Incorporation can be taxing when operating in the U.S.

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Tapping into U.S. markets may be a sound business strategy to help grow your Canadian company, but as you make your plans, it is important to understand the legal landscape, as well as the geographic one. Two major legal considerations are:

- At what point is your company subject to U.S. federal income tax?
- When should your company form a separate entity in the U.S. instead of maintaining a division in the U.S.?

The United States - Canada Income Tax Convention (the "Treaty") governs whether a Canadian company is subject to U.S. federal income tax. The threshold question for taxation under the Treaty is whether a Canadian company has a "permanent establishment" in the U.S. This can mean anything from maintaining an office in the U.S. to having an employee in the U.S. for more than 183 days on a 12-month rolling basis. Conversely, a Canadian company may not be deemed to have a "permanent establishment" (and, as a result, may not be not subject to U.S. federal income tax) if its activities in the U.S. are limited to maintaining a storage facility, advertising, or hiring independent contractors to act in in the U.S. The treaty sets forth some additional guidance, the applicability of which is very fact-dependent and should be discussed with legal counsel.

If your company is subject to U.S. federal income tax, it may be advantageous to form an entity in the U.S. Forming a U.S. subsidiary will provide your parent company with liability protection and will allow your parent company to avoid filing a U.S. tax return. In most cases, forming a U.S. corporation is preferable to forming a limited liability company (or LLC) because Canada treats an LLC as a corporation, whereas the U.S. typically treats an LLC as a partnership or a disregarded entity. This distinction eliminates offsetting foreign tax credits under the Treaty and subjects the subsidiary to double taxation. Bear in mind, too, that in the U.S., entity formation occurs at the state level and certain states have more favorable corporate laws than others. The Treaty does not bind states within the U.S. and most states have separate income tax laws and other legal requirements. Your company is not required to form a new entity where its U.S. headquarters are located, but the new entity must qualify in each state in which it transacts business.

In sum, a sound business expansion strategy should involve consultation with legal counsel to minimize risk and maximize your return on investment. For more information on corporate formation in the U.S., please contact Phil Delmont of Harter Secrest & Emery at 716-853-1616 or pdelmont@hselaw.com