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The U.S. TAXFACTS

***Kotler van den Brink & Company** has been providing US and cross-border (Canada-US) tax consulting and compliance services to accounting and legal professionals since 1988.*

This edition of the U.S. TAXFACTS will discuss state level issues that may impact a Canadian company doing business in the United States.

NEXUS

As U.S. state governments look to mitigate ever increasing budget shortfalls, they are increasingly, and aggressively, looking to Canadian entities with business activities in their state as a potential source of tax revenues.

We have previously discussed that a Canadian company will often be protected from U.S. federal tax under Articles V and VII of the Canada - U.S. income tax treaty, in that the company must have a permanent establishment or fixed place of business in the U.S., before it will be subject to federal tax. We have also noted that it is very important to understand that the treaty is a *federal* document, and that the states are under no requirement to adhere to its rules, some states do, but many do not. This can often lead to is a Canadian company being subject to U.S. state tax while exempt from U.S. tax at the federal level.

In order for a state to tax an out of state company, the company must have "nexus" in that state. Nexus occurs where an out of state taxpayer has a sufficient level of business contact with, or derives a sufficient level of economic benefit from, a state such that the state is constitutionally permitted to tax under the commerce clause of the U.S. constitution.

There are a myriad of ways to create nexus with a state, with each state setting its own threshold as to the degree of activity that might render a company taxable. A company will likely have nexus with a state if it does any of the following in a state:

- opens an office
- installs, delivers, or repairs products
- accept deposits or performs credit checks
- stores inventory even if this inventory is stored in a public warehouse
- attends more than one trade show in a state

The list goes on and on, and varies depending on the state.

If a company has Nexus with a state, the next step is determining how that particular state will tax in-state sales. Unfortunately, this is another area where each state differs. Forty-four states levy a corporate income tax with rates ranging from 4% (North Carolina) to 12% (Iowa). Nevada, Ohio, Texas and Washington impose gross receipts taxes instead of corporate income taxes. Only two states, South Dakota and Wyoming do not levy a corporate tax of some sort. In most cases, where net income is taxed, states are now apportioning income to their state based on state source sales relative to worldwide sales. To add complexity to an almost overwhelming system, many states also impose specific taxes unique to their state, ranging from replacement taxes (Illinois) to surtaxes (Kansas) to business & manufacturing taxes (Massachusetts), to capital taxes (New York) and beyond.

ECONOMIC NEXUS

It used to be that some form of physical contact with a state was required to establish nexus. In 2012 California changed the rules by expanding their definition of doing business to include an “economic nexus” concept. Many other states have now followed California’s lead and have adopted their own versions of economic nexus.

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Economic nexus legislation allows a state to tax an out of state business with a sufficient level of sales to in-state customers even if it has no physical presence in the state. Where a state adopts an economic nexus principle, a Canadian company could find itself with a potentially significant state tax liability despite never having set foot outside of Canada.

As an example, California will assert that a foreign company has nexus with California where sales to California customers during a fiscal period exceed more than $547,711 (2017) or more than 25% of total revenue.

SALES & USE TAXES

Often when a cross-border business does consider state level taxes it is income taxes that come to mind, rather than the potential exposure associated with sales taxes. Depending on the nature of the business, the potential for costly exposure may rest more with sales taxes, given that sales taxes are applied on gross sales rather than on net income.

The good news with sales taxes is that states are still bound by the 1992 U.S. Supreme Court case of *Quill v. North Dakota*, which requires that a taxpayer have a physical presence in a given state before that company is required to collect sales taxes.

That being said, states will often find creative ways to impute physical presence to an out of state taxpayer. Take for example "click-through nexus" sometimes called the Amazon tax. Click through nexus provides that if an in-state business with a physical presence has a link on their website to an out of state seller's website, and a customer "clicks-though" the in-state sellers website to make a purchase from the out of state seller, for which the in-state seller receives a commission, click-through nexus will impute a physical presence to the out of state seller, and require that they collect sales taxes.

A common misconception with sales taxes is that they are only applied on the sale of tangible goods. While this is generally true, there are an ever increasing number of states that apply sales taxes to certain types of services (e.g. construction and repair services). Another big push by states is to tax online transactions such as the delivery or license of pre-written software (e.g. Washington and Texas).

STATE TAX PROBLEMS…

We are often contacted by companies who have been doing business in the U.S. for a long time and have not complied with any state obligations. Many of these companies clearly have nexus with a particular state. The question invariably asked is how will the state ever find out about them and what can they do now about past noncompliance?

Our answer to this question is that it depends on a variety of factors most importantly being which state is being considered and what is the level of continuing activity. If there are significant ongoing sales to a state such as California and/or inventory is being stored in that state, it is likely only a matter of time before the company receives a notice from the state. Often this notice is triggered because a California customer is required to request certain information from non-resident suppliers or service providers and this information is being forwarded to the state.

The good news for companies that have not complied with past state tax requirements is that most states now have voluntary disclosure programs (“VDP”) whereby penalties are abated and the number of prior years’ required to be filed is restricted. These programs are only available if the taxpayer files before being contacted by the State’s tax authorities. We have found these VDPs to be very helpful in limiting the state tax exposure for our clients.

What the future holds with respect to state taxes is anyone’s guess. Many U.S. industry groups have spent years unsuccessfully lobbying the federal government to introduce legislation that would simplify the taxation of multistate businesses. Instead of simplification, the states seem to be heading in the other direction and are looking to nonresident companies (who do not vote in state elections) as a potential source of revenues to cure their often profligate spending habits.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained within this edition of the US TAXFACTS