Income Tax Planning for Cross-Border Business Investment Between the United States and Canada
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General Scenarios
Entity Symbol Legend

- **Corporation**
- **Hybrid: passthrough for U.S. purposes only**
- **Hybrid: passthrough for CDN purposes only**
- **Partnership**
- **Business (no entity)**
Doing Business in Source Country Without a Permanent Establishment

Country 1 resident and non-resident individual and corporate owners

Country 1 Corporation

Sales directly to Country 2 customers

Country 1 is “residence” country; Country 2 is “source” country
Doing Business in Source Country Through a Permanent Establishment

Country 1 resident and non-resident individual and corporate owners

Country 1 Corporation

Sales office in Country 2 selling to customers
“Pure” Deferral Structure

Country 1 resident and non-resident individual and corporate owners

\[ \text{Country 1 Corporation} \]

\[ \text{Country 2 Corporation} \]
“Pure” Passthrough Structure Using Limited Partnership

Country 1 resident and non-resident individual and corporate owners

Country 1 Ltd. Partnership

Country 2 Ltd. Partnership

Country 1 Corporation

99%

1%
Hybrid Northbound Structure

Country 1 (U.S.) resident and non-resident individual and corporate owners

Entity is passthrough for Country 1 but not for Country 2 purposes
Hybrid Southbound Structure

Country 1 (Canada) resident and non-resident individual and corporate owners

Entity is passthrough for Country 1 but not for Country 2 purposes
U.S. Federal Domestic Tax Rules
U.S. Federal Domestic Tax Rules in General

- U.S. corporations and individuals taxed on a net basis on worldwide income.
- Income of foreign company generally not taxable until paid. “Anti-deferral rules”
- U.S. passthrough entities themselves not subject to U.S. tax. Not U.S. taxpayers. Instead, for U.S. purposes, owners/members/partners are taxed at their own rates, as if they had earned income directly at the time earned by entity.
- Entity tax classification as corporation or passthrough is elective for most entities.
- U.S. corporate rates are progressive at the low end; main rate for mid-sized companies is 34%.
- U.S. citizens and resident individuals are taxed on all worldwide income at progressive rates depending on marital status. Top rate bracket of 39.6% begins at $413,351 for singles. Capital gains, domestic dividends and most foreign dividends are taxed at 15% (20% for top U.S. bracket).
- State tax rules generally follow federal rules; but state nexus rules differ from U.S. rules.
  - State corporate income tax rates vary from 4-12%; a handful instead have gross receipts taxes; WY and SD have neither.
  - A few states do not follow LLC federal tax classification rules and tax passthrough entities directly as corporations.
  - Individuals: top rates range 2.9-13.3%. None: NV, WA, WY, TX, SD, FL, & AK.
U.S. Federal Domestic Tax Inbound Rules
Engaged in a Trade or Business in the U.S.

- Jurisdiction to tax a foreign corporation (or individual nonresident alien) on a net basis turns on whether “engaged in the conduct of a trade or business within the United States” (ETBUS).
  - Vague facts and circumstances standard: requires considerable, continuous and regular activities in the United States, and not a few isolated activities.
  - Includes physically performing services in the U.S.
    - Exception: working for a foreign employer, < 90 days, & < $3,001.
    - Can be created through use of a U.S. agent.
  - Exception: Trading in stocks, securities, commodities for own account or through a resident broker or other independent agent.
  - ETBUS modified by tax treaty to “permanent establishment.”
Effectively Connected Income

- Income effectively connected with the conduct of a trade or business in the United States (ECI) is taxable on a net basis and at regular corporate (or individual) rates.
  - U.S.-source business income of foreign person is generally ECI. Including from services.
  - U.S.-source “FDAP” income - dividends, interest, royalties, rents and similar - and capital gains or loss - are ECI if:
    - Derived from assets used in or held for use in the conduct of the trade or business; or
    - The activities of the trade or business are a material factor in the realization of the income, gain or loss.
  - Foreign-source income is ECI only if:
    - Attributable to taxpayer’s U.S. office or fixed place of business, and consists of either:
      - Rents or royalties for use of intangible property derived in T/B,
      - Dividends or interest derived in U.S. financing business or by stock/security trading corporation, or
      - Certain foreign sales of goods.
    - Sale of U.S. real property interest, whether directly or indirectly (also subject to withholding).
- Foreign partners of domestic or foreign partnerships are deemed to be ETBUS if partnership is, and to have ECI if partnership does. Donroy, Ltd. V. U.S., 301 F.2d 200 (9th Cir. 1962).
- If partnership is ETBUS through a U.S. fixed place of business, gain on sale of partnership interest is characterized as ECI, as if assets have been sold.
- Foreign corporations are subject to additional “branch tax” on ECI @30%, including through passthrough entities.
Federal Withholding on Investment Income (FDAP) and Partnership ECI

• Tax is withheld @ 30% on payments of U.S.-source investment income -- fixed and determinable annual or periodical gains, profits and income (“FDAP”) -- to foreign corporations and other foreign entities, and nonresident aliens.

• Applies to U.S.-source payments of dividends, interest royalties, rents, and similar income, that is not ECI. Includes:
  • Income from sale of intangibles to the extent contingent on productivity, use or disposition.
  • Certain discounts on bonds.
  • Net U.S.-source capital gains received in a taxable year while NRA, if present in U.S. on 183 days or more in that taxable year. No loss carryover.
    • Note: For many assets, source of such NRA’s CG will be foreign unless NRA has a “tax home” in U.S.

• Generally collected by withholding; U.S. withholding agent is required to withhold tax, and to submit tax and report to IRS; advance treaty claim may be made.

• Main exceptions: Portfolio (non-contingent) interest from U.S. and domestic corporate bonds if not 10% shareholder; bank deposit interest; short-term OID.

• Includes U.S.-source FDAP earned by foreign persons through domestic partnerships, regardless of whether actually distributed to partner.

• A foreign or domestic partnership that has ECI must withhold on partnership net income allocable to foreign partners at top applicable marginal rate.
Earnings Stripping

- Earnings stripping rules (thin capitalization) limit U.S. federal income tax deduction for interest paid to related person if:
  - Ratio of debt to equity exceeds 1.5 to 1 on last day of taxable year, and
  - Net interest expense exceeds 50% of taxable income plus the following deductions: net interest expense, net operating loss, amortization and depreciation.

- If tests above are met, deduction for “disqualified interest” is limited:
  - Interest paid or accrued to related person if no tax is imposed (by U.S.) on interest; or
  - Interest paid or accrued to unrelated person if no gross basis tax is imposed (by U.S.) on interest and there is guarantee by related foreign (or tax-exempt) person.
U.S. Federal Domestic Tax Outbound Rules
Foreign Tax Credits – Direct Credits

Direct credit (IRC § 901): a U.S. individual or U.S. corporation (U.S. person) can credit foreign taxes paid or accrued on its foreign source income. This includes:

• Canadian taxes incurred by U.S. person directly, or through a foreign or domestic pass-thru entity (or series of such entities).

• Creditable Canadian taxes:
  • Federal income and provincial income taxes.
  • TP must exhaust effective and practical remedies to taxation.
  • Taxes may not be taken into account before related income (“splitter” rules IRC § 909).
  • Includes Canadian withholding taxes on payments of dividends, interest, and royalties made directly to U.S. person, or indirectly through a pass-thru entity (or entities).

• Alternative to deduct foreign taxes, but less tax efficient.
Foreign Tax Credits – Indirect Credits

Indirect or “deemed paid” credit (IRC § 902):

• A U.S. corporation (but not individual) can also credit foreign taxes paid or accrued by foreign subsidiary corporation upon the receipt of a dividend paid by the foreign subsidiary.
  • To qualify, U.S. corporation must own directly 10% or more of voting stock of a first-tier foreign subsidiary from which it receives dividends.
  • 902 credits can accompany dividends paid up a chain of foreign corporations and this may be used to plan to blend foreign tax rates if certain requirements are met.
  • Creditable foreign taxes are calculated proportional to the E&P of the foreign subsidiary distributed in the form of a dividend (= Tax pool X (Dividend/E&P)).
  • To equalize treatment for direct and indirect credits, taxes for which indirect credits are allowed are treated as additional taxable dividends received by domestic corporation. “Gross-up.” IRC § 78.
Foreign Tax Credits - Limitation

• Direct and indirect foreign tax credits are added together and are subject to annual FTC limitation calculation (IRC § 904):

  \[
  \text{FTC limitation} = \frac{\text{Foreign-source taxable income}^* \times (\text{U.S. tax liability})}{\text{Total taxable income}^*}
  \]

  * Expenses, including interest, are allocated to foreign-source income.
  * Long-term capital gains and qualified dividends are subject to reduction in proportion to the reduction in tax rate applicable to such income.

• Foreign taxes exceeding the limitation for a particular taxable year (“excess credits”) may be carried back 1 year and carried forward 10 years.

• These calculations done separately for “passive category income” and “general category income” baskets. (IRC § 904(d)).
Anti-Deferral Rules: Controlled Foreign Corporation (CFC)

- A foreign corporation is a controlled foreign corporation (“CFC”) if:
  - It is owned over 50% in vote or value by one or more “U.S. shareholders.”
  - A “U.S. shareholder” is a U.S. person that owns 10% or more of the voting power of the CFC.
- In general, voting power is ability to elect members of the board of directors.
- Complex stock attribution rules attribute foreign company stock to other persons based on (proportional) indirect ownership through foreign entities, special constructive attribution rules, and certain family attribution.
CFC Anti-Deferral rules: Subpart F

• Certain tainted income of a CFC – “subpart F income” -- must be currently included pro rata in income of every U.S. shareholder, at ordinary income rates, even if the underlying income is capital gains.

• Subpart F income includes:
  • Foreign personal holding company income – dividends, interest, rents, royalties; gains from: sales of stock, a partnership interest, other property not giving rise to income; excess of gains or losses from commodities transactions, certain foreign currency net gains, and other specified passive income.
  • Income from insurance or reinsurance of certain U.S. risks.
  • Certain active sales and services involving related parties, including:
    • Foreign base company sales income.
    • Foreign base company services income.
    • Foreign base company oil related income.
  • To the extent of current CFC’s E&P.
  • Several exceptions, including high tax, active rents and royalties, active financing, same country, look-thru, manufacturing.

• Investment of the CFC’s earnings in “United States property,” including:
  • Obligations of U.S. person, including a loan or receivable of CFC to a U.S. owner.
  • Other assets located in the U.S., including stock of a domestic corporation, and right to use intangibles in U.S.
  • Exceptions for several assets, including deposits in U.S. banks.
  • To the extent of current and accumulated E&P of CFC.

• Indirect FTC rules apply to domestic corporate U.S. shareholder, as if dividend were paid.
Other Outbound Rules of Special Attention

- Cross-border outbound transfers of assets to foreign corporations generally trigger income inclusion unless they are to be used in a trade or business.
  - Tax in any case on certain “hot assets,” like inventory and A/R.
  - Special and onerous deemed royalty rules for intangibles.
  - Overall foreign losses and cumulative branch losses must be recaptured upon incorporation of foreign branch.

- Outbound transfers of stock are also subject to taxation with exceptions.

- U.S. persons owning interest in foreign passive investment corporation (“PFIC”) are treated harshly. PFIC test: 75% income or 50% assets.

- Individuals are subject to NIIT @3.8% on investment income, including foreign corporate dividends.

- Individual’s active business income earned through passthrough is not subject to NIIT, but is subject to self-employment income earned by LLC.
Canadian Domestic Tax Rules
Canadian domestic law

• Canadian domestic law taxes income earned by non-residents from “carrying on business in Canada”.

• The meaning of “carrying on business in Canada” is a question of fact though certain prescribed activities are deemed to be carrying on business in Canada.

• For example, a non-resident that solicits orders or offers anything for sale in Canada through an agent or employee is deemed to be carrying on business in Canada.
U.S.-Canada Double Taxation Treaty
Treaty Principles Applicable in the United States

• Bilateral tax treaties the income tax imposed by one treaty partner on residents of other treaty partner. They are the exclusive treaties for applicable taxes.

• Tax treaties only add to taxpayer rights and can not restrict existing benefits.

• Principles are universal and based on OECD and U.S. Model treaties. U.S. Technical Explanations (TE) are official U.S. guides. TE for U.S.-Canada 2007 Protocol states that both governments have agreed that 2007 TE accurately reflects policies of 2007 Protocol and understandings reached by governments. Diplomatic notes and OECD Commentaries are also recognized interpretational tools.

• U.S. Treasury Dept. negotiates initials; President signs; Senate must ratify by 2/3 vote.

• In U.S., Internal Revenue Code is applied with “due regard” to treaties: statutes and treaties have equal force in U.S., so if in conflict, the “last in time” rule applies in U.S.


• U.S. can generally tax its citizens and residents regardless of treaty rules.
U.S. Taxes to which Treaty Applies (Art. II)

• Generally, U.S. federal income taxes and any substantially similar taxes. Includes:
  • Accumulated earnings tax and personal holding company tax only to extent necessary to implement pars. 5 and 8 of Article X (dividends).
    • These don’t apply to Canadian companies unless 50% or more of value is directly or indirectly owned by U.S. citizens or residents.
  • Private foundations rules only to the extent necessary to implement par. 4 of Article XXI (Exempt Organizations).
  • U.S. social security taxes only to the extent necessary to implement par. 2 of Article XXIV (Elimination of Double Taxation) or par. 4 of Article XXIX (Miscellaneous Rules, transition rule).
  • U.S. estate tax, only to the extent necessary to provide certain double tax relief.

• U.S. states are split on whether to honor income tax treaties. Same with U.S. possessions and territories.
Article IV(2) – Residency of an individual

• Determining an individual’s residency status under the treaty rule is key to proper application of the treaty provisions.

• When dealing with dual resident taxpayers, one must examine the residency tie-breaker rules.

• Examples of dual residents to whom the tie-breaker rules apply:
  • US citizens living in Canada.
  • Canadian retirees who spend more than six months in the US
Residency tie-breaker rules:

The tie-breaker rules are hierarchical; stop as soon as a test is met.

1. Location of the person’s permanent home.
2. Location of personal and economic relations, family and friends, social clubs, employment, business activity.
3. Location of one’s “habitual abode”. Where is the person really living from a common sense perspective?
5. The competent authorities will decide.
Article IV(3) – Residence of a company

- **IV(3)(a):** Corporations created under the laws of the US or Canada are deemed to be a resident only of the US or Canada, respectively (this rule could apply to break the tie of a US corporation with head office and management in Canada).

- **IV(3)(b):** In any other case, corporate residence is determined by the Competent Authorities (this rule could apply to a corporation that retains a corporate charter in both countries).

- If Competent Authority agreement is required under (b) but not obtained, the company is deemed not to be a resident of either country.
Income “Derived By” a Resident – Art. IV, par. 6

• “Who is the taxpayer for treaty purposes?”
• This paragraph provides treaty benefits to:
  • A person resident in treaty country who is considered by resident country as deriving amount through entity that is not resident of other treaty country; and
  • Because entity is fiscally transparent under laws of residence country, treatment by that country of the amount is the same (character & source) as if amount had been derived directly by that person.

• Examples:
  • Resident owner of “Pure” Passthrough Structure Using Limited Partnership(s).
  • U.S. residents who derive Canadian-source income through an LLC (that is not a Canadian resident), or
  • Canadian residents who derive U.S.-source income through a Canadian limited partnership treated as a corporation for U.S. purposes.

• Apply residence country law to look through the passthrough entity to its members to determine treaty benefits:
  • Canadian-resident company pays dividends to an U.S. LLC owned 50/50 by a U.S. individual and a U.S. “C” Corp. They are subject to 15% tax on half the dividend and 5% on the other half.
  • Non-U.S. members receiving Canadian dividends through a U.S. LLC are denied a treaty rate even if Canada’s treaty with their home country has a reduced rate (look to Canada-home country treaty rules).
  • U.S. LLC doing business in Canada, with U.S. member and foreign member can only claim Art. V/VII benefits w/r/t portion owned by U.S. resident member. Canada only looks at activities of LLC; U.S. also considers activities of members/partners.

• Procedurally, Canada still views U.S. passthrough hybrid as taxpayer, that only qualifies for benefits based on its ownership.

• In addition, Canada considers S Corp incurring Canadian taxes to be a resident of the U.S., qualified for treaty benefits (and apparently can qualify for 5% withholding on dividends from Canadian company of which it owns 10%).
Hybrid: Canadian unlimited liability company (“ULC”)

- ULC is treated as a corporation for Canadian purposes but a disregarded entity for US purposes.
- As a Canadian corporation, some compliance is simplified; no requirement to post security bond for GST/HST, easier to set up bank accounts and payroll.
- No 15% backup withholding on payments to ULC for services rendered in Canada.
- 3.8% NIIT is not payable on distributions from a ULC.
- Watch for 15% withholding tax on payments by ULC to US parent if ULC subcontracts the Canadian work to US company.
Article IV(7) - Canadian ULC treaty denial rule

• Treaty reduced rates on non-dividend distributions (e.g., interest, royalties, management fees) from a ULC to its US shareholder are denied.

• Consider having US related company charge fees to a ULC rather than the parent company.

• The reduced 5% rate for dividends may be available indirectly by a capitalization of retained earnings into paid up capital followed by a distribution of this newly created PUC to the US shareholder.

• The US “E&P before PUC” rule does not apply to ULC distributions of PUC to the US shareholder because a ULC is a disregarded entity for US purposes.
ULC owned by LLC

- LLC parent of ULC is not entitled to the 5% reduced rate of withholding tax on dividends.
- Domestic rate of 25% applies to dividends paid by ULC to LLC even if the LLC members are US persons.
- Example: ULC earns $100,000 in Ontario. Corporate income tax of $26,500 plus dividend withholding tax of $18,375 results in 44.875% effective tax rate.
- Review whether all LLC’s members can get full foreign tax credit before using this structure.
Permanent Establishment ("PE") (Art. V)

• General rule (pars. 1 & 2): a Permanent Establishment ("PE") is a fixed place of business through which the business of a resident of a treaty country is wholly or partly carried on. Includes:
  • a place of management, branch, office, factory, workshop; and
  • a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

• "Fixed": a particular building or physical location is used by the enterprise for the conduct of its business, and it must be foreseeable that the enterprise’s use of that will be “more than temporary.” Usually, personnel of enterprise conduct the business there.

• PE can also exist where enterprise has space at its disposal, including at facilities of another enterprise. No formal legal right is required. Operations must be carried out there on a regular basis, but not necessarily continuously.

• Typically not a PE if less than 6 months (note this is not a rule).

• “Overstays” can create a PE from inception.
PE – Leasings, Building Sites, Installation and Drilling

• Buildings, equipment and intangible property leased by enterprise of treaty country to enterprise of other treaty country do not constitute a PE of lessor in other country unless leasing is through a fixed place of business of lessor in other country. Lessor can also send people to operate the equipment there as long as they are under lessee’s direction without creating a PE.

• A building site or construction or installation project constitutes a PE only if it lasts for more than 12 months (par. 3).

• Use of an installation or drilling rig or ship to explore for or exploit natural resources constitutes a PE if (and only if) such use lasts for more than three months in any 12-month period (par. 4).
PE – Activities Not Forming a PE (Par. 6)

• The following fixed places of business activities used solely for one or more of the following activities do not constitute a PE:
  • The use of facilities for the purpose of storage, display or delivery of goods or merchandise belonging to the resident;
  • The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display or delivery;
  • The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;
  • The purchase of goods or merchandise, or collection of information, for the resident; and
  • Activities that have a preparatory or auxiliary character, such as advertising, the supply of information, scientific research or similar activities.

• Not preparatory and auxiliary activity if it forms an essential and significant part of the activity of the enterprise as a whole.
PE Agency Rules (pars. 5, 7 & 8)

• Dependent agent PE (par. 5):
  • A “dependent agent” is a person that has and habitually exercises in treaty country
    authority to conclude contracts in the name of the resident of the other country
    (binding on that resident). This creates a PE for the resident even if there is no
    fixed place of business in treaty country.
    • This rule does not apply to activities described in paragraph 6.
    • May include employee of company.

• Beware the appearance of head office rubber stamping of contracts negotiated in potential PE country.

• Example: Is anyone at US head office going to overrule, change or
  challenge terms of a contract negotiated in Canada by the president?

• Head office contract approval policies should be documented and
  followed, head office staff should perform credit checks on new
  customers, review billing and payment terms, etc.
PE Agency Rules (pars. 5, 7 & 8)

• Independent agent generally not a PE (par. 7):
  • A broker, general commission agent or other independent agent acting in the ordinary course of its business as an independent agent does not constitute a PE, even if it may bind the resident. OECD principles speak to certain factors, among others:
    • Independence must be both legal and economic.
    • “Independent”: Reliance on special skills and knowledge rather than significant control.
    • Subject to detailed instructions or comprehensive control vs. freedom within scope of authority conferred by agreement.

• It is irrelevant that the treaty-resident company controls or is controlled by a company that is resident or carries on business in the other treaty country (par. 8).
PE – Special Services Rule (par. 9)

• Not found in most other U.S. treaties:

• PE may also exist if one of these conditions is met:
  • 9(a). Individual is performing services for a treaty-country enterprise and is present in other treaty country for 183 or more days in any 12-month period, and during that time, more than 50% of the gross active business revenues of the enterprise consists of income derived from such services by that individual; or
  • 9(b). Services are provided by the treaty-country enterprise in the other treaty country for 183 or more days in any 12-month period for customers who are resident in the other country or have a PE there to which the services are provided, with respect to same or “connected” project.
    • “Connected”-ness means both commercially and geographically coherent, and is a facts and circumstances test.

• Subject to general building site rule of par. 3.

• The rules of par. 6 apply to par. 9 – those non-core activities and days do not count.
Takeaways from the deemed services PE rules

- Ensure a detailed daily log of work locations is maintained by all US workers entering Canada.
- New PE tests based on days present in Canada provide CRA auditors with numerical tests that they seem to be more comfortable with than many of the more subjective PE tests.
- CRA auditors have become increasingly focused on the number of days a worker is present in Canada.
- Ensure customer invoices identify the number of US work days and number of Canadian work days.
- CRA will often take the position that all work days were in Canada unless documentation exists to show otherwise.
PE – Electronic Commerce

• Gaming and vending machines that operate in other country for own account or through dependent agent may create PE (with no personnel).

• A website is neither a PE nor agent – neither a person, tangible nor at the disposal of owner of website (on the server).

• Use of server that enterprise owns and operates may be PE in country of server if “fixed” more than temporarily.
  • In addition, can par. 9(b) apply to server in source country? In another country?

• Is it carrying on essential and significant business (core) activities, or activities exempt under par. 6?
  • Internet services provider (ISP) is carrying on core business activities.
  • E-tailer is carrying on core activities if sales are concluded on server in country.

• ISP is not an agent for its customers because it has no authority to conclude contracts.
Business Profits (Art. VII)

• Business profits of an enterprise resident in a treaty country are taxable only in that country unless the enterprise has a PE in the other country, in which case the source country may only tax profits that are - or were - “attributable” to that PE.
  
  • Policy: Must participate in the economic life of the source country.
  • “Attributable” profits are determined as if the PE were a distinct and separate enterprise operating at arm’s length with other parts of the enterprise – under transfer pricing principles of the OECD Transfer Pricing Guidelines. Can be foreign source.
  • This is the Authorized OECD Approach (AOA) – transfer pricing principles that are based on functions performed, assets used, and risks assumed through the PE vs. other parts of the enterprise.

• These rules also apply to independent services rendered in the source country, whether through a physical office or a paragraph 9 PE.

• No profits are attributed to the PE for purchasing goods or providing executive, managerial or administrative services or facilities for the resident.

• Amounts of deductions are to be allowed to PE based on an arm’s length charge for expenses incurred by PE or reasonably allocated from the resident for the benefit of the PE, including for executive and G&A expenses and regardless of the where incurred, as long as that type of a deduction is allowable.

• In general, income items addressed in other articles are not affected by Article VII.
A foreign company may carry on both a taxable PE business and a separate non-taxable business with no PE.

- For example: a US company has a sales office in Toronto selling to east coast customers while its west coast sales are handled by its Seattle office.
  - Only profits associated with the east coast sales are taxable in Canada.
- A taxpayer can choose domestic or treaty rules that result in lowest tax, but must be “consistent.”

“Consistent” means: taxpayer cannot mix domestic and treaty rules of one article within one PE or among different PEs.

- However, consistency has its limits, for example, taxpayer can choose domestic law – ECI rather than PE rules of Arts. V/VII, and treaty rules for interest withholding under Art. XI.
Article VI – Real property rental income

• Passive rental income from real property is among the most common types of income for which there is no treaty relief.

• Compliance by landlords with rules for foreign owned rental properties is critical to avoiding punitive rates of withholding tax on gross rents.

• IRC 871(d) election for US rental properties owned by Canadians and ITA 216 election for Canadian rental properties owned by Americans allow for net income based taxation of rental income.
Article X(2) - Withholding rate on dividends

- 5% withholding if shareholder is a treaty-resident company that owns at least 10% of the company’s voting stock.
- 15% to all other treaty-resident shareholders.
Article XI(1) – No withholding on interest

• Cross border interest payments to treaty-resident persons are exempt from withholding.
• Watch for LLC members that are not residents of US or Canada; their share of cross border interest from Canada is subject to 25% withholding tax.
Article XII(2) – Withholding rate on royalties

- 10% withholding tax unless fully exempted under article 3 (discussed on next page)
- Rent payments for equipment and other tangible personal property (not real estate) are considered royalties (see definition in paragraph 4).
- Note: Because rent payments for TPP are not commonly thought of as royalties, it is sometimes overlooked that TPP rents are eligible for the 10% treaty rate under this royalties article.
Article XII(3) – Royalties exempt from tax

• The following royalties are exempt from withholding tax:
  • Use of or right to use computer software.
  • Business know-how and use of patents (but not payments in connection with a rental or franchise agreement).
    • Note: Patents and trademarks are often thought of interchangeably but they are not the same thing. Patent royalties are exempt, trademark royalties are not.
  • Copyright royalties for production/reproduction of literary, musical, artistic works (subject to various exclusions).
Article XIII - Gains

- Generally, except for gains associated with real property, most other gains are sourced to an individual’s country of residence.

- Real estate gains are sourced to the country in which the real property is located (different rules may apply to real estate owned prior to September 26, 1980).

- Gains on private company shares that derive their value from real property may be taxable as real property.

- For US citizens living in Canada, stock market gains are sourced to Canada, including gains realized on US stocks traded through US brokerage accounts.
Other Income (Art. XXII)

- Items of income owned by a resident of a treaty country, wherever arising, and not dealt with under Articles I-XXI are taxable only in resident country, but if income arises in other country then it may also be taxed there.
  - Includes income from gambling, punitive damages, covenants not to compete, certain financial income not derived in a trade or business, guarantee fees to related parties (if not in T/B of guaranteeing), interest or dividends arising in a third country, and unemployment benefits.

- Exceptions:
  - Guarantee fees paid to resident of treaty country if attributable to a PE in other country (i.e., when it is earned by a business it is business profits).
  - Distribution to beneficiary who is resident of treaty country by estate or trust resident in other (source) country is taxable at maximum 15% rate on separate type of income, but only to extent underlying income is taxable in source country. Provision is N/A to U.S. accumulation trusts.
  - Wagering losses incurred by resident of treaty country are deductible in other treaty country if gains would be taxable there; deductible to the same extent that resident of other treaty country could deduct them.
Relief From Double Taxation (Art. XXIV)

- U.S. allows direct credit to resident or citizen, in accordance with the U.S. domestic law provisions and limitations, on income tax “paid or accrued” to Canada.

- U.S. allows indirect (deemed-paid) credit to U.S.-resident company owning 10% of voting stock of Canadian-resident company (based on Canadian income taxes on profits out of which dividends paid).

- Canada allows direct credit for U.S. income taxes on U.S. income. (Also, for social security taxes on U.S. income for individuals.)

- Canada allows indirect (deemed-paid) credit to Canadian-resident company owning 10% of voting stock of U.S.-resident company (based on U.S. income taxes on profits out of which dividends paid).

- Credits also available for general income taxes of U.S. states and localities and Canadian provinces.

- Resourcing: Item of income of resident of treaty country that is taxable under treaty by other country is resourced to other country to facilitate FTC. Generally, income not taxable under treaty by other country is deemed to arise in residence country.
Limitation on Benefits – (Art. XXIX A)

• Article XXIX A determines whether nexus between the a treaty country resident and that country is sufficiently strong to entitle resident to benefits and prevent treaty shopping.

• Domestic anti-abuse rules, beneficial ownership and “derived by” principles are applied first (par. 7).
  • U.S. substance over form and anti-conduit rules.
  • Canadian domestic anti-abuse rules.

• In addition to any other requirements, one of following must be met:
  • A resident must be a “qualifying person” under par. 2; then resident qualifies for all benefits under the treaty; or
  • An item of income must otherwise qualify for treaty benefits under par. 3, 4, or 6.
Qualifying Person – Par. 2 of Art. XXIX A

A qualifying person is a resident that is:

a. Individual.

b. Contracting state, political subdivision or local authority, or agency or instrumentality of same.

c. A company or trust whose principal class of shares or units (and any disproportionate class) is primarily and regularly traded on one or more recognized stock exchanges (public trading test).

d. A company if 5 or fewer persons meeting public trading test directly or indirectly own more than 50% of aggregate vote and value of shares (and of each disproportionate class), and each company/trust in chain of ownership is a qualifying person.

e. Entity meeting the ownership/base erosion test (see next slide).

f. Estate.

g. Not-for-profit organization (tax-exempt in treaty country where it is established), if >50% of beneficiaries, members or participants of organization are qualifying persons.

h. Not-for-profit organization, trust or company operated exclusively to administer or provide pension, retirement or employee benefits (tax-exempt in treaty country where it is established), if >50% of beneficiaries, members or participants of organization are/were qualifying persons.

i. Tax exempt organization, trust or company operated exclusively to earn income for entity described in (g) or (h).
Entity Ownership/Base Erosion Test (Par. 2(e))

• Both parts of test must be met to be qualifying person.

• Ownership test: 50 percent or more of the aggregate voting power and value or shares (or 50% or more of trust beneficial interests), and also of each disproportionate class of shares (or interests), is not owned, directly or indirectly, by persons who are not qualifying persons; and

• Base erosion test: For preceding tax year, the amount of expenses deductible from gross income in residence country that are paid or payable, directly or indirectly, to non-qualifying persons is < 50% of company/trust’s gross income.
Benefits for Items of Income under LOB

• Apply the following tests separately to items of income.

• Active trade or business test (par 3).

• Derivative benefits test for dividends, interest and royalties (par 4).

• Discretionary benefits for an item of income (par 6).
Active Trade or Business Test

- A resident of a treaty country engaged in the active conduct of a trade or business in that country may obtain the benefits of the treaty with respect to an item of income derived from the other treaty country in connection with, or incidental to, that actively conducted trade or business.

- The trade or business in residence country must be “substantial” compared to the activity in the other treaty country giving rise to income for which benefits are claimed. Substantial means not a very small percentage of activity in the other country (to prevent treaty shopping).

- Making or managing investments for own account is not a T/B, unless the activities and business are banking, insurance or securities dealer. Holding company is not active conduct of a trade or business.

- “Connection” may be upstream, downstream or parallel to activity in residence state: relating to same product line(s), or complementary activities in same overall industry.

- Item of income may be derived, directly or indirectly, through residents of the other treaty country.

- Item of income from source country is “incidental to” the residence country active trade or business if the production of the income item facilitates the conduct of the T/B. Example: the temporary investment of T/B working capital in other country securities.
Derivative Benefits Test

• Applies to Articles X (Dividends), XI (Interest) and XII (Royalties).

• General idea is that a company resident in a treaty country may be granted treaty benefits if the owner(s) of the resident would have been entitled to at least the same benefit had the income in question flowed directly to that owner.
  • Has ownership and base erosion subtests.
  • Very useful for employee-owned and family-owned companies where ownership/base erosion test not met.

• Ownership subtest: Shares representing more than 90% of aggregate vote and value (and at least 50% of any disproportionate class) are owned, directly or indirectly, by persons, each of whom is either a qualifying person or meets all of the following 3 tests:
  1. The person is a resident of a country with which the other treaty country has comprehensive income tax treaty and is entitled to all benefits under that treaty (including under that treaty’s LOB);
  2. The person would qualify for benefits as qualifying person or under active trade or business test if the person were a resident of company’s country under U.S.-Canada treaty (and carried on active business in that country); and
  3. The person would be entitled to a treaty rate of tax on that class of income under the other treaty that is at least as low as the rate under U.S.-Canada treaty.

• Example: Company resident in third country that qualifies under 1 and 3, and is 100% owned by resident of 3rd country.

• Base erosion subtest: For preceding tax year, the amount of expenses deductible from gross income in residence country that are paid or payable, directly or indirectly, to non-qualifying persons is < 50% of company’s gross income.
Discretionary Benefits for an Income Item

- This provision allows a resident of a treaty country not otherwise meeting any LOB criteria to request a discretionary grant of treaty benefits for all or some income from the competent authority of the other country, whether, on the basis of all factors (including history, structure, ownership and operations of that person):
  - Its creation and existence did not have a principal purpose the obtaining of benefits under the treaty that would not otherwise be available; and
  - It would not be appropriate to deny benefits to that person, considering purpose of LOB article.

- If that competent authority determines that one of these points are met, then person “shall be granted benefits.”
  - TE says that if benefits are allowed they will be allowed retroactively. Does this and “shall” conflict with discretion of competent authority?
  - U.S. competent authority user fee is discouragingly high – currently $37,000 per entity.
Northbound and Southbound Transactions
Entity Symbol Legend

- Corporation
- Partnership
- Hybrid: passthrough for U.S. purposes only
- Hybrid: passthrough for CDN purposes only
- Business (no entity)
Northbound Transactions: U.S. Investment into Canada
U.S. Corporation Doing Business in Canada Without a Permanent Establishment

U.S. resident and non-resident individual and corporate owners

U.S. Corporation

Sales directly to Canadian customers

U.S. is “residence” country; Canada is “source” country
No PE in Canada

• All income and expenses reported on US return with no amounts allocable to Canada.
• No need to calculate foreign tax credits, no need for Canadian branch financial statements.
• Treaty based tax return disclosing various details about the Canadian business and source of revenues must be filed within six months after year-end.
• $2,500 failure to file penalty.
• Canada does not grant extensions.
No PE in Canada

• GST/HST and other provincial sales tax registrations need to be considered because the treaty PE rules do not apply to sales tax nexus tests.

• Regulation 102 employer payroll compliance needs to be addressed if US employees are working in Canada.

• Regulation 105 backup withholding of 15% from payments for services rendered in Canada.

• CRA’s Reg. 102 and 105 compliance programs are widely considered to be a disorganized quagmire.
Treaty override of Canadian domestic law

- Many US companies have been selling goods into Canada through independent agents for years and many would be surprised to learn they have been relying on the Canada-US treaty to override Canadian domestic law.
Treaty protected business

- A treaty protected business typically refers to an otherwise taxable activity that is not taxable because the company does not have permanent establishment ("PE") in Canada, as defined in the treaty.

- A treaty protected business carried on in Canada by a US company does not provide exemption from Canadian GST/HST compliance for goods and services supplied in Canada, provincial sales tax nexus issues or employer payroll compliance associated with US or Canadian employees or subcontractors working in Canada, even for short periods of time.
Is there a permanent establishment in Canada?

- Because Canadian business income of a US company is taxable in Canada only if the US company has PE in Canada, there is generally no need for complex cross border structuring unless a PE exists.

- The treaty extends the meaning of PE well beyond a traditional bricks and mortar office location and can deem a PE even where there is no physical location in Canada.

- Canadian provinces respect the treaty’s PE rules; a US company will not have a provincial PE if it does not have a PE under the treaty.
U.S. Outbound Tax Results

- U.S. Corporation is taxable on Canadian sales at U.S. corporate rates (mostly @34%). [Tax credits are available in U.S. under Code and treaty for any (unlikely) Canadian or provincial income taxes.]
- When income of U.S. Corporation is distributed to shareholders as a dividend:
  - U.S. individual residents are taxed as qualified dividend @15% (20% for highest bracket taxpayers).
  - U.S. corporate taxpayers are taxed at regular corporate rates; but are allowed a dividends received deduction of: in general 70%; 80% if own 20% of vote and value of payor; 100% if own 80% of vote and value of payor.
  - U.S. non-resident withholding @30% or lower applicable U.S. tax treaty rate.
U.S. Corporation Doing Business in Canada Through a Permanent Establishment

U.S. resident and non-resident individual and corporate owners

U.S. Corporation

Sales office in Canada selling to customers
PE rules unique to LLC’s

- CRA’s position is that an LLC is not itself directly entitled to treaty benefits because an LLC is not subject to tax in US.
- Is it possible to have a PE and not have a PE in Canada at the same time? Yes, if the entity is an LLC.
- For example, a US LLC with US and non-US members may claim PE exemption only on the portion of Canadian business profits attributable to the US members.
- The LLC is liable for Canadian tax on the portion of its earnings attributable to the non-US members.
Branch vs. subsidiary

• If a taxable Canadian PE exists, one must then decide between:
  • Reporting Canadian earnings annually in US and optimizing foreign tax credit, or
  • Leaving the earnings in Canada and deferring US tax until earnings are repatriated to US.

• Often a tendency to assume that maximizing foreign tax credit flow-through to the US tax return is the preferred objective but this is not always true.

• It can be advantageous to avoid flow-through of the Canadian PE earnings and tax to the US tax return.

• If the US company is a C corporation that can claim indirect foreign tax credits, US company may be indifferent to branch versus subsidiary tax analysis.
Canadian branch of US company

- Simple to implement with little or no legal fees.
- Easy to start up and close down and is generally recommended in early stages of expansion into Canada.
- Branch profits and losses and Canadian taxes flow through to US parent.
- Eligible for branch profits tax exemption on the first $500,000 of branch profits.
- Can easily revert to a treaty exempt filing position if Canadian business expansion is scaled back.
Branch of US company

• When to consider:
  • US parent intends to repatriate Canadian profits on an annual basis.
  • Canadian business has been started from scratch by the US company and there is no acquisition debt or purchase price of an existing Canadian business.
  • Canadian business does not require substantial ongoing cash investment to facilitate growth.
  • Client looking for a simple structure to expand into Canada.
Branch of US company

Disadvantages:

• Immediate taxation of Canadian profits at higher US corporate tax rates.

• CRA auditors seem to struggle to understand branches of foreign companies and in particular the concept of a head office allocation of costs charged to the branch.

• LLC issue: Treaty reduced rate of branch tax of 5% is only available on portion of LLC’s branch earnings that are allocable to US corporate members (i.e., S or C corp. members); US individuals and non-US members pay 25% branch tax.
U.S. Outbound Tax Results

• U.S. Corporation is taxable on Canadian sales at U.S. corporate rates (mostly @34%). Tax credits are available in U.S. under Code and treaty for any Canadian or provincial income taxes, subject to limitation under U.S. rules.
• When income of U.S. corporation is distributed to shareholders as a dividend:
  • U.S. individual residents are taxed as qualified dividend @15% (20% for highest bracket taxpayers).
  • U.S. corporate taxpayers are taxed at regular corporate rates; but are allowed a dividends received deduction of: generally 70%; 80% if own 20% of vote and value of payor; 100% if own 80% of vote and value of payor.
  • U.S. non-resident withholding @30% or lower applicable U.S. tax treaty rate.
“Pure” Deferral Structure

U.S. resident and non-resident individual and corporate owners

U.S. Corporation

Canadian Company
Subsidiary - defer US tax on Canadian profits

• When to consider:
  • US company acquires an existing Canadian business.
  • Faster recovery of the parent’s acquisition cost and/or repayment of acquisition debt by using the Canadian earnings taxed at 26.5% (in Ontario).
  • Canadian business requires reinvestment of earnings into the business to finance growth, asset acquisitions, etc.
Subsidiary used to finance Canadian acquisition

• Canadian subsidiary financed with funds to acquire target stock.

• Subsidiary repays the purchase debt with tax-free dividends from target, or merges with target to get the purchase debt and interest expense onto target’s books.

• Dividends between target and subsidiary are tax-free.

• Purchase debt repayment is accelerated because there is no incremental US tax on target’s earnings.
Subsidiary - defer US tax on Canadian profits

Disadvantages:

• US income tax will be payable in future when the Canadian earnings are repatriated to US “S” corporation, LLC or individual shareholder as dividends (“C” corporation shareholder can generally claim indirect foreign tax credit).

• Canadian income tax paid may not be claimed as a foreign tax credit on US tax return of individual US shareholders when dividends are paid.

• NIIT will be payable by individual US shareholders on dividends.
U.S. Outbound Tax Results

• Income of Canadian Company is subject to U.S. deferral but may be currently taxable to U.S. Corporation at corporate rates if income is subpart F. This is unaffected by U.S.-Canada tax treaty.
• Dividend from Canadian Company is taxed at regular U.S. corporate rate.
• Subpart F income or dividend from Canadian Company carries with it indirect tax credit allowed for Canadian taxes. Tax credit also allowed for Canadian withholding taxes on dividends. All credits are subject to limitation under the Code and treaty.
• When income of U.S. Corporation is distributed to shareholders as a dividend:
  • U.S. individual residents are taxed as qualified dividend @15% (20% for highest bracket taxpayers).
  • U.S. corporate taxpayers are taxed at regular corporate rates; but allowed dividends received deduction of: generally 70%; 80% if own 20% of vote and value of payor; 100% if own 80% of vote and value of payor.
  • U.S. non-resident withholding @30% or lower applicable U.S. tax treaty rate.
Northbound “Pure” Passthrough Structure Using Limited Partnership

U.S. resident and non-resident individual and corporate owners

U.S. Ltd. Partnership

Canadian Ltd. Partnership

99%

1%

U.S. Corporation
U.S. Outbound Tax Results

• U.S. LP not subject to U.S. tax.
• U.S. individual owners are currently taxable at U.S. individual rates on their shares of 99% of income of Canadian LP, regardless of whether income is distributed.
• U.S. corporate owners are currently taxable at U.S. corporate rates on their shares of 99% of income of Canadian LP, regardless of whether income is distributed.
• U.S. Corporation directly owning Canadian LP is taxable on 1% share of income of Canadian LP at U.S. corporate rates.
• U.S. individuals and corporations are permitted direct tax credit for any Canadian taxes of Canadian LP under U.S. Code and tax treaty, subject to limitations.
• Non-U.S. residents are not taxable in U.S. on their shares of 99% of income of Canadian LP.
• No U.S. withholding taxes on distributions of income to any owners of U.S. LP.
Hybrid Northbound Structure

U.S. resident and non-resident individual and corporate owners

Entity is passthrough for U.S. but not for Canadian purposes

U.S. LLC

Canadian Company
LLC owns Canadian subsidiary

- Article IV(6) of the treaty is the LLC look through rule.
- Withholding tax rate on dividends is based on US residency status of LLC’s members.
- Dividends paid to LLC subject to withholding tax as follows: 5% US corporate members, 15% US individual members, 25% all others.
- Example: LLC owned 50% by US corporation, 20% by US individual, 30% by UK company.
- Withholding tax on dividends = 13% (50% * 5% + 20% * 15% + 30% * 25%).
U.S. Outbound Tax Results

- US LLC is not subject to U.S. tax.
- Owners of US LLC are not subject to U.S. taxes on Canadian Company’s income until dividends are distributed by Canadian Company.
- When income of Canadian Company is distributed to US LLC as a dividend:
  - U.S. individual residents owning interests in US LLC are immediately taxed on qualified dividend @15% (20% for highest bracket taxpayers), regardless of whether US LLC redistributes income.
  - U.S. individual residents owning interests in US LLC are allowed credit for Canadian withholding taxes on dividend but not underlying Canadian taxes paid by Canadian Company on its income.
  - U.S. corporate taxpayers owning interests in US LLC are immediately taxed on dividend at regular corporate rates; dividends received deduction generally unavailable (such a deduction is allowed only for U.S.-source portion of dividend and only if such taxpayer owns 10% or more of Canadian Company).
  - U.S. corporate taxpayers owning interests in US LLC are allowed indirect credit for Canadian income taxes of Canadian Company that arise with dividend, provided that they indirectly own 10% of Canadian Company. They may also credit Canadian withholding taxes on dividend. Credits are both subject to U.S. Code and tax treaty limitations.
  - U.S. non-residents are not subject to U.S. tax on their shares of Canadian dividends.
- No U.S. tax is due or withheld upon distribution by US LLC.
Southbound Transactions: Canadian Investment into United States
Canadian Company Doing Business in United States Without a Permanent Establishment

- Canadian resident and non-resident individual and corporate owners

- Canadian Company

- Sales directly to U.S. customers

Canada is “residence” country; U.S. is “source” country
U.S. Inbound Tax Results

• No U.S. federal taxes if Canadian Company is resident in Canada under tax treaty and qualifies for benefits under Article XXIX A (LOB). Otherwise, federal taxes are likely to be imposed on Canadian Company, assuming company is ETBUS and to the extent of Canadian Company’s ECI.

• If Canadian Company does not qualify for treaty benefits, U.S. federal taxes would consist of:
  • Corporate tax on net ECI at corporate rates, mostly 34%; and
  • Branch tax on net ECI (subject to adjustments), @ 30%.

• U.S. state taxation depends on state nexus rules:
  • May depend on some physical presence or even economic presence (amount of sales).
  • States split on whether solely pure solicitation is protected under Public Law 86-272 (e.g., Illinois yes, California no).
Canadian Company Doing Business in United States Through a Permanent Establishment

Canadian resident and non-resident individual and corporate owners

Canadian Company

Sales office in U.S. selling to customers
U.S. Inbound Tax Results

- Federal taxes apply to income of Canadian Company attributable to U.S. branch office.
- Federal taxes consist of:
  - Corporate tax on income attributable to U.S. branch office under principles of treaty Article VII, at corporate rates, mostly 34%.
  - Branch tax is imposed on income attributable to U.S. branch office. If Canadian Company is resident in Canada under tax treaty and qualifies for benefits under Article XXIX A (LOB), rate is 5%; if not, rate is 30%.
- State with corporate income tax will tax a branch.
“Pure” Deferral Structure

Canadian resident and non-resident individual and corporate owners

Canadian Company

U.S. Corporation
U.S. Inbound Tax Results

- U.S. Corporation income is taxed at U.S. and state corporate rates.
- Dividend from U.S. Corporation to Canadian Company is taxed by federal withholding.
  - If Canadian Company is resident in Canada under tax treaty and qualifies for benefits under Article XXIX A (LOB), w/h rate is 5%; if not, w/h rate is 30%.
- Most states allow DRD for foreign dividends paid to domestic corporation.
Southbound “Pure” Passthrough Structure Using Limited Partnership

Canadian resident and non-resident individual and corporate owners

Canadian Ltd. Partnership

99%

1%

U.S. Ltd. Partnership

Canadian Company
U.S. Inbound Tax Results

- U.S. LP itself not subject to U.S. tax.
- If U.S. LP is engaged in a trade or business in the U.S. and earns ECI, the owners of Canadian LP and Canadian company derive that income under U.S. passthrough principles. See IRC sec. 875(1); Donroy v. U.S., 301 F.2d 200 (9th Cir. 1962). Similar rule applies to PE/ECI in US.
- If not ECI, no U.S. tax imposed.
- If ECI, non-U.S. individual and corporate owners of Canadian LP (and Canadian Company) are taxpayers that must be tested for both Canadian residence and qualification under LOB of U.S.-Canada treaty.
- If taxpayer (or item of income) qualifies for treaty benefits, taxpayer is only taxed on income attributable to a U.S. PE (which may include FDAP).
  - Such taxation will ultimately be at regular U.S. individual or corporate rates of partner.
  - U.S. LP will withhold @ maximum rate of direct or indirect partners on taxable income attributable to PE.
  - Canadian corporate taxpayers who meet LOB tests are also subject to branch tax @ 5% (under treaty).
- In general, no withholding tax due on any distributions from U.S. LP.
Hybrid Southbound Structure

Canadian resident and non-resident individual and corporate owners

Canadian Ltd. Partnership

Entity is passthrough for Canadian but not for U.S. purposes

U.S. Corporation
U.S. Inbound Tax Results and Issues

- U.S. Corporation income is taxed at corporate rates.
- Dividend from U.S. Corporation to Canadian LP is subject to U.S. withholding tax.
  - Owners of Canadian LP derive dividend income from U.S. Corporation under Article IV, par. 6. They must separately be examined for Canadian residence and qualification for benefits under Article XXIX A (LOB).
    - A qualifying person has a dividend w/h rate of 5% if it is a corporation indirectly owning 10% of U.S. Corporation;
    - Any other qualifying person has a dividend w/h rate of 15%;
    - A non-qualifying person or non-Canadian resident has dividend w/h rate of 30%, but could possibly qualify under U.S. treaty with his/her residence country (if other than Canada).
Q & A?
Notice

• This presentation and these slides are merely informational and educational in nature. They are summary in nature and mainly designed to assist in issue spotting.

• They are not a substitute for professional legal or tax advice.

• The information contained herein may be qualified or subject to exceptions that are neither mentioned nor discussed in the presentation or slides, due to time limitations.
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