

NEW IRS COMPLIANCE AND CANADIAN COMPANIES

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The IRS's Large Business and International Division recently announced the identification and selection of 13 separate compliance campaigns in order to improve tax return selection, identify issues representing non-compliance risk, and maximize the use of limited IRS resources. One of these campaigns—the form 1120-F non-filer campaign—may affect many Canadian companies. This campaign may be viewed as the corporate corollary to compliance efforts aimed at US citizens who have failed to file US income tax returns.

Very little information about the program's scope was released, but clearly the IRS is focusing on foreigncos that do business in the United States and on the fact that they often fail to file form 1120-F ("U.S. Income Tax Return of a Foreign Corporation"). Data gathered by the IRS suggest that many of these companies are not filing as required; the IRS intends to use various sources of external data to identify non-filing foreigncos and encourage them to file the required returns. The outreach effort begins with a letter-mailing campaign; if a foreignco does not take appropriate action upon being contacted, the IRS will conduct examinations to determine the correct US tax liability. The goal is to increase voluntary compliance by foreigncos that have a US business connection.

The announcement of this new compliance campaign serves as an important reminder to a Canco that is engaged in a US trade or business that it is obliged to annually file a form 1120-F and an IRS form 8833 ("Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)"). Fortunately, a Canco has a different threshold than another non-US company when it comes to taxation by the US taxing authority: if the Canco does not have a US PE, no tax results from this filing.

Generally, a non-US corporation must file a US income tax return if it is engaged in a US trade or business and has earned income that is effectively connected therewith. Neither the Code nor the regulations make a meaningful attempt to comprehensively define "engaged in a US trade or business." Code section 864 provides that the term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year.

In general, the courts have held that, before a taxpayer is found to have engaged in a trade or business within the United States, "it must, during some substantial portion of the taxable year, have been regularly and continuously transacting a substantial portion of its ordinary business in [the United States]." Rev. rul. 73-522 also provides that a foreignco is deemed to be engaged in a US trade or business if it carries on "considerable, continuous, and regular" business activities in the United States. Generally, the sale of goods in the United States by a foreignco, without additional activity such as the use of an office or agent or employees in that country, does not constitute a US trade or business. However, the activities of a direct employee or agent of the foreignco may result in the foreignco's being deemed to be engaged in a US trade or business.

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Because a foreignco can easily meet the threshold for a US trade or business, it is often prudent for a Canco with US business activities to file a return that essentially agrees that the threshold has been met, but asserts that no US tax is owed by virtue of the Canada-US income tax treaty. Under that treaty, Canco is exempt from US tax if it does not maintain a US PE. A PE can include an office, branch, or other fixed place of business, but it does not include a fixed place of business used solely for activities of a preparatory purpose, such as the maintenance of a stock of goods for the purpose of storage, display, or delivery. In certain circumstances, a PE is also deemed to exist on the basis of the activities of the Canco's employees in the United States.

Even if the Canco does not have a PE, it must file form 1120-F along with form 8833 in order to claim these treaty benefits. Failure to file form 8833 and thereby disclose the Canco's treaty-based return position may result in a \$10,000 penalty (Code section 6712). Also, failure to file a corporate income tax return allows the statute of limitations for auditing Canco's return to remain open indefinitely; this is another reason to fulfill this annual compliance requirement.