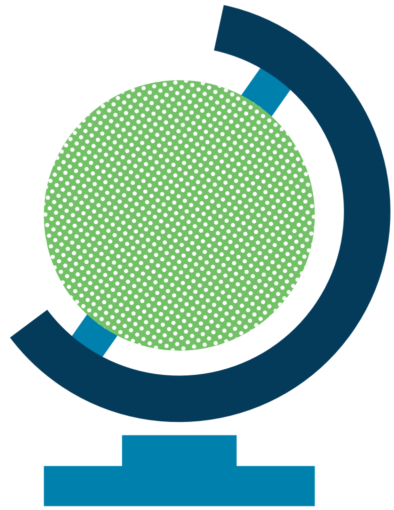

INTERNATIONAL TIDBIT:

Tax Exposure in Canada – It's a Whole Other Country!

The U.S. and Canada share a long border and a rich history of doing business across it. They remain two separate countries with different tax systems, no matter how closely integrated they have become economically thanks to the North American Free Trade Agreement. Despite the commonalities, for U.S. limited liability companies ("LLCs") treated as partnerships for U.S. federal income tax purposes and performing services for Canadian clients, there are several traps for the unwary. Magnifying this risk for such LLCs is the use of a virtual workforce of employees and independent contractors who may be based in the U.S. but travel to Canada regularly during the course of a project benefiting a Canadian client. Not only can tax exposure arise in Canada for the individuals but also for the U.S. LLC that pays them.

DOUBLE TAXATION TREATY

The U.S. has had a double taxation treaty ("DTT") with Canada since 1942, with the most recent treaty dating from 1980 and modified by a protocol concluded in 2007. Two key provisions of the current DTT are helpful for U.S. LLCs performing services for Canadian clients. The first protects the U.S. LLC from having a taxable presence or permanent establishment ("PE") in Canada unless, for example, services are performed there by an individual who is present 183 days or more in a 12-month period and during that period more than 50% of gross active business revenues of the U.S. LLC consist of income derived from services performed in Canada. The second protects an individual (whether employee or independent contractor) from personal income taxation in Canada unless the expense of his or her remuneration is ultimately borne by a Canadian taxpayer, such as the PE of the U.S. LLC, and provided other conditions are also met.

WITHHOLDING REQUIREMENT

U.S. service providers with Canadian clients may not realize that those clients are required to withhold 15% tax on payments for services rendered in Canada. This tax may be refunded if a Canadian tax return is filed by the U.S. LLC and it is entitled to an exemption from income tax under the DTT. A mechanism is also available to obtain a waiver from the Canadian tax authorities to reduce or eliminate such withholding tax. The 15% (or reduced) tax already withheld can be credited against Canadian income tax on the PE when the US entity files a Canadian tax return.

This same withholding tax rule can apply when a U.S. LLC is found to have a PE in Canada and is paying independent contractors in the U.S. for work performed on the project for the Canadian client. In that case, the U.S. LLC is required to withhold 15% Canadian tax on payments to its independent contractors who are not Canadian residents.

If employees are physically present in Canada, then additional withholding tax requirements, such as payroll withholding, may arise for the U.S. LLP having a PE in Canada and the individuals may have to file a Canadian tax return.

SPECIAL RULE FOR BRANCH PROFITS TAX

A tax surprise awaits U.S. LLCs treated as partnerships for U.S. federal income tax purposes and owned by individuals. Canadian tax authorities take the position that such LLCs having a PE in Canada are not eligible for the reduction in Canadian branch profits tax to 5% under the DTT. Rather, this tax is paid at the rate of 25% in addition to the federal and provincial income taxes levied on the Canadian PE.

OTHER TAXES

In addition to income tax exposure, responsibilities with respect to goods and services tax ("GST") or harmonized sales tax ("HST"), depending on the province, may arise. Both GST and HST apply to charges for services performed, for example, if the U.S. LLC carries on business in Canada or has a PE in Canada. Relief from these taxes is not offered by the DTT.

In conclusion, while it may be possible for U.S. LLCs to perform services for Canadian clients without incurring Canadian tax, it is important to plan ahead to minimize Canadian tax exposure. Steps include limiting the company's presence in the form of employees and independent contractors traveling to Canada, and requesting a withholding tax waiver from the tax authorities before invoicing Canadian clients.

If you have additional questions regarding this topic, please feel free to contact:

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