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Foreign corporations operating in the United States

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With increasing frequency, Canadian corporations are venturing across the border into the United States to perform services or sell their products. Consequently, we often field questions about the U.S. corporate income tax filing requirements for Canadian corporations generating revenue from our trading partner to the south. This article summarizes some of those requirements.

The general rule

The instructions for the U.S. corporate income tax return for foreign corporations (Form 1120-F) state:

"… a foreign corporation must file Form 1120-F if, during the tax year, the corporation was engaged in a trade or business in the United States, whether or not it had U.S. source income from that trade or business, and whether or not income from such trade or business is exempt from United States tax under a tax treaty…"

In other words, any Canadian corporation sufficiently engaged in U.S. trade or business, regardless of the amount of income that is taxable in the U.S., must file a U.S. tax return. This is a fairly broad, all-encompassing rule that would subject many Canadian corporations to U.S. filing requirements. As a result, an examination of the definition of "trade or business" is key to determining whether a Canadian company meets the test.

Trade or business

Being considered to be "engaged in trade or business" is not determined by objective or quantitative tests. Instead, an overall consideration of the foreign corporation's facts and circumstances, including the extent of activity within the U.S., is required. A Canadian corporation need not be physically present within the U.S. to be considered engaged in U.S. trade or business. Active, continuous and sufficient activities or sales in the U.S. are a key factor in the test. For example, regular sales in the U.S. can be enough to indicate engagement in U.S. trade or business, assuming the sales are material compared to overall company sales. Other factors include the overall purpose of the U.S. activity (i.e. one-off transaction vs. plans of growth), physical presence and/or the use of agents within the U.S.

Income that is considered effectively connected with the U.S. trade or business is subject to U.S. income tax, and deductions allocable to that income can help to reduce or eliminate the U.S. tax liability. The Canada-U.S. Tax Treaty may also provide the Canadian company with relief from any U.S. tax liability (discussed further below).

A Canadian corporation that is engaged in a U.S. trade or business and fails to timely file a U.S. tax return will face a penalty of losing the privilege to deduct expenses and claim credits allocable to the effectively connected U.S. income. In other words, the IRS will assess tax based on the effectively connected gross revenue rather than imposing income tax net income.

Where a Canadian corporation has limited U.S. activity and is thus unsure of its requirement to file a U.S. tax return, the corporation may take advantage of a Protective Return procedure. The corporation may file Form 1120-F to protect its right to deductions and credits in cases where its requirement to file a U.S. tax return is questionable. If, in the future, the IRS determines that the corporation was engaged in trade or business with effectively connected U.S. income, the corporation will have protected its ability to claim deductions against gross income that would otherwise be denied absent the Protective Return.

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Canada-U.S. Tax Treaty

In many situations, the Canada-U.S. Income Tax Treaty (the Treaty) overrides domestic tax law and permits a Canadian corporation that is engaged in U.S. trade or business to avoid U.S. income tax so long as the corporation does not maintain a permanent establishment in the U.S.

The Treaty provides specific examples of permanent establishment including, but not limited to, a place of management, a branch, an office or an employee concluding contracts in the name of the Canadian company. The Treaty excludes from the definition of permanent establishment such items as storage facilities, advertising and the mere maintenance of goods/merchandise in the U.S. However, the concept of permanent establishment also includes tests that consider the number of days corporate personnel are physically present in the U.S., whereby a corporation can be deemed to have a permanent establishment even though it might not meet the traditional “bricks and mortar” tests. Consequently, it is important to assess a corporation’s activity in the U.S. to determine whether it has a factual or deemed permanent establishment.

A company that can rely on the Treaty to provide an exemption from U.S. corporate tax still must file a U.S. tax return. The return is an important indicator of the corporation’s claim to the Treaty position being taken. A penalty of $10,000 may result from failure to disclose a Treaty position on a tax return (using Form 8833).

Due dates

Canadian corporations without an office or place of business in the U.S. must file Form 1120-F by the 15th day of the sixth month after the end of its taxation year. Otherwise, the due date is the 15th day of the fourth month after the end of its taxation year. For Canadian corporations taking advantage of the protective filing procedures, the tax return is generally considered timely filed if it is filed no later than 18 months after the due date of the current year’s return.

If you have a Canadian corporation engaged in U.S. activity and would like to discuss its U.S. filing requirements, please do not hesitate to contact your Collins Barrow U.S. tax advisor for more information.

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