Growing globally by doing cross-border business? Keep taxes in mind.

If you're a Canadian-based company doing business anywhere in the world, do you know what your potential income tax liabilities are? If you're doing international business by providing products or services in the U.S., for example, do you know if you may be subject to U.S. federal, state or local taxation?

In general, Canadian-based companies doing business directly in the U.S. must pay U.S. taxes, based on the amount of income earned from their U.S. business. They also will likely be subject to state taxes, which can vary greatly across the U.S.; they often will be liable for local taxes as well.

The Canada-U.S. Tax Treaty makes it possible for Canadian companies doing business in the U.S. to prevent the double taxation that might otherwise arise due to their U.S. tax exposure. Some recent changes to that Tax Treaty, contained in a new Protocol, will help Canadian companies conduct cross-border business; others, however, have the potential to negatively impact this business.

Not all the Protocol changes come into effect at the same time. In general, however, the more significant changes that may have a negative impact on cross-border business come into effect as of January 1, 2010.

Canadian-based companies expanding into the U.S. for the first time may find themselves particularly vulnerable to the complexity of U.S. taxation rules.

"If you haven't had any previous experience doing cross-border business, you may not be aware of how complex tax rules can be in the U.S.," explains Dean Gresdal, senior tax counsel, International Taxation, RBC®. "This could put you at a disadvantage and you may find yourself with unexpected tax issues."

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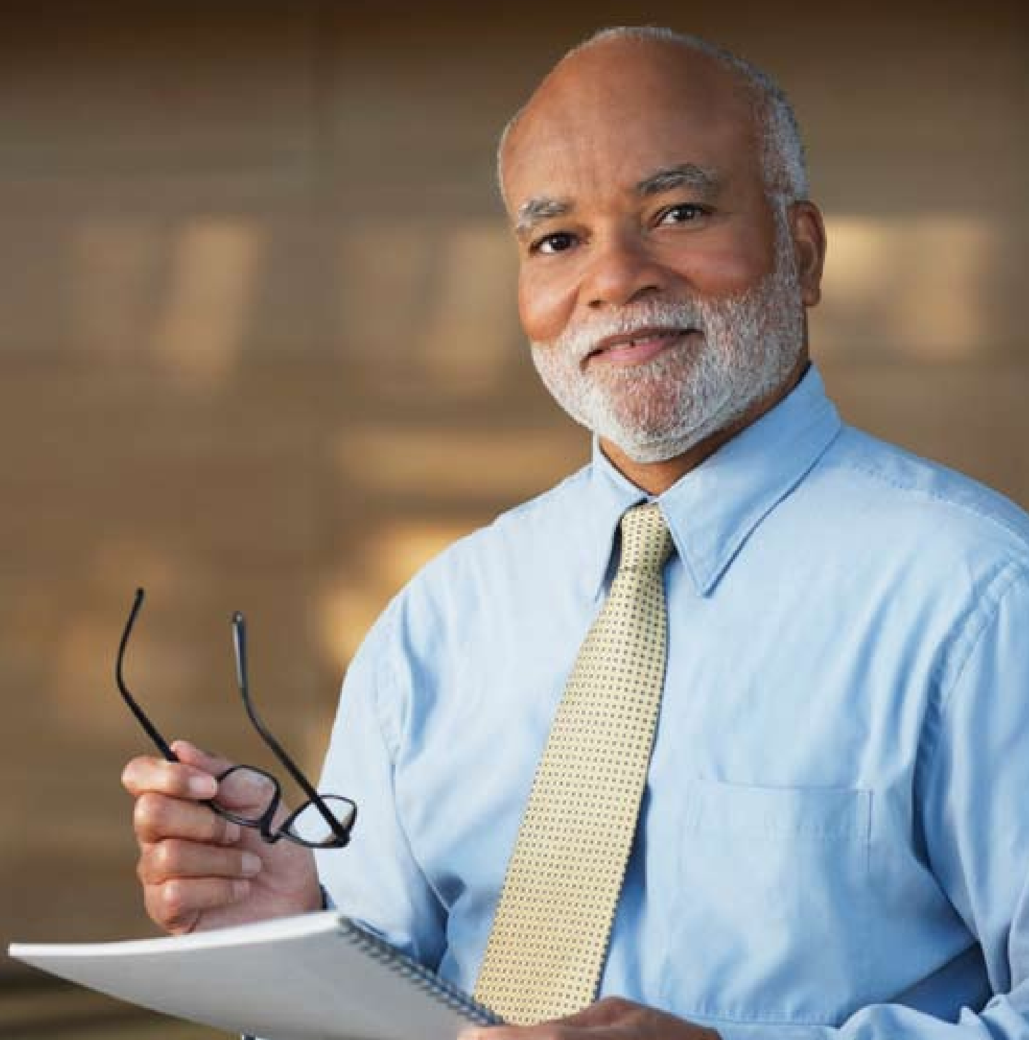
> **Heather Kerr**
> **International Taxation Specialist**
> **Ernst & Young**



Detailed information about the new Protocol changes is available on the websites of the Department of Finance Canada and the Internal Revenue Service (IRS). And while tax updates may not typically be top of mind for small and medium-sized enterprises, the potential impact of three of the Protocol changes on cross-border bottom lines deserves attention.

1. "Permanent establishment" definition now includes "providing services"

One of the most significant Protocol changes is the broader definition of "permanent establishment" – one of the factors used to determine whether a Canadian resident is liable to tax in the U.S. No longer limited to such criteria as having a "fixed place of business", permanent establishment in the U.S. now includes providing services in the U.S.

As a general rule, a Canadian-based company's taxable status in the U.S. previously was based on "bricks and mortar" permanent establishment tests: Does your Canadian-based company have an office, a branch or a factory in the U.S.? Does it have staff in the U.S. or U.S.-based phone numbers?

The new Protocol definition, however, includes services-related tests: Is your Canadian company providing services to U.S. customers, for a single project, or connected projects? If so, is anyone from your company travelling into the U.S. for an aggregate of 183 days or more, in any 12-month period, to provide those services?

"A cross-border service provider may reach that 183-day aggregate threshold easily, with the tremendous amount of cross-border activity that is carried on between Canada and the U.S.," notes Heather Kerr, international taxation partner, Ernst & Young. "Canadian-based companies will now have to track all their cross-border visits over any 12-month period and see if they've got an issue."

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> Vice-President
> International Taxation
> RBC

Kerr emphasizes *any* 12-month period. "You can't divide up your activities between two years and get a fresh start. That's one thing that's concerning people about this particular Protocol change. This is a 'rolling' test and it could require a huge amount of tracking."

2. "Hybrid entities" may be subject to higher taxes

Another important Protocol change is the new "hybrid entities" clause. "Hybrids" are entities that are regarded one way by Canadian tax law and another way by U.S. tax law. As an example, a Limited Liability Company (LLC) is generally regarded as a corporation under Canadian tax law, but may be regarded as a partnership under U.S. tax law. The new Protocol allows or denies benefits under the Tax Treaty for certain amounts paid by, or derived through, hybrid entities.

"Under the new Protocol, a hybrid entity utilized to make an investment in the U.S., that might previously have been entitled to the benefits of lower Tax Treaty rates, may now be subject to a 30 per cent U.S. withholding tax rate," explains Kerr. "Anybody using a hybrid entity – and they're very commonly used – needs to seek out tax advice to see how their business may be impacted."

"Businesses definitely should be aware of the implications for the type of entities they're setting up cross-border," agrees Carmine Arcari, vice president, International Taxation, RBC. "Companies may find that the use of these hybrid entities has been affected – they may no longer be practical for certain cross-border business, under this new Protocol."

3. Eliminating withholding taxes on cross-border interest payments

Not all the changes in the Protocol are potentially negative ones for Canadian-based firms. A very positive change is the elimination of withholding tax on cross-border interest payments.

Formerly under the Tax Treaty, these payments were subject to a reduced withholding tax of 10 per cent. In Canada, an earlier amendment to domestic law – effective in 2008 – generally eliminated withholding tax on interest payments made by Canadians to unrelated parties. Under the new Protocol, at varying dates, withholding tax is generally being eliminated for payments between non-related parties and related parties. Guarantee fees generally will no longer be subject to withholding tax as well. These new provisions should reduce borrowing costs and have a positive impact on cross-border investment.

"The big benefit of eliminating withholding tax on cross-border interest payments is that cross-border businesses will have more flexibility in choosing and working with their bankers," notes Carla Pehowski, senior tax counsel, U.S. Taxation, RBC.

Prior to the Protocol changes, Pehowski explains, a Canadian parent company and its U.S. subsidiary would have to establish separate banking relationships on each side of the border, with the associated administrative and legal expense.

"Any attempt to centralize all lending in Canada would trigger a request by the bank for reimbursement of withholding tax on any interest due from the U.S. borrower," says Pehowski. "There's a whole layer of complexity and potential expense that will disappear in future cross-border loans."

Seek advice before making cross-border business decisions

So, as a Canadian-based company doing business in the U.S., how can you ensure you're benefiting from Tax Treaty rates and not running afoul of U.S. federal, state and local tax regulations?

The level of taxation a Canadian company may find itself facing anywhere in the world may make a business venture uneconomical.

"As Canadian companies continue to grow internationally, into the U.S. and around the world, it's important that they

obtain the advice they need to support their success – not only on business structure and international business banking considerations, but on legal and taxation issues," notes Jana Henderson, director of Global Solutions, RBC.

A good option is to seek advice from an accounting or law firm that has experience advising Canadian companies about the tax implications of carrying on business in the U.S. To obtain the business licences required to enter the U.S., you need to engage the services of a law firm and/or an accounting firm – add pre-tax and post-tax questions into your business case discussions with such firms and with your financial institution.

"It really is important that Canadian companies also take the time to plan how they want to enter the U.S. market from a taxation point of view, as part of their business case," advises Arcari. "For example, do they want to enter the U.S. via a branch operation, or by hiring an independent agent in the U.S. to sell for them, or by incorporating a U.S. subsidiary to carry on the business? Their choices will have tax implications that will ultimately impact their bottom line."

"We don't like tax to be the tail that wags the dog," Kerr stresses. "However, I'm always mystified why anybody ever does business planning on a pre-tax basis. Tax can be the largest expenditure a company has – why would you ignore one of your largest expenses?"

Online Resources:

Department of Finance Canada (U.S. Tax Treaty backgrounder, Protocol)
www.fin.gc.ca/n07/07-070-eng.asp

IRS – U.S.-Canada Tax Treaty
www.irs.gov

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