



# IS YOUR BUSINESS SUBJECT TO US INCOME AND SALES TAX? PART I

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It has become increasingly common for Canadian businesses to sell products and services into the United States. While they file their Canadian income tax returns to report their income, they seldom consider if they are subject to US income and sales taxes. They may be very surprised that they are.

The three main sources of taxation in the United States that a Canadian business should be concerned with are US federal income tax, state income tax and states sales tax<sup>1</sup>. In this Part I of our two part newsletter series we discuss US Federal Income Tax.

## US FEDERAL INCOME TAX

### US TRADE OR BUSINESS

For some business people, the mention of CRA sends shudders down their spine. The mention of the IRS usually invokes convulsions. For these reasons, business people try to steer clear of both. That is not always an easy thing to do when a Canadian business is expanding its clientele beyond our borders. If your business dealings extend into the United States, you have to consider your exposure to US taxation.

A Canadian business may be subject to US federal income tax based upon US domestic tax law if they are conducting a US Trade or Business. This is the case when there is a considerable, continuous and regular activity in the



*Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.*

conduct of the business in the United States. There is very little guidance in the tax code, however, guidance has been provided over time by the courts. In general, activity extends beyond mere physical presence in the US. For example, having an employee or dependent agent in the US conducting your business may satisfy this requirement. There is a high degree of subjectivity

1. This can include franchise and minimum taxes. There may also be municipal taxation, which is not discussed in this newsletter.

to this determination and the advice of a US income tax specialist is generally required.

### **CANADA—USA INCOME TAX TREATY**

Luckily, there is an agreement between Canada and the United States (the “Treaty”) that sets a minimum threshold of activity under which a Canadian business would not be subject to US federal income tax. The Treaty states that a Canadian business would be subject to US income tax only if they have a permanent establishment in the United States<sup>2</sup>.

A permanent establishment is defined as a fixed place of business through which the business is wholly or partly carried on<sup>3</sup>. The Treaty expands on this definition to include a place of management, branch, office, factory, workshop, mine, oil or gas well, quarry and other places of extracting natural resources. A building site or construction or installation project will also constitute a permanent establishment but only if it lasts more than 12 months. A US employee or dependent agent will be considered a permanent establishment in the United States if they have and habitually exercise the authority to conclude contracts in the name of the business.

By contrast to the US domestic rules, a permanent establishment under the Treaty tends to require a more conventional and substantial presence. Some would refer to this as a “bricks and mortar” presence.

The Treaty departs from this theme for service businesses. The Treaty may deem a US permanent establishment for Canadian businesses providing services to the customers in the United States. This will occur if: (a) the services are performed by an individual who is present in the United States for greater than 183 days or more in any 12 month period and during that period the revenue related to those US activities represent greater than 50% of the gross business revenue of the business, or (b) the services are provided in the United States for an aggregate of 183 days or more in any 12 month period with respect to the same or connected projects. Management and computer consultants, to name a few, can find themselves having a deemed permanent establishment in the US.



US domestic tax law and the Treaty are based upon concepts that may not translate well to modern ways of doing business, such as internet sales. A Canadian software supplier could offer their product for sale throughout the United States by download from a Canadian server. The Treaty does not address this situation well. The Organization for Economic Development and Cooperation<sup>4</sup> (“OECD”) is conducting a review of its model treaty with a view to modernizing its provisions to more effectively address the taxation of e-commerce. The OECD has set a target date of 2020 to implement new rules for e-commerce. This will likely result in future changes to the Treaty and could lead to Canadian software suppliers having a US permanent establishment. Until then, Canadian businesses have to contend with the current, somewhat outdated, rules under which they may not have a US permanent establishment.

If a Canadian business falls below the Treaty minimum threshold of US activity for a permanent establishment, it is not subject to US federal income tax. If, however, it exceeds this minimum threshold, it should seek advice from a US income tax specialist to determine if it is conducting a US trade or business under US domestic federal tax law.

### **US FILINGS**

If the Canadian business is subject to US federal income tax, it is required to file a US income tax

2. Article VII(1) of the Treaty

3. Article V(1) of the Treaty

4. Both Canada and the USA are members of the OECD and their income tax treaties are based upon the OECD model treaty

return<sup>5</sup>. It will surprise many Canadian businesses that the IRS requires a Canadian business that is not subject to US income tax by virtue of the Treaty to still file income tax forms to report this position<sup>6</sup>.

### WHAT TO DO NEXT?

If your business is selling products or services to the United States, either over the internet or otherwise, you should consider your US federal income tax obligations. A review of your activities should be conducted to determine if you have a US federal tax obligation based upon the Treaty and US domestic tax law.

Our industrious Tax Team at Hendry Warren LLP can assist with this, in conjunction with our external US tax advisors, Jansen Valk Thompson Reahm PC. We are always available to help. For more information, please feel free to contact our office to speak to one of our tax specialists.

Stay tuned for Part II of our newsletter series dealing with state level taxation.



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5. Generally Form 1120-F

6. Form 1120-F and Form 8833

