



# US – Canada Cross Border Update HLB North American Tax Conference

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- Canadian Income Tax Update
- Canada – US Treaty - Fifth Protocol
- GST/HST Update



- Taxable Canadian Property
- Refunds under Reg. 105 & Section 116
- Non-resident corporation filing requirements
- US and other foreign employers providing services in Canada



## *Canadian Tax Rates*

- Improve international competitiveness
- Confirmed scheduled Canadian tax rate reductions
- Lowest general corporate rate in G7 countries
- 28.25% combined federal and Ontario - 2011
- 25% combined federal and Ontario - 2013
- Applicable to Canadian corporations controlled by non-resident corporation or a Canadian branch of non-resident corporation
- No change to top marginal tax rates for Ontario resident individuals for 2011 (46.41% for income and 23.2% for capital gains)



## ***Taxable Canadian Property (“TCP”)***

- Non-residents of Canada – taxable on gains realized on dispositions of TCP
- Dispositions of TCP require Canadian tax reporting
- Non-residents taxable in Canada on disposition of TCP unless treaty capital gains exemption applies
- Purchaser of TCP from non-resident required to withhold 25% of gross purchase price
- 116 certificate to avoid withholding on gross purchase price and withhold on net proceeds/capital gain
- Often delays in obtaining 116 certificate resulting in delay in vendor receiving full proceeds from sale



## ***Taxable Canadian Property (“TCP”) (cont’d...)***

- Changes in Canadian domestic legislation in 2009
  - to alleviate 116 reporting requirements where qualify for treaty capital gains exemption
- If treaty protected property, new Canadian legislation and new Form T2062C notification within 30 days after sale
- New rules:
  - i. purchaser concludes after reasonable inquiry that non-resident vendor is resident in treaty country (due diligence defence) ***and***
  - ii. the property would be treaty protected property (legal determination)
- If (i) and (ii) met, no 116 Certificate by Vendor
  - Instead, purchaser files notice (T2062C) within 30 days of acquisition
- Non-resident gives declaration
  - signs T2062C form and indicates where resident
- Proof of residency of US LLC members required



## ***Refunds under Regulation 105 and Section 116***

- Regulation 105 – withholding on payments for services performed in Canada by non-resident
- Section 116 – withholding on proceeds to non-residents on disposition of Taxable Canadian Property
- Section 164 of Income Tax Act (Canada)
- Permits taxpayer to claim a refund of overpayment of tax if tax return filed within prescribed time period
- Problem where CRA assesses non-resident outside of prescribed time period
- Amendment to permit issuance of refund where taxpayer files a return within 2 years of the date of the assessment under Regulation 105 or section 116



- Requirement to file corporate income tax return if:
  - Carried on business in Canada
  - Disposed of taxable Canadian property
- Filing due date is 6 months after fiscal period
- Failure to file a return results in late-filing penalty based on the amount of tax payable for the year that was unpaid when the return was required to be filed. (i.e. non-resident branches operating in Canada)
- Extended definition of “carrying on business” (COB) under Canadian domestic legislation is quite broad and encompassing



- For COB no requirement for a permanent establishment (“PE”) – therefore must file corporate income tax return under domestic legislation.

However,

- Canada-US Treaty Article VII - Business Profits only taxes profits in Canada if such profits are earned through a PE situated in Canada

No PE and don't file Treaty Based return?

- Late filing penalty of \$2,500 per year, even though no taxes owing



- Non-resident corporation is liable to same withholdings and remitting obligations as Canadian employers
- Before coming to Canada may need to set up appropriate payroll account with CRA
- Valid work Visa
- If independent contractors from US need to file T4A-NR return and slips



- Employees resident in countries having a tax treaty with Canada can apply for a waiver of withholding tax by writing to CRA at least 30 days before the Canadian service begins
- New simplified process allows employer and employee to jointly complete and file Form R102-J to apply to the CRA for a Regulation 102 waiver



- Employees using Form R102-J must be:
  - Resident in the United States and expected to earn less than CAD \$10,000 in the year, or
  - Resident in another treaty country and expected to earn less than CAD \$5,000
- Non-resident employees are required to file a Canadian income tax return if treaty does not exempt employment income earned in Canada from tax



- Foreign employers are required to report all Canadian source remuneration and any withholdings/remittances made on the employee's T4 slip



Non-residents expanding their businesses into Canada should also give consideration to the following:

- The best ownership structure for the Canadian activity such as a branch, corporation, partnership or limit activity in Canada so there is no PE in Canada
- Non-residents carrying on business in Canada may be required to register and charge sales tax (GST/HST) on sales to Canadian customers . GST/HST rates vary from province to province. The threshold for “carrying on business” in Canada differs for GST/HST and income tax purposes



- 15% Canadian withholding tax on payments made to non-residents of Canada for services rendered in Canada must be withheld by Canadian customers
- Non-residents may have payroll obligations where employees are conducting employment duties in Canada.
- Transfer pricing planning to mitigate audit exposure and reduce the overall effective tax rate for the group. Evaluate whether the income attributable to a PE in Canada is reasonable in light of the functions performed and risks assumed by the Canadian branch or corporation



***Questions?***



- Fifth Protocol was eagerly anticipated by Canadian and US tax practitioners
- Many tax benefits introduced including removal of withholding tax on related party interest and extension of treaty benefits to US LLCs
- approx. 3 years since ratified
- addressed treaty benefits issue for LLCs
- Still uncertainty and confusion on application of treaty



## ***Article V – Deemed PE for Services***

US Entity providing services in Canada

- New paragraph 9 of Article V
- May deem PE where US Entity performs services in Canada
- Applies where PE does not otherwise arise
- 2 deeming rules
  - Article V(9)(a) – Single Individual Test
  - Article V (9)(b) – Enterprise Test



## *Article V – Deemed PE for Services (cont’d...)*

- Single Individual Test
  - Services performed by an individual;
  - in Canada aggregating 183 days or more in any twelve-month period; **and**
  - More than 50% of gross active business revenue of company relates to services performed “in” Canada by individual.



## ***Article V – Deemed PE for Services (cont’d...)***

- Enterprise Test
  - providing services “in” Canada;
  - to Canadian resident customer(s) or maintains PE in Canada;
  - in Canada for aggregate of 183 days or more in any twelve-month period; **and**
  - “same or connected” project
    - projects considered to be connected if they are a “coherent whole” in both a commercial and geographical sense;
    - whether projects are connected should be determined from the point of view of the enterprise providing services, not that of the customer;
    - Determination is fact dependent.



## Article V – Deemed PE for Services (cont'd...)

- Enterprise Test (cont'd...)
  - Are Projects Connected
    - Would the projects have been a single contract without consideration to subparagraph 9(b)?
    - Is the work involved under different projects the same?
    - Are the same individuals providing the services under the different projects?
  - *Enterprise has one contract to install a computer system and a separate contract to train client's staff on unrelated software - **not abusive** to Subparagraph 9(b)*
  - *A single contract for the installation of an inventory control system for a dairy that would take 240 days is segregated into three contracts based on inventory product (milk, cheese and yogurt) to avoid the 183 day/12 month threshold - **abusive***



## ***Article V – Deemed PE for Services (cont'd...)***

- Requires tracking of individuals working in other contracting state
- Activities of subcontracted parties are not attributable to non-resident
- *Example 1:*
  - 10 individuals work in Canada on the same project on the same 10 days
  - 10 days are included, not 100



## ***Article V – Deemed PE for Services (cont'd...)***

- **Example 2:**

- 10 individuals work in Canada on the same project on 10 different days
- 100 days are included



## ***Article V – Deemed PE for Services (cont'd...)***

- Subparagraph 9(b) excludes non-working days spent in the other country such as weekends where no services are provided in the other country on such days (count days services are performed)
- Subparagraph 9(a) includes such days (physical presence test).
- For both, day count not affected by number of the enterprises employees present on any given day.



## ***Article V – Deemed PE for Services (cont'd...)***

### Other considerations

- Regulation 105 withholding tax
- 15% withholding on revenues for services performed in Canada;
- Additional 9% withholding on revenues for services performed in Quebec;
- Regulation 102 payroll withholding – income tax, CPP & EI
- If US resident hires another subcontractor outside Canada to perform services in Canada, also required to withhold

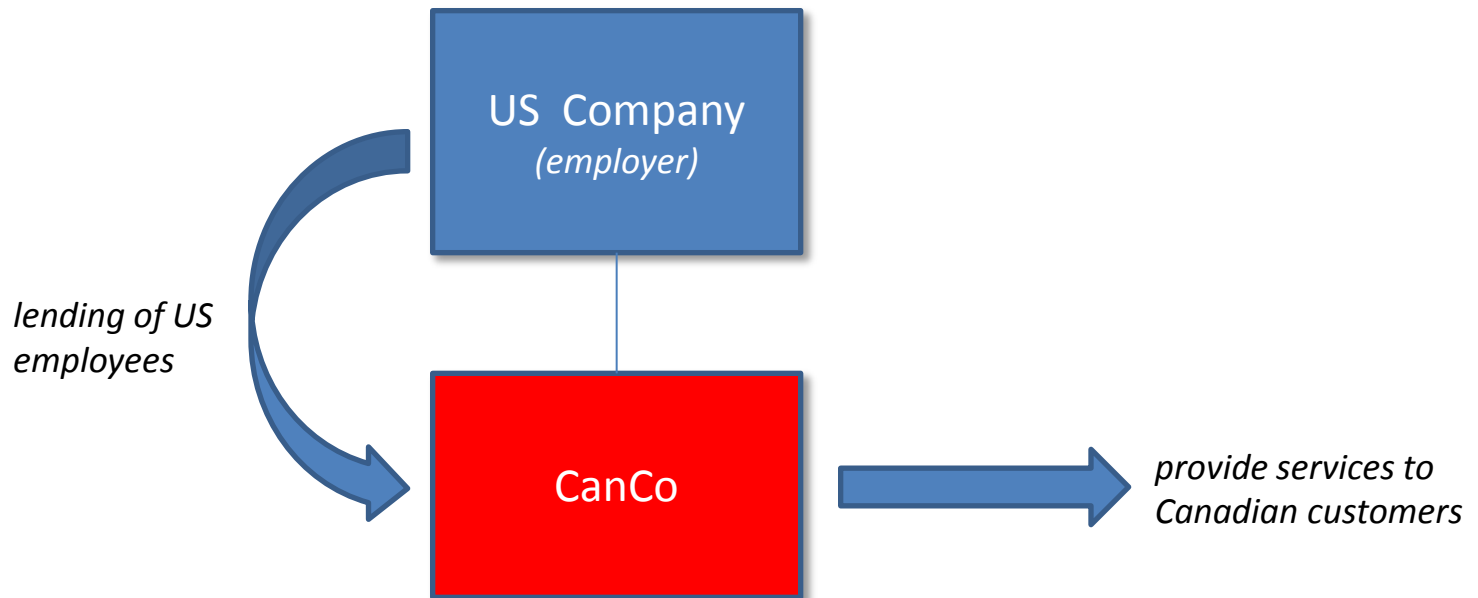


## *Article V – Deemed PE for Services (cont'd...)*

### Other considerations (cont'd...)

- cash flow constraints due to withholding
- If no PE in Canada, refund of Reg. 105 withholding tax by filing Canadian return
- consider treaty based waiver;
- income/expense waiver based on estimated income & expenses;

# Secondment Arrangement



- Exempt from Regulation 105 withholding
- Obligation under Regulation 102 remains



## *Planning*

- Secondment arrangement - US employer loans employee to Canadian related company
- If properly structured, no Reg.105 withholding
- US employee performs services for benefit of Canadian company
- Canadian company takes full responsibility, bears risks and rewards with assignment
- US employer continues to pay remuneration and make withholdings
- Canadian company reimburses US company for portion of wages and benefits attributable to Canadian activities
- No mark-up
  - Transfer pricing issues
  - Risks US company being regarded as COB in Canada



## ***Limited Liability Companies (“LLCs”)***

- Canada regards US LLC as a corporation
- US treats LLC as fiscally transparent or a partnership
- US LLC only visible taxpayer for Canada
- Members of US LLC do not file Canadian tax returns
- Pre-Fifth Protocol (prior to 2009), CRA’s long standing administrative position - no treaty relief for LLCs carrying on business (“COB”) in Canada
- LLCs not liable to tax in US - not resident in US for purposes of treaty



## ***Limited Liability Companies (cont'd...)***

- Common law meaning for COB and extended meaning under Canadian domestic legislation;
- Low threshold- offer anything for sale in Canada through agent or servant, mere solicitation of business;
- 25% withholding on all passive payments (interest, dividends, management fees)
- 25% branch tax rate – do not benefit from reduced treaty rate
- Pre-Fifth Protocol, no permanent establishment protection



## ***Limited Liability Companies (cont'd...)***

- No treaty capital gains exemption pre-Fifth Protocol
- *TD Securities (USA) LLC v. The Queen*
  - overturned CRA's longstanding position that LLCs do not get treaty benefits
- Consistent with treaty benefits provided to LLCs effective January 1, 2009 post Fifth Protocol
  - Good HEC Article IV(6)



## *LLCs – What's next? (cont'd...)*

- Post Fifth Protocol (effective 2009), if LLC expanding into Canada, eligible for treaty benefits
- Good HEC Clause – Article IV (6) applies
- Look through LLC to members
- Residence of LLC members – higher standard of due diligence
- Documentation to support treaty relief



## *LLCs – What's next? (cont'd...)*

- US LLC owned solely by US residents – treaty benefits
- If no PE under Article V and COB, LLC files Canadian treaty based exemption
- If PE under Article V, LLC files Canadian return
  - LLC pays corporate tax on branch income
    - 28.25% tax combined rate (Ontario) for 2011 on ABI
  - Computation of branch income
    - transfer pricing considerations
  - LLC pays branch tax
    - look through LLC to determine branch tax rate



## *LLCs – Unresolved Issues*

- Article IV (6) does not treat LLC as US resident person – deems payments to an LLC as amounts derived by US members of an LLC
- Article IV (6) extends treaty benefits to income, profits and gains “derived by residents of the US” on payments made from a Canadian source to a fiscally transparent entity in US



## ***LLCs – Unresolved Issues (cont'd...)***

- Article IV (6) provides relief only to residents of a Contracting State (i.e., the US or Canada);
- A non-US member of the LLC will not be entitled to treaty relief
- This is the case even though person resides in a country that has a tax treaty with Canada



## *LLCs – Unresolved Issues (cont'd...)*

- No treaty relief under Paragraph IV (6) for Canadians investing in US LLCs
- US withholding tax at 30% on dividends, interest (unless portfolio exemption) or royalties;
- FAPI rules apply in Canada if passive income. FTC problem in Canada if US 1446 withholding on income allocable to foreign partner
  - no entity level tax
  - interpose US “C” Corp between CanCo & US LLC



## ***US LLC Investing in ULC***

### Article IV(7)(b)

- Provincial corporate law of Nova Scotia, Alberta, BC allow ULCs
- Check the box election in US to treat as a partnership
- Ordinary corporation for Canadian purposes
- Bad HEC Clause – Article IV(7)(b)



## ***US LLC Investing in ULC (cont'd...)***

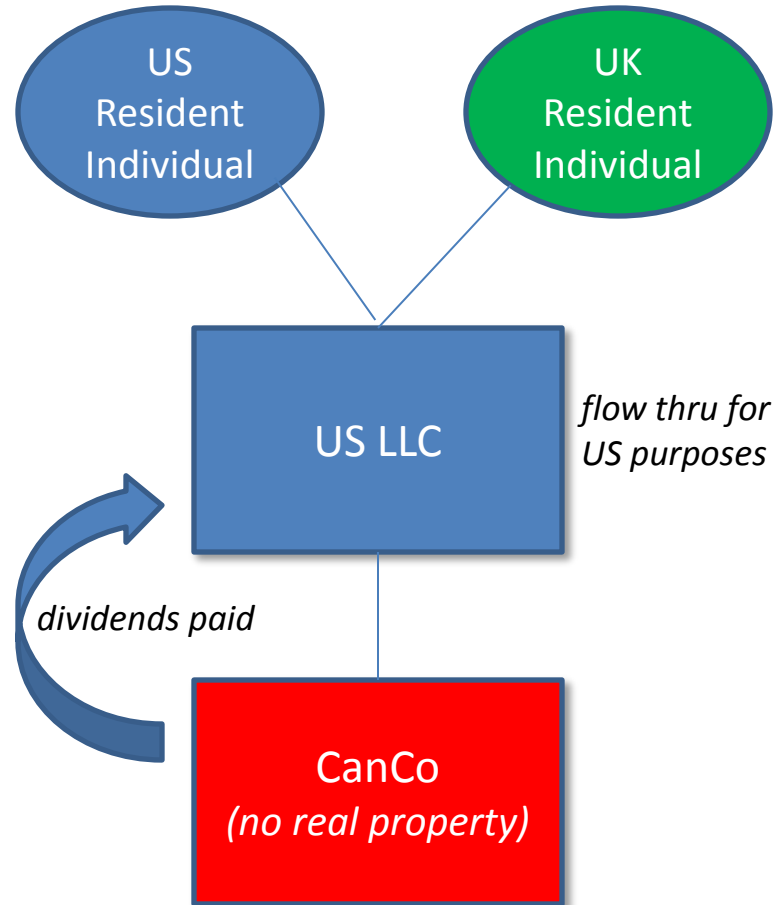
- Effective January 1, 2010 no treaty relief for withholding tax on dividends, interest to related person, royalties
- If ULC has arm's length loan from US lender
  - Canadian domestic exemption available
  - No withholding on interest paid
- Treaty capital gains exemption continues to be available unless shares of ULC derives value principally from Canadian real estate



## *Case Studies*



## Case Study #1





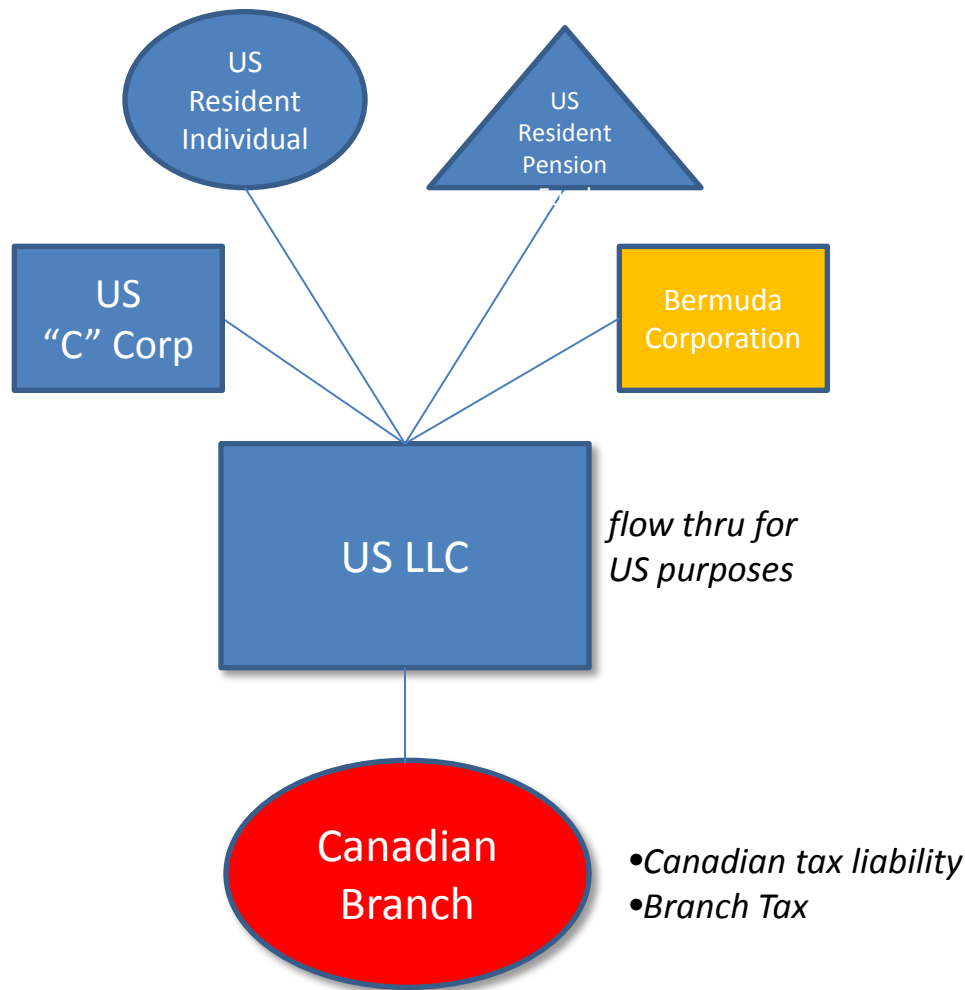
## Case Study #1

### **Questions:**

1. What is the withholding tax rate on dividends to US Resident Individual?
2. What is the withholding tax rate on dividends to UK Resident Individual?
3. If the shares of CanCo are sold, is the US resident subject to tax in Canada on the gain?
4. How would your answer to Q3 change if the value of CanCo is derived primarily from real estate?
5. If the shares of CanCo are sold, is the UK resident subject to tax in Canada on the gain?
6. Is the US LLC required to obtain a 116 Clearance Certificate on the disposition of its shares of CanCo?



## Case Study #2





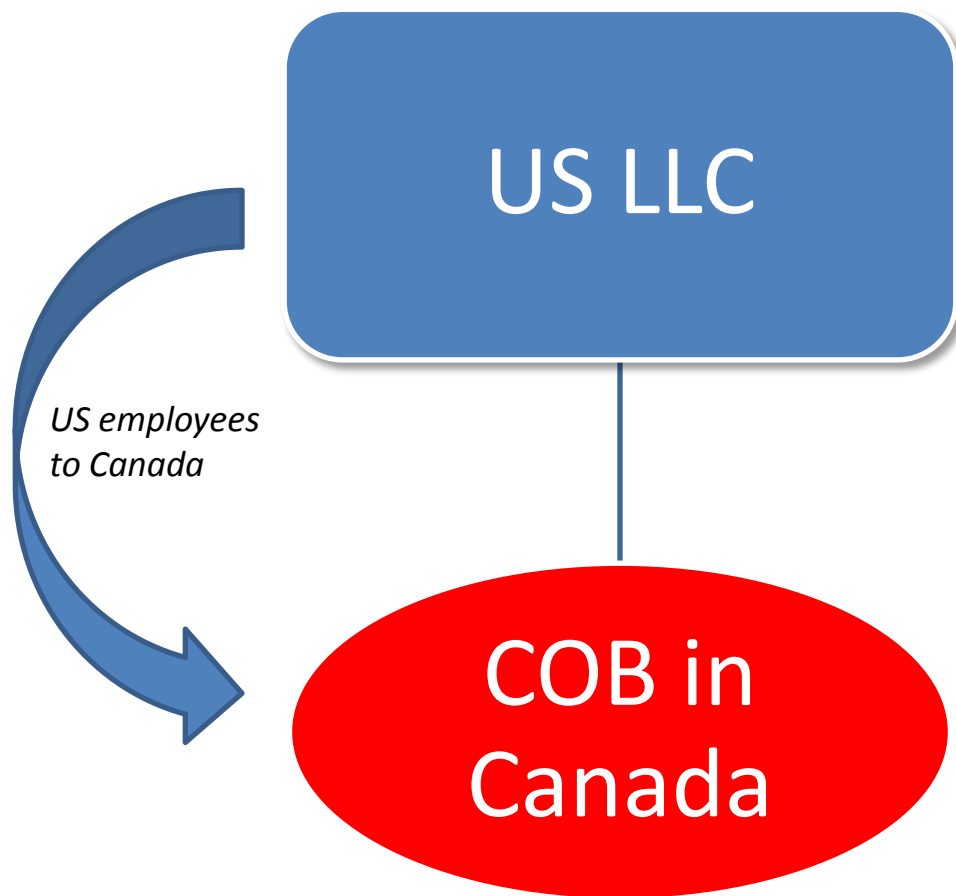
## Case Study #2

### ***Questions:***

1. What is the applicable branch tax rate for US “C” Corp?
2. What is the applicable branch tax rate for Pension Fund?
3. What is the applicable branch tax rate for Bermuda Corp?
4. What is the applicable branch tax rate for US Individual?



## Case Study #3



- *Flow thru for US purposes*
- *US employees sent to Canada for a construction project*
- *Construction project lasts less than 12 months*
- *10 US employees in Canada for same 19 days in a 12-month period*



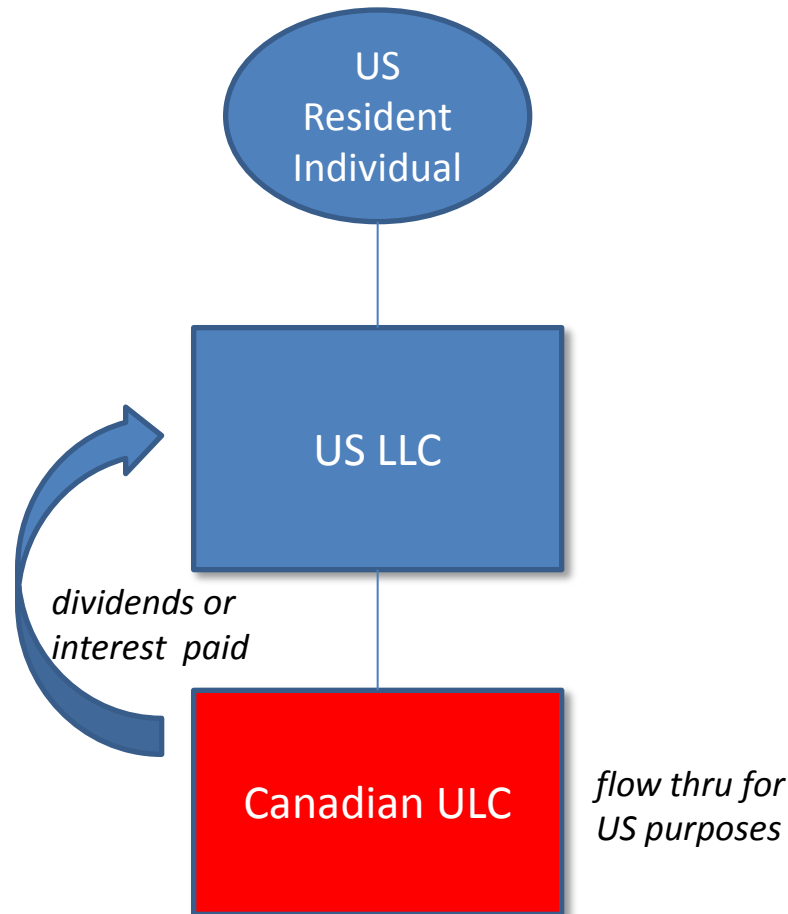
## Case Study #3

### ***Questions:***

1. Is the US LLC required to file a Canadian Tax Return?
2. Is the US LLC liable to pay tax in Canada?
3. How does your answer in Q2 change if each US employee is in Canada for 19 days with only one US employee in Canada on a given day?
4. Are there any Canadian withholding requirements?



## Case Study #4





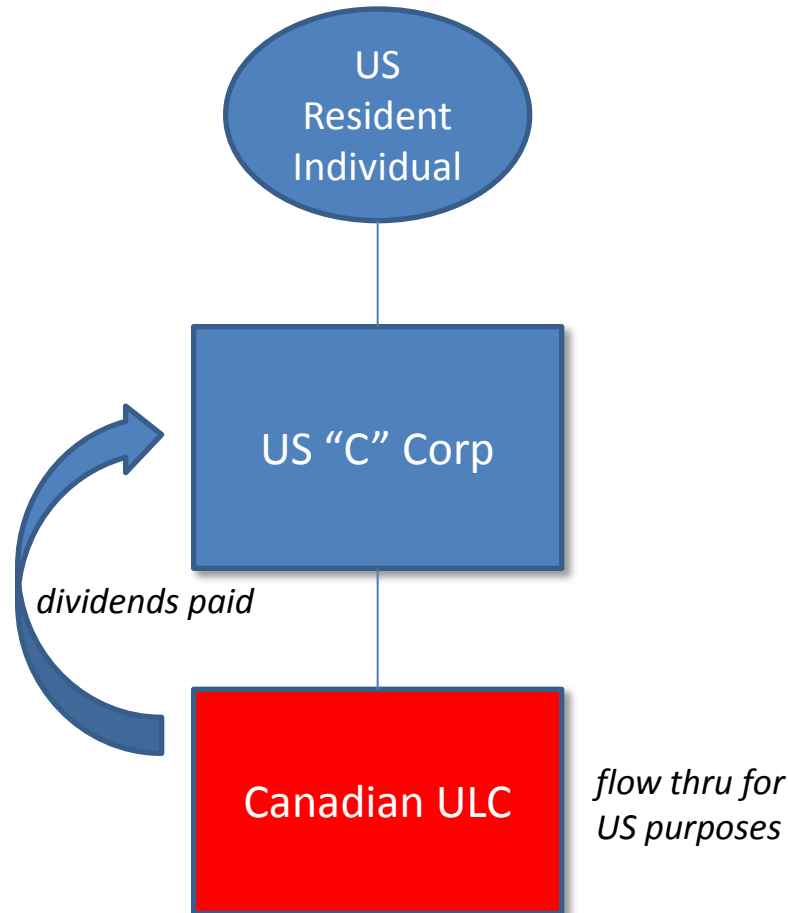
## Case Study #4

### ***Questions:***

1. What is the withholding tax rate applicable on dividends paid by the Canadian ULC?
2. What is the withholding tax rate applicable on interest paid by the Canadian ULC?
3. If the paid up capital of the shares of ULC held by US LLC is increased to trigger a deemed dividend for Canadian tax purposes, what is the withholding tax rate applicable on the deemed dividend?



## Case Study #5





## Case Study #5

### ***Questions:***

1. What is the withholding tax rate applicable on dividends paid by the Canadian ULC?
2. If the paid up capital of the shares of ULC held by US "C" Corp is increased to trigger a deemed dividend for Canadian tax purposes, what is the withholding tax rate applicable on the deemed dividend?
3. Would the answer for Q2 change if the shareholder was an "S" Corp rather than a "C" Corp?



***Questions?***