IRS SCRUTINIZES US PE POSITIONS UNDER TREATY

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Under the US Internal Revenue Code, a Canco that carries on a trade or business in the United States is subject to US corporate income tax on income effectively connected with that trade or business. The Canco is subject to US income tax only on its profits attributable to a US permanent establishment (PE), but if eligible the Canco can elect taxation under article V of the Canada-US treaty. Generally, the nature and amount of trade or business are broader than those create a US PE, and thus a treaty benefit may avoid US tax for some Cancos otherwise subject to it.

The treaty defines a US PE as a fixed place of business through which a Canadian business is wholly or partly carried on. A Canadian business also has a US PE if a person acting in the United States on behalf of a Canco (other than an independent agent) has, and habitually exercises in the United States, an authority to conclude contracts in the Canco's name. A Canco is not deemed to have a US PE merely because it carries on business in the United States through a broker, a general commission agent, or any other agent of an independent status that acts in the ordinary course of its business. In addition, a Canco is not deemed to have a US PE if its activities in the United States are limited to those of a preparatory or auxiliary character for the Canco.

In December 2018, the IRS announced the formation of a practice unit in its compliance function to examine whether a non-US corporation has a US PE as a result of an agent concluding contracts in the United States on its behalf. A second practice unit focused on whether an activity had a preparatory or auxiliary character in order to determine the existence of a US PE. The IRS has instructed its agents in these practice units to look at a variety of sources—including finan- cial statements, websites, and the corporation's invoices—to analyze whether a US PE exists.

A Canco discloses a treaty-based return position on IRS form 8833, which must be attached to a foreign corporation's US income tax return (form 1120-F). The IRS cannot deny a treaty benefit if form 8833 is not timely filed (by June 15 of the following year for a corporation using a calendar year taxation period), but it may impose a penalty of $10,000 on a corporation for the late filing of form 8833.

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Moreover, the exception (for a corporation with no US PE) to the IRS form 5472 filing requirement technically applies only if form 8833 is timely filed to disclose the treaty-based return position, and a fine is imposed for late filing. (Form 5472 is required to be filed by a Canco engaged in a US trade or business when reportable transactions occur during the year between the Canco and a US or Canadian related party.) Also, importantly, the statute of limitations for an IRS assessment of tax does not begin to run until form 1120-F is filed. Thus, in light of the IRS's new focus on PE positions, it is advisable for a Canco that takes the position that it has no US PE to timely file form 1120-F with form 8833 attached in order to lodge its position with the IRS, avoid the automatic $10,000 penalty for failure to timely file form 5472, and start the statute of limitations running. It is now more important than ever to carefully analyze whether a position of having no US PE safely exists.