirements that can arise for Canadians (individuals and corporations) who are considered to be carrying on business in the U.S. Note that this bulletin does not cover issues that need to be considered by Canadian partnerships and trusts doing business in the U.S. — please contact your BDO Canada U.S. tax advisor for assistance in these situations.

What's New for 2020

U.S. Economic Relief Package - the Coronavirus Aid, Relief, and Economic Security Act

The Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), enacted on March 27, 2020, is an over $2 trillion economic relief package delivered in response to the economic fallout of the COVID-19 pandemic in the U.S.

Below is an overview of the key tax relief provisions included in the CARES Act for businesses.

Modifications to Net Operating Loss Rules

Following the enactment of the Tax Cuts and Jobs Act (TCJA) in 2017, taxpayers' ability to carry back net operating losses (NOLs) to prior tax years was repealed, and deductions for NOLs incurred in tax years beginning after December 31, 2017 are limited to 80% of taxable income in carryforward years.

The CARES Act permits NOLs arising in 2018, 2019, and 2020 tax years to be carried back to each of the five preceding tax years, and suspends the 80%-of-taxable-income limitation through the 2020 tax year. The CARES Act also made the technical correction to allow NOLs generated in a year beginning in 2017 and ending in 2018 to be carried back two years.

NOL carrybacks may offer cash flow and tax rate benefits to taxpayers by amending tax returns for the applicable years to claim cash refunds arising from the use of eligible NOLs. However, to the extent it is disadvantageous to carry back NOLs, a taxpayer can still elect to waive the carryback period. Canadian businesses with U.S. operations need to consider the collateral impacts of the NOL changes to their tax situations and act accordingly.

Modifications to Business Interest Limitation

The TCJA added the new business interest limitation, which generally limits the net interest expense deduction for most businesses, regardless of form, to 30% of adjusted taxable income (ATI).

The CARES Act temporarily increases the ATI limit to 50% for 2019 and 2020 tax years. However, taxpayers can opt out of the 50%-of-ATI limit if desired. Another special election permits taxpayers to use their 2019 ATI in lieu of 2020 ATI in computing the 2020 limit.

Bonus Depreciation for Qualified Improvement Property

Under the TCJA, due to a drafting oversight, qualified improvement property (QIP) was caused to have a 39-year cost recovery period, and consequently, ineligible for 100% bonus depreciation.

The CARES Act made the technical amendment to retroactively include QIP acquired and placed in service on or after January 1, 2018 as 15-year property and eligible for 100% bonus depreciation.

Alternative Minimum Tax Acceleration

The TCJA repealed the corporate alternative minimum tax (AMT) and allowed corporations to claim a refund of AMT credit carryovers during 2018 to 2021 tax years.

The CARES Act accelerates the refund timeline and permits corporations to claim any remaining AMT credits as a refund in full in either 2018 or 2019 tax year.

Charitable Contribution

The CARES Act provides for an enhanced deduction from 10% to 25% of taxable income for qualified charitable contributions made by corporations in 2020.

Employee Retention Credit

The CARES Act adds a new refundable payroll tax credit equal to 50% of qualified wages (up to $10,000 per employee) paid by eligible employers from March 13, 2020 to December 31, 2020.

Deferral of Employer Payroll Taxes

The CARES Act allows employers to defer deposits of the 6.2% employer's share of the Social Security tax on wages paid from March 27, 2020 through December 31, 2020, with 50% due by December 31, 2021, and 50% due by December 31, 2022.

U.S. basis of taxation

Under U.S. domestic tax law, a non-resident — whether an individual or corporation — is subject to U.S. federal tax if they have income that is "effectively connected with the conduct of a trade or business within the United States". This is an ongoing test, which means that if you carry on a trade or business in the U.S. at any time in the year, you will be subject to U.S. tax for that particular taxation year. This is similar to the Canadian domestic law that taxes non-residents of Canada on any income they earn from carrying on a business in Canada.

Are you carrying on a trade or business in the U.S.?

If you operate a business in Canada and have dealings with U.S. customers, you may be considered to be carrying on business in the U.S. Whether or not this is the case will depend on the facts of your involvement with U.S. customers. The level of activity required for "trade or business" status in the U.S. is relatively low. The following situations could mean that you are subject to U.S. tax:

- If you make sales into the U.S. market, you may have a U.S. trade or business. If, however, you are merely accepting unsolicited purchase orders from U.S. customers, you probably will not be considered to be carrying on business in the U.S. If you ship goods to the U.S. and title

to the items passes in the U.S., you will likely be considered to have a U.S. trade or business.

- The activities of your employees or agents may cause you to have a U.S. trade or business. For example, you may be considered to have a U.S. trade or business if your employees or agents travel regularly to the U.S. to make sales calls or if your employees or agents are doing marketing, demonstrating goods, or soliciting orders in the U.S. However, you will not likely have a trade or business from passive solicitation in the U.S. through mail order catalogues, or casual or infrequent trips to the U.S. by your employees.
- If you (or your employees and/or independent contractors) perform employment or self-employment services in the U.S., you are considered to be carrying on a U.S. trade or business. For example, if you go to the U.S. on consulting contracts and work at customer sites, you will be considered to have a U.S. trade or business. Note certain exceptions may apply.
- If your technicians travel to the U.S. on a regular basis to help clients with installations, training, or servicing products, you may have a U.S. trade or business. However, such staff would have to be involved in selling products or negotiating additional services (in other words, generating income for you).

It's important to recognize when you start to have business connections with the U.S. because as soon as you do, you may be subject to U.S. tax, or at least have U.S. filing requirements.

Effectively connected income

If you are engaged in a U.S. trade or business, you will be taxed at graduated rates on a net basis on income that is effectively connected with the conduct of that U.S. trade or business. Effectively connected income generally includes business income and salaries attributable to services performed in the U.S. Generally, you will be allowed to claim deductions to reduce effectively connected income, but only to the extent that the deductions are connected with that income. Note that special tests are applied to determine whether investment income from U.S. sources is treated as effectively connected income.

If you have a trade or business in the U.S., certain types of foreign-source income could also be considered effectively connected with the U.S. trade or business. For example, if certain conditions are met, royalties received for the use of intangible property outside the U.S. could be treated as effectively connected income where the royalties are from the active conduct of a U.S. trade or business. Similarly, income from the sale of inventory in a foreign country could be treated as effectively connected income, if the sale is made from the U.S.

Also note that gains or losses earned on the disposition of U.S. real property, including shares of a U.S. real property holding company, are considered effectively connected to the U.S., even if you are not considered to be engaged in a U.S. trade or business.

The benefits of the Canada-U.S. tax treaty

If you have income that is effectively connected with a U.S. trade or business, you may be able to seek relief from U.S. federal tax, due to relief provided under the Canada - U.S. tax treaty (the treaty). However, you will still have U.S. filing requirements. Under the treaty, Canadian residents are only taxable in the U.S. on their U.S. business profits if they carry on their business in the U.S. through a U.S. permanent establishment (PE) as defined in the treaty.

What is a PE?

A PE is basically a fixed place of business through which a non-resident carries on a business. Examples of a PE include:

- a place of management;
- a branch;
- an office;
- a factory or workshop;
- a place of extraction of natural resources, such as a mine;
- a building, construction or installation project lasting more than 12 months; and

- use of an installation or drilling rig or ship for the exploration or exploitation of natural resources for more than 3 months in any 12 month period.

You will also be considered to have a U.S. PE if a person acting on your behalf in the U.S. regularly has the authority to conclude contracts in your name and habitually exercises such authority while in the U.S. For example, if an employee of a Canadian company travels to a U.S. trade show annually and makes sales there, the Canadian company could be considered to have a U.S. PE by virtue of the employee's general authority to conclude contracts (including the ability to negotiate prices, and not simply by using a fixed price list) at the annual trade show.

PE rules for services

Effective January 1, 2010, there are two additional specific tests under the treaty that if met, will deem a Canadian service provider to have a PE in the U.S. Under the first test, you will have a PE in the U.S. if services are performed by an individual (you or an employee) who is present in the U.S. for 183 days or more in any 12-month period, and during that period, more than 50% of the "gross active business revenue" of the business consists of income derived from the services performed by that individual in the U.S. "Gross active business revenue" refers to gross revenues from active business activities that the service provider has charged or should charge, regardless of when the actual billing takes place or when the revenues are taxed.

Under the second test, you will have a deemed PE in the U.S. if services are provided by your business 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 resident of the U.S., or who maintain a P.E. in the U.S. (and the services are performed in respect of that PE.) Projects will be considered connected if they "constitute a coherent whole, commercially and geographically" from the point of view of the service provider (not that of the customer) and will depend on the specific facts and circumstances of each case. This rule is designed, in part, to prevent the use of potentially abusive situations in which work is artificially divided into separate projects or pieces to avoid meeting the 183-day threshold.

Activities that do not give rise to a U.S. PE

Under the treaty, certain fixed places of business are not considered a U.S. PE if used solely for specified activities. Examples of these activities include:

- the use of facilities, for storage, display, or delivery of goods or merchandise;
- the maintenance of a stock of goods or merchandise for storage, display and delivery or for processing by another person;
- the purchase of goods in the U.S.,
- the collection of information in the U.S.; and
- advertising, supplying information or scientific research done in the U.S. that is preparatory or secondary to the business.

As well, if you use a U.S. broker, general commission agent, or any other independent agent, you will not be considered to have a PE in the U.S., as long as the broker or agent is of independent status and is acting in the ordinary course of their own business.

You need to consider your presence and level of activity in the U.S. to determine whether you have a PE there. If you do have a PE, you will be taxable in the U.S. with respect to the income attributable to that PE. Review your circumstances with your BDO tax advisor to determine whether or not you have a PE in the U.S.

Relief for COVID-19 Emergency Travel Disruptions

In April 2020, the IRS provided guidance in relation to relief to certain foreign businesses that have activities in the U.S. affected by COVID-19 emergency travel disruptions.

A nonresident alien, foreign corporation, or a partnership in which either is a partner (affected person) may choose an uninterrupted period of up to 60 calendar days, beginning on or after February 1, 2020, and on or before April 1, 2020 (the COVID-19 Emergency Period), during which services or other activities conducted in the U.S. will not be taken into account in determining whether the nonresident alien or foreign

corporation is engaged in a U.S. trade or business or has a U.S. PE.

This relief only applies if the services or other activities were performed by one or more individuals temporarily present in the U.S., and such activities would not have occurred in the U.S. but for COVID-19 Emergency Travel Disruptions

An "individual temporarily present in the U.S." means an individual who is present in the U.S. during the relevant 60-day period, and is a non-resident alien, or a U.S. citizen or lawful permanent resident who had a tax home outside the U.S. in 2019 and reasonably expects to have a tax home outside the U.S. in 2020.

U.S. filing requirements

Treaty-based filing positions

Canadian businesses with income that is effectively connected with a U.S. trade or business must file U.S. tax returns, even if such business is not attributable to a U.S. PE and is therefore not subject to U.S. federal income tax.

In the case of a Canadian corporation, Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation* must be filed to disclose U.S. source income, together with Form 8833 *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)* to claim relief under the treaty from U.S. federal taxation on income from U.S. activities because the corporation does not have a U.S. PE.

If you are a Canadian individual, you must file Form 1040NR *U.S. Non-resident Alien Income Tax Return* and attach Form 8833 disclosing that you are claiming relief under the treaty from taxation on income from your U.S. activities because you do not have a PE in the U.S. Note that it is necessary to indicate on Form 8833 the appropriate provision of the treaty whereby your income from your U.S. activities is not taxable in the U.S.

If you are uncertain as to whether you have income from carrying on a business in the U.S., you should consider filing a U.S. return to protect yourself from penalties for failure to file and disclose a treaty-based filing position.

U.S. permanent establishment

If it is determined that you have a U.S. PE, the income that is attributable to the U.S. PE is subject to U.S. tax and therefore no treaty exemption is available. Corporations with a U.S. PE must file Form 1120-F, and individuals with a PE in the U.S. must file Form 1040NR.

Taxpayers with U.S. PEs can generally claim foreign tax credits on their Canadian tax returns for U.S. income tax that is paid on their U.S. source income. As Canadian residents (both corporate and individual) are taxable on their worldwide income for Canadian tax purposes, U.S. effectively connected income will be taxed in both Canada and the U.S. However, by claiming a foreign tax credit for the U.S. tax paid against your Canadian income tax, you can generally avoid double taxation on the U.S. effectively connected income.

Deadlines

For Canadian corporations with a PE in the U.S., the original deadline for filing a U.S. income tax return for a particular year is the 15th day of the 4th month following the end of the fiscal year of the business for corporate fiscal periods that start after December 31, 2015. For example, for calendar year businesses, the deadline would be April 15th of the following year.

There is an exception for corporations with a June 30th year-end for tax years starting after December 31, 2015 and before January 1, 2026. For these corporations, the tax returns are still due on the 15th of the 3rd month following the year-end of the corporation, or September 15th.

These corporate filing deadlines also apply to Canadian corporations that do not have a PE in the U.S., but have a place of business in the U.S. The deadline for Canadian corporations that do not maintain an office or place of business in the U.S. is the 15th day of the 6th month following the end of the fiscal year of the business.

It is possible to extend these filing dates if an application for extension is made on or before the first due date. The application for extension of a corporate tax return is made by filing Form 7004 *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and*

Other Returns. However, an extension in time to file a return does not defer the payment of any taxes that may be due. By filing this form, generally a six-month extension is available.

However, for calendar-year corporate filers, the extension is only five months for year-ends that start after 2015 and before January 1, 2026. For June 30th fiscal corporations, the extension can be granted for seven months for corporate year-ends that start after December 1, 2015 and before January 1, 2026.

For individuals who are not U.S. residents and U.S. residents living outside of the U.S., the original deadline for filing the return for a particular year is the 15th day of the 6th month following the end of the calendar year, i.e. June 15th. Note, however, if an individual has income subject to U.S. withholding at source (for example, employment income), the filing deadline is April 15th instead. Individuals can also ask for an extension of time to file their return by filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, on or before the original due date.

Penalties

If you file late, but no tax is payable because of the treaty exemption, no interest and penalties should apply if a second filing deadline is met. For corporations, this second filing deadline is 18 months after the original due date. For individuals, this deadline is 16 months after the original due date for the return. For example, as an individual, where your 2019 return was originally due June 15, 2020, the final deadline for filing is 16 months after this date or October 15, 2021. In either case, if these second deadlines are missed, penalties may apply even if no tax is payable.

Individuals who miss the second deadline for filing returns will be denied personal exemptions and deductions on their return. In effect, you will be taxed on U.S. source gross business income. If you claim a treaty exemption to eliminate the tax at that time, you may be charged a $1,000 non-disclosure penalty for each item of income. Similar rules apply to corporations. If your corporation files later than the second deadline, it will be taxed on its U.S. source gross business income. If a treaty exemption is then claimed to eliminate the tax, a penalty for non-disclosure of $10,000 may be charged for each item of income. Note that temporary regulations may allow later filings in very restricted circumstances. Contact your BDO advisor for further information on the application of these rules.

U.S. taxpayer identification

Forms 1120-F, 1040NR and 8833 all require a U.S. taxpayer identification number.

For individuals, a U.S. taxpayer identification number can be either:

- A U.S. Social Security Number (SSN), which is the U.S. equivalent of a Social Insurance Number, or
- An Individual Taxpayer Identification Number (ITIN).

Only individuals who have U.S. immigration status are entitled to an SSN. For those individuals not eligible for an SSN, an ITIN will be required. To obtain an ITIN, you must file Form W-7 and proof of your identity and foreign status, along with your original completed tax return. Once Form W-7 has been processed, the Internal Revenue Service (IRS) will assign an ITIN to the return and process the return. If you do not have a return filing requirement, but meet one of the exceptions for obtaining an ITIN (for example, individuals subject to certain tax treaty benefits or third party reporting or withholding), you will be required to file specific documentation instead of a tax return. Your BDO advisor can assist you with this process.

For corporations, the taxpayer identification number is the Employer Identification Number (EIN). To obtain an EIN, a Canadian corporation must file Form SS-4 with the IRS.

U.S. withholding tax

Your U.S. customer is required by the IRS to ascertain your status as a U.S. or a foreign (non-U.S.) person to determine the amount of withholding tax required to be withheld from any payments owed to you. In order to determine your status, your customer may request you to complete Form W-8BEN, W-8BEN-E, W-8ECI,

W-8IMY or W-EXP depending on your situation. In some cases, Form W-9 is provided; however, Form W-9 should only be completed by U.S. persons. U.S. trade or business income is generally not subject to withholding tax, however, a 30% withholding tax may be deducted from your payment and remitted to the IRS should you choose to ignore a request to complete a W-8 series form by your U.S. customer.

If the withholding is remitted to the IRS, a U.S. tax return must be filed to obtain a refund of any excess withholding. W-8 series forms are not filed with the IRS, but are kept on file by your U.S. customer in the event of an IRS audit. Generally, a U.S. taxpayer identification number is required to complete these forms. Your U.S. customer acts as a withholding agent on behalf of the IRS and may be liable for such withholding for failure to determine your status.

Note that with the introduction of the *Foreign Account Tax Compliance Act*, FATCA, legislation in the U.S. form W8-BEN-E may also be used by a U.S. payor to determine your status under FATCA legislation, and in some circumstances, this will also lead to a 30% withholding on certain defined payments. Contact your local BDO Canada U.S. tax advisor should you require assistance completing these forms.

U.S. State taxation

You may also have U.S. state income tax obligations. You could be liable for state income taxes even if you do not have a PE in the U.S. The states are not bound by the federal treaty and therefore have the power to impose income tax even when the income is otherwise exempt by virtue of a provision in the Canada-U.S. tax treaty. Most U.S. states impose income tax on companies that carry on business in their state. The basis of state taxation varies; some states base their tax calculation on U.S. federal taxable income, whereas other states impose tax on a portion of a Canadian company's total income. States impose income tax using a "nexus standard". In other words, the taxpayer has some connection to the state, which is often a more encompassing concept than a PE. Certain states have adopted an economic nexus standard and impose taxation and filing obligations on entities solely on the basis of a minimum revenue amount. Although the amounts of tax may be small, there are often penalties for not filing these returns.

In addition, sales and other state tax should not be overlooked. If you make sales into a state, you need to determine whether there is a requirement to collect and remit sales tax in that state.

As the result of the 2018 U.S. Supreme Court *South Dakota v. Wayfair* case, most states that impose sales tax have adopted economic nexus standards that require out of state retailers to register for sales tax and to collect and remit sales tax. While each state has its own standards, the typical threshold for economic nexus is $100,000 in sales in a state during the calendar year. The *Wayfair* decision has expanded Canadian companies' obligation to register for U.S. state sales tax, and to collect and remit this tax with U.S. state sales tax returns even where there is no physical presence in a state. Canadian companies that are under a state's economic nexus thresholds could also have sales tax nexus based on physical presence. This physical presence can be meet through agents and independent contractors. As a result of these recent changes in the U.S. sale tax environment, Canadian companies that sell in the U.S. through the internet will need to re-evaluate their U.S. sales tax footprint to ensure that they are complying with expanding sales tax obligations.

Other state taxes which may apply are often calculated based on activity in the state. You also need to consider franchise or capital tax, city or municipal sales tax, property taxes, industry specific taxes and possibly others. In addition, a Canadian company carrying on business in a U.S. state must generally register with the state in which it carries on business. There may be a registration fee or other legal or administrative requirements.

It's also important to remember that each state has its own filing requirements and deadlines that may differ from the U.S. federal requirements and deadlines. Your BDO Canada U.S. tax advisor can help you determine whether you have any state tax liabilities and what your filing requirements might be.

Other considerations for CCPCs

When a Canadian-controlled private corporation (CCPC) carries on business in the U.S. through a PE, any income derived from that PE will not qualify for the small business deduction. As well, where services are rendered in the U.S., income derived from the provision of those services will not normally be eligible for the small business deduction, even if the CCPC does not have a PE in the U.S. As a result, such income could be taxed at the general corporate tax rate in Canada rather than the lower tax rates that apply to qualifying small business profits.

In addition, having U.S. operations in a CCPC can affect the CCPC's eligibility to be a qualifying small business corporation (QSBC). If the shares of the CCPC are not QSBC shares, the shareholders will not be able to claim the lifetime capital gains exemption on the sale of such shares. The lifetime capital gains exemption is $883,384 in 2020.

The QSBC rules are also important to consider if you are thinking about running the U.S. business in a U.S. subsidiary of the CCPC. A CCPC with a U.S. subsidiary may not meet all of the tests required in order to be a QSBC, as the shares of the U.S. subsidiary are a non-qualifying asset. This problem may be avoided by setting up another Canadian corporation to hold the shares of the U.S. company, rather than having the U.S. company established as a subsidiary of a Canadian company that would otherwise be a QSBC. Planning ahead is important for CCPCs doing business in the U.S. Consult your BDO advisor to determine the best strategy for your business.

Summary

If you have business operations in the U.S., you could be liable for a myriad of different taxes. And there are a number of considerations to make in order to determine the appropriate filing requirements. Whether you are liable for U.S. federal income taxes on income from your business operations will depend on whether you are carrying on a trade or business in the U.S. through a U.S. permanent establishment. Even if you determine that you are not liable for U.S. federal income taxes, you may still have U.S. filing obligations. Also remember that state income taxes may be determined on a different basis, and filing requirements can vary depending on the state. If you have business dealings in the U.S. or are thinking about expanding to the U.S., contact your BDO advisor to discuss your U.S. tax obligations.

If you have questions regarding how the proposed U.S. tax reforms in the recently announced draft bills might affect you or your business, please contact our U.S. Tax Practice Leaders in Canada:

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Learn more about our U.S. Tax practice.

The information in this publication is current as of November 1, 2020.

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