

Must You Pay Taxes in the United States if You Do Business There?

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Today, small and medium-sized Canadian businesses do more and more business in the United States. The following is a general overview of our American neighbours' income tax rules.

Taxes To Be Paid in the United States

Under American federal tax legislation, a non-resident business will be taxed on its business income only if, among other things, it carries on business there. This concept is important, because every non-resident who operates a business in the United States must also file an income tax return there. The following three conditions are used to determine whether a non-resident business will be subject to income tax in the United States:

Operation of a Business in the United States

One must determine whether a business is being operated in the United States, based upon the following criteria:

- continuity and regularity of the business activities carried on in the United States;
- number of transactions carried out in the United States;
- work performed by the employees and agents who act on behalf of the business in the United States (agent or representative empowered to bind the business);
- income derived from assets used or held in the United States;

- services rendered in the United States;
- regular sales of items to American customers.

American-source Income

American-source income generally originates from a "business venture" or business operated in the United States. For example, a sale completed in the United States will give rise to American-source income. Conversely, a sale completed outside the United States (FOB province of Quebec) will generally yield foreign income.

Link Between the Operation of a Business in the United States and American-Source Income

- American tax authorities will presume that American-Source business income is in fact linked to the business operated in the United States. This is the case when the first two conditions have been met.
- When a business is subject to corporate income taxes pursuant to American tax rules, one must

determine whether the business can avoid being taxed in the United States pursuant to the *Canada-United States Income Tax Convention, 1980* (the "Convention").

One must therefore determine whether the business has a permanent establishment in the United States through which it operates its business. This notion refers to a certain physical presence which may consist of assets, or of personnel or representatives empowered to enter into contracts, or both. A *Permanent establishment* means headquarters, an office, a branch office, a plant, a workshop, etc. If a business has a permanent establishment in the United States, it will be taxed there on the profits generated by the permanent establishment. However, it will be granted a credit for foreign taxes paid.

Conversely, if a business does not have a permanent establishment in the United States, it will not pay any federal taxes there. If a business is exempt from American taxes under the Convention because it does not have a permanent establishment in the United States, the business must file American return 1120F (the Treaty-Based Return) which allows it to claim the exemptions available to it under the Convention.



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Taxation and the States

Most American States and certain cities have an income tax system which is separate from the federal system. The States are not required to abide by the provisions of the Convention. In order to determine whether or not a foreign business will be subject to taxation in an American State or city, one must determine whether there is a "nexus" with the State in question. In summary, the concept of "nexus" refers to the existence of a minimum connection between a foreign business and a State. For example, if the business elects its legal or corporate residence in the State, uses business assets, capital or property in the State or provides services there, these are all criteria which will be deemed sufficient to determine that a "nexus" exists.

Consequently, we recommend that any firm wishing to carry on business in the American market should seriously consider the tax implications of its operations. A tax adviser will be able to help you make the appropriate choices based upon your objectives and the nature of your business. For information, please do not hesitate to contact Luc Pariseau at (514) 877-2925, Stéphane Séguin at (514) 877-2982 or Diane Bellavance at (514) 877-2907, of the law firm *Lavery, de Billy*.

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