United States Permanent Establishment
Enforcement and Expansion

Recently, U.S. Internal Revenue Service (IRS) and Department of Treasury officials made statements expressing the increasing focus of U.S. enforcement activity and audit scrutiny on permanent establishment issues. In addition, newly effective changes enacted by the Fifth Protocol to the Canada-U.S. Tax Treaty expand the circumstances in which a Canadian corporation can be deemed to have a U.S. permanent establishment. Permanent establishment issues can be particularly worrisome to North American corporations operating in both Canada and the United States, where efficient operational decision-making often requires cross-border reporting and divisional integration. Canadian and other non-U.S. corporations operating in the United States should be sensitized to the potential increase in U.S. permanent establishment audit activity, while companies operating in the United States and Canada should also consider the implications of the expanded definition of permanent establishment enacted by the Fifth Protocol.

Under the Canada-U.S. Treaty, and also the U.S. and OECD Model treaties, a corporation resident in Canada may be taxable in the United States only where its activities in the United States give rise to a permanent establishment. A permanent establishment is generally defined to include either a fixed place of business (e.g., an office, branch, place of management, factory, etc.) or a dependent agent who habitually exercises the authority to conclude contracts on behalf of the corporation in the United States. Furthermore, a recent addition (effective January 1, 2010) to the Canada-U.S. Treaty provides that a Canadian corporation may be deemed to have a U.S. permanent establishment if it either (a) performs services in the United States through an individual present in the United States for an aggregate of 183 days or more in any given twelve-month period and certain other conditions are met, or (b) provides services in the United States for an aggregate of 183 days or more in any given twelve-month period with respect to the same or connected project for U.S. customers. If a Canadian corporation has or is deemed to have a permanent establishment in the United States, the Canadian corporation will be subject to U.S. tax return filing obligations and will be required to pay U.S. tax on business profits attributable to that permanent establishment. If profits of a permanent establishment that are taxed by the United States are also taxed in Canada and foreign tax credits are unavailable to offset the full amount of the U.S. tax payable, double taxation on the U.S. source income of the Canadian resident may result. Moreover, if a Canadian corporation fails to file a U.S. tax return because it believes its U.S. activities do not constitute a permanent establishment, that Canadian corporation (if it is later found to have had a U.S. permanent establishment during taxable periods for which a U.S. return was not filed) may be denied the ability to subsequently claim any deductions against income attributed to its U.S. permanent establishment.
For North American businesses with integrated operations, segregating activities between Canadian and U.S. employees and affiliates in an attempt to avoid creating a U.S. permanent establishment can often prove cumbersome and contrary to the business goals of operating in a cross-border capacity. In addition, efforts to rely on “dotted-line” operational reporting between U.S. and Canadian employees participating in an integrated business function to segregate taxability may be weakened by inconsistent factual operating patterns. Some U.S. case law and OECD commentary provide support for the proposition that a Canadian corporation consistently looking to guidance from a U.S. manager might be regarded as having a permanent establishment in the United States, even if its contracts are formally concluded only outside the United States. While the U.S. government officials’ statements were coupled with the reassurance that the United States remains committed to a high permanent establishment threshold, the statements nonetheless suggest that the United States may soon be looking to advance these and other arguments on audit in an attempt to more aggressively assert that Canadian corporations have U.S. permanent establishments and should be subject to U.S. tax.

Like the United States, the European Union has also given consideration to looking beyond the historic separation of corporations in taxing the operations of an integrated multi-national group by extending an elective formulary apportionment mechanic under its laws. In addition, some tax reporters have suggested that the principles of economic nexus and formulary apportionment used by many of the States of the United States in administering their corporate income taxes may be a compelling alternative to the permanent establishment regime for the future of international corporate tax by countries. These remarks, together with the recent changes to the Canada-U.S. Tax Treaty and the renewed IRS audit activity on permanent establishment issues, suggest a global interest in developing international tax nexus standards to better address the economic integration of a multinational group’s business.

Frequently, Canadian and other non-U.S. corporations with distinct product and cost advantages look to the U.S. market as their long-term growth opportunity. As these corporations succeed in penetrating the U.S. market, they often find an increasing need to move executive and other personnel into the United States to be close to customers and operations. The ability of these corporations to successfully navigate the limits of the permanent establishment standard in order to keep their non-U.S. parent corporation’s business profits segregated and untaxed by the United States, particularly in this still developing area where definitive standards remain to be developed, can directly affect profitability and competitiveness. Such companies need to cautiously and carefully approach the cross-border operational integration of their businesses, particularly in light of the elevated attention being directed at their activities by tax administrators around the world. Canadian corporations with U.S. activities should consider the advisability of filing protective U.S. tax returns in order to preserve the right to claim deductions if they are ultimately found to have had a taxable presence in the United States.

Please contact any member of the Osler New York Tax Department for further advice on this subject.

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