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US TAX ALERT

Our American Customers: the Watchdogs of the U.S. Tax System

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With today's technology, it is becoming increasingly easy to sell products to individuals and companies all around the world. Many Canadian companies have developed great business relationships with U.S. customers, selling a wide variety of goods.

In recent years, an increasing number of my Canadian entrepreneur clients have been telling me that their long-time U.S. customers are now demanding a signed IRS form, and without this form, the U.S. customer will withhold 30% of the gross payment and remit to the IRS. My now extremely confused clients then cite the following form names: W8-BEN, W8-ECI, W-8IMY, W8-EXP, W8-CE, SS-4, W-7, W-9. They tell me, "I never had to do this before, and not all my U.S. customers are asking me to do this. What is going on?"

Before explaining to my clients the technical aspects of doing business with U.S. persons, I point out the various events that led us to this place. Who can forget the recession of 2008 that morphed into the popping of the housing bubble? (Or was it the popping of the housing bubble that led to the recession?) But as I tell my clients, the why and the how are less important. Just know that it happened.

To compound the situation, the U.S. government uncovered information that allowed it to estimate the potential tax revenue lost due to aggressive tax-evasion strategies promoted by Swiss and Liechtenstein banks. At this point, my clients often stop me to ask, "what does this have to do with my situation?" My response is that the U.S. government is under considerable pressure to gain control over the U.S. National deficit, which is currently $16.8 trillion dollars and growing by $46,000 every second.[1] In order to gain control over the deficit, the U.S. government must increase revenue, decrease expenditures, or do both.

There are few political parties that campaign on the idea of increased taxes or decreased government programs. In light of these difficulties, the U.S. government adopted a different approach to increase tax revenue. This approach requires diligent tax compliance and enforcement to ensure the protection of the tax base and reduce tax leakage. It is accomplishing this objective through two means: new legislation (FATCA)[2] to promote compliance, and enforcement of old legislation.

2008 marked a turning point for the IRS with regard to cracking down on various aspects of U.S. tax enforcement. Douglas Shulman, then Commissioner of Internal Revenue, spoke at the 21st Annual George Washington University International Tax Conference on December 8, 2008:

> Today, the IRS will add withholding taxes to the Tier I list of issues. The tier issue process will provide the needed organizational priority and coordination to ensure taxpayer compliance with the U.S. withholding tax provisions. Our compliance efforts will span efforts to ensure individual, business and corporate taxpayers understand and fulfill their withholding tax filing obligations to addressing transactions that attempt to circumvent withholding taxes or claiming improper tax treaty withholding rates.

It would appear that the mandate for the IRS is quite clear. So, why would our U.S. customers want to become the watchdogs of the U.S. tax system and force Canadian businesses to jump through administrative hoops with IRS forms and documents or face the wrath of an arbitrary 30% withholding tax? The answer is contained in Internal Revenue Code sections 6672(a)[3] and 7202.[4] Both these provisions contain penalties for any withholding agent[5] that fails to withhold and remit taxes to the IRS when taxes were required to be withheld.

So now we know why we are faced with the task of filling out IRS forms and getting IRS identification numbers. But the next question is, what form do you complete and what do you do with it?

There are many different forms for many different purposes. But let's focus for now on the more common situations faced by Canadian businesses dealing with U.S. customers (individuals and corporations).

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In order to determine which forms are required, we must determine if the recipient of the U.S. income is a U.S. person[6] or a foreign person with regard to the United States. If the recipient is not a U.S. person, then they are a foreign person by default. As we continue the analysis, we will assume the recipient is a Canadian resident and thus a foreign person.

The U.S. imposes income tax on foreign persons with respect to two principal categories of U.S. sourced income:

- **Effectively connected income (ECI)** – income effectively connected with the conduct of a trade or business in the United States.
- **Fixed, determinable, annual or periodical income (FDAP)** – all other types of income that are not classified as ECI (e.g. dividends, interest, pension, rent, royalties).

As a starting point, all income from the U.S. is subject to a 30% withholding tax unless the correct paperwork is completed. The penalty regime imposed by the IRS on the withholding agents helps to ensure that the correct paperwork is filed and the correct withholding tax rate is applied.

If the recipient is a foreign business with ECI (which means it has income connected with a trade or business in the United States), then it would be subject to U.S. taxation on a net basis[7] and subject to graduated tax rate schedules for both individuals and corporations when it files its U.S. income tax return. In order to avoid withholding taxes on ECI, a foreign person must complete Form W8-ECI[8] and submit it to the payor (i.e. the U.S. customer). The foreign person then is required to file a U.S. tax return and determine their potential U.S. tax liability.[9]

If the foreign person has FDAP, then the starting point for withholding tax is 30% of the gross payment. The Canada-U.S. Tax Treaty provides limitations on the amount of withholding tax that may be collected by either country for certain forms of income. In order to reduce or eliminate the 30% withholding tax based on some favorable term of the Canada-U.S. tax treaty, Form W8-BEN must be completed and submitted to the payor. There is no automatic requirement to file a U.S. income tax return in such a case.

In order to properly complete either W8-BEN or W8-ECI, a U.S. taxpayer identification number (TIN) is required.[10] A corporation or business would apply for an Employer Identification number (EIN) using Form SS-4. An individual would apply for an Individual taxpayer identification number (ITIN) using W-7. These forms must be submitted to the IRS to obtain a U.S. TIN, which is used for all respective IRS forms and tax returns.

The final question is, do you need to file a tax return or not?

If you filed a W8-ECI, then the answer is "yes," as you are stating that you have income effectively connected with a business or trade in the U.S. Even if you don't have a permanent establishment in the U.S., you are still required to file a U.S. tax return if you filed a W8-ECI. If you don't have a permanent establishment in the U.S., then you may claim a treaty exemption (Form 8833) with your U.S. tax return to absolve yourself of any U.S. tax burden.

If you filed a W8-BEN, then the answer is "maybe." If the payor did not withhold the required withholdings, then you are required to file a U.S. tax return to reconcile the difference. If the payor withholds the correct tax, which could be no withholdings if you claimed full treaty exemption on the W8-BEN, then you should have no requirement to file. That being said, I have received calls from clients indicating that the IRS is sending them a request to file. It would appear that if you apply for an EIN, the IRS will request that you file regardless of whether there is an actual requirement to do so. Given this scenario, you can either contact the IRS to explain that you are not required to file, or simply file the U.S. tax return and claim a treaty exemption on Form 8833.

Now let's return to the question of a Canadian business that has a U.S. customer demanding the completion of one of these forms or facing a 30% withholding tax on gross payments. If the Canadian business (that meets the definition of a foreign person) does not have ECI, then it should complete a W8-BEN and claim a treaty exemption stating no permanent establishment in the U.S., and supply this form to the U.S. customer. The U.S. customer should then continue to make payments to the Canadian business with no withholding taxes.[11]

It is very important to consult with your Collins Barrow Tax Advisor regarding any treaty election claimed. There could be significant undesirable tax consequences if you inadvertently claim a treaty exemption to which you were not entitled. Furthermore, the fact that the IRS is requesting Canadian businesses with EINs to file a U.S. tax return increases the detection risk.

With the IRS committed to enforcing the withholding tax rules, Canadian individuals and businesses will be forced to complete a lot more paperwork than in the past.

References:

1. http://www.nabber.org/projects/debtcounter/

2. For an in-depth review of FATCA, see "Welcome to America!," April 19, 2012, by Joseph Sardella, CA, CPA, Collins Barrow (http://www.collinsbarrow.com/en/cbn/publications/welcome-to-america).

3. **Sec. 6672(a). General Rule**
Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

4. **Sec. 7202. Willful Failure To Collect Or Pay Over Tax**
Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

5. The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 1441, 1442, 1443, or 1461.

6. A U.S. person is defined as:

   - an individual who is a U.S. citizen or U.S. resident alien;
   - a partnership, corporation, company, or association created or organized in the United States or under the laws of the United States;
   - an estate (other than a foreign estate); or
   - a domestic trust (as defined in Regulations section 301.7701-7).

7. The net basis refers to the reduction of the gross amount of ECI by the apportionment of appropriate deductions, thereby resulting in a net taxable income used to calculate U.S. taxes.

8. If the foreign person did not provide a U.S. tax identification number, then withholding taxes might still apply.

9. A foreign person that has ECI may or may not have a permanent establishment, which would determine the ultimate taxability of the foreign person in the U.S. The determination of permanent establishment is beyond the scope of this article.

10. U.S. Tax identification number (TIN) is the generic term referring to the different numbers assigned by the IRS for various categories of filers. Various TINs are: Employer identification number (EIN); Individual taxpayer identification number (ITIN); Social Security number (SSN); Taxpayer identification number pending U.S. adoptions (ATIN); and Preparer taxpayer identification number (PTIN).

11. The W-8BEN election will remain in effect for a period starting on the date the form is signed and ending on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect.

Financing a U.S. Subsidiary: Debt vs. Equity

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Canadian corporations seeking to expand their operations often look southward to grow their business. By expanding into the United States, Canadian corporations can potentially gain access to a much larger market than is available in Canada. For a variety of valid reasons, Canadian corporations often choose a U.S. corporation as a vehicle for expansion into the U.S. But once this structural decision is made, the question becomes, how to finance the U.S. operations?

New U.S. businesses often face a lack of U.S. external funding options. Consequently, such U.S. corporate operations are often financed internally with equity, or through either advances or non-interest bearing loans from the Canadian parent corporation to the U.S. subsidiary (or a combination of equity, loans and advances). From a Canadian tax perspective, this tendency should not be problematic. However, from a U.S. income tax perspective, the use of non-interest bearing loans may create issues that are both costly and time-consuming to resolve.

Characterization of debt and equity: the issue

Under U.S. federal tax legislation, the Internal Revenue Service (IRS) has the authority to recharacterize debt as equity and equity as debt, or a combination of the two. Yet the holder of the interest in the U.S. corporation is bound by its own classification of the investment.

The IRS' ability to recharacterize the investment in the U.S. corporation can create unintended consequences for the taxpayer. For example, assume that the Canadian parent would prefer to treat the investment as a loan to the U.S. subsidiary. This strategy would allow the U.S. subsidiary to reduce its U.S. taxable income by claiming an interest deduction for the interest expense paid to the Canadian parent. Generally, claiming a deduction in the U.S. corporation should reduce the overall tax rate of the related companies, as the U.S. federal and state tax rates generally are higher than the tax rates in Canada. If the IRS disagrees that the investment in the U.S. subsidiary is a loan, then it would treat the investment as an equity investment. Payments that were made to the Canadian parent corporation would be treated as equity distributions, which might be considered as dividends (to the extent of earnings and profits within the U.S. subsidiary). If the payments were treated as dividends, the U.S. subsidiary would be required to withhold and remit 5% of the dividend to the IRS and fulfill the reporting requirements related to the dividend payments. Some of the implications of this change in treatment include:

1. denial of the interest deduction by the U.S. subsidiary, resulting in a higher taxable income and potential tax owing;
2. late payment and estimated tax penalties as a result of the larger tax liability;
3. failure to file and failure to pay penalties on dividends paid to the Canadian parent; and
4. potential substantial understatement penalties.

In order to avoid this possible situation, the corporate taxpayer should reflect the investment on the subsidiary's books in the manner that it intends to treat the investment. It should ensure that the income tax filings and other reporting requirements reflect a treatment consistent with how the taxpayer wants to treat the investment.

Criteria for characterization as debt

Initially, with its authority to recharacterize debt and equity, the IRS had issued regulations setting out the criteria to be used to determine when it would treat an investment as debt. These regulations were never finalized, however, leading to a lack of guidance from the IRS. Over the years, the courts have tried to establish criteria to determine when an investment will be treated as debt or equity. However, again, due to the variety of investment structures and financing options available in the market, a clear definition of what is debt and the criteria needed for an investment to be treated as debt, have not been set out clearly. It is very much a "facts and circumstances" analysis specific to a particular situation. The following criteria will be relevant:

- An instrument labelled as a note is more likely to be considered to represent debt, provided it has the terms that a third party lender would include, such as a fixed term, an interest rate, a repayment schedule, etc.
- If repayments are primarily tied to the ability to generate earnings, an equity classification is more probable.
- The ability to demand repayment of advanced funds indicates a debt instrument.
- The ability to participate in management might indicate equity.
- Advances subordinate to other corporate loans are closer to the equity classification.
- The intent of the parties should be considered.
- The debt-equity ratio of the company should be considered.
- An instrument that allows interest payments to be dependent primarily upon the availability of future earnings (i.e. dividend money) is more likely to be considered equity.
- Evidence that a corporation could receive financing from other third-party lenders increases the chance that an instrument will be classified as debt.

Generally speaking, at a minimum, if a taxpayer desires debt treatment it should ensure that it has a written agreement in place that contains all of the conditions that a bank would require to support debt treatment. These would include, among other things, a fixed loan term, a stated rate of interest, and a repayment schedule. Furthermore, it should ensure that the terms of the agreement are complied with – that is, the terms of the agreement are actually followed and reflected in the corporate documents and accounting records of the corporation.

Summary

The IRS is searching for opportunities to generate revenues for the U.S. government. It is becoming more aggressive in attacking situations where it may perceive the lack of a clear treatment of an item, and specifically in regard to situations – such as the debt-equity treatment – where it has the latitude to treat the item as it wishes. To the extent taxpayers can remove any potential ambiguity in their accounting records and related tax returns, this can minimize the chance that the IRS will identify potential issues to attack.

This article addresses a specific area of concern, but it does not address the circumstances under which debt or equity is preferable, the rules to deduct interest in the U.S., or other financing or structural issues. Contact your Collins Barrow adviser for more information on how to structure and finance your U.S. operations and any other U.S. tax matters.

Collins Barrow publishes a regular *US Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada with respect to US issues. While *US Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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