

Canadian outfits should look at U.S. state taxes too



**ACCOUNTING
ISSUES**

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Many Canadian companies have considered expanding their businesses across the border into the United States over the years but have hesitated due to the relatively weak value of the Canadian dollar.

Times have changed, however, and the weakening of the U.S. dollar has prompted many Canadian companies to reconsider expanding into the United States.

After working through the myriad of Canadian and U.S. federal tax laws and the U.S.-Canadian Income Tax Treaty, Canadian companies and their advisers should take a careful look at yet another area: state taxation.

According to a report published annually by Ernst & Young in conjunction with the Council on State Taxation, businesses paid \$577 billion in state and local taxes in fiscal 2007. This not only includes corporate income taxes, but also non-income-based taxes such as property taxes, sales and use taxes, excise taxes and countless others. There are a number of important state tax considerations that Canadian businesses need to be aware of in order to minimize potential tax exposure with the states.

The nexus net

First and foremost, states are not bound by the U.S.-Canadian Income Tax Treaty, which means that a state can impose taxes on any business that has nexus in its state.

Nexus is the minimal connection or link necessary between a state and a business the state seeks to tax. While the U.S. Constitution and federal tax law protect businesses involved in interstate commerce from taxation by multiple states, this protection applies only to state income taxes when a business' activities within a state are limited to soliciting sales for tangible property (sales of intangible property or services are not protected). Additionally, federal protection does not apply to other taxes imposed by a state, such as sales and use taxes or any non-income-based tax, such as gross receipts or capital-based taxes. Nexus thresholds for these types of taxes are minimal and can be met simply by visiting a potential customer.

Nexus-causing activities include operating business locations (for example, a sales office or warehouse), having resident employees or sales representatives, maintaining inventory, or engaging independent contractors to make sales or service calls in a state.

Historically, some measure of physical presence has been the trigger for nexus and, therefore, state taxation. However, in recent years, the advent of electronic commerce has made physical presence unnecessary for many businesses.

States have quickly realized that they are losing revenue on untaxed sales by remote sellers and have aggressively begun looking for ways to impose nexus on out-of-state or foreign businesses generating sales in their state. They are enacting legislation that will create nexus for businesses that don't have physical presence in the state based on the activities of affiliates or "related" parties.

States have the technology too

States are also utilizing a number of enforcement tools to identify unregistered businesses operating in their states. As businesses use the Internet and other technological advances to expand into new markets, states have similarly begun using technology to identify unregistered taxpayers.

For example, when a company registers with a state to withhold employee payroll taxes, information from that state's payroll tax database is cross-referenced against databases maintained by the state's income and sales-tax departments to determine whether the company is registered for other state taxes. If not, the company should expect an inquiry from the state directing them to register.

State auditors are also using the Internet to review business Web sites to determine a taxpayer's office locations (including sales-representative offices), the locations in which they are selling their products, who their customers are and what types of services are performed at customer locations. Even federal agencies such as the U.S. Customs Department share inbound duty information with states.

When officials believe an unregistered seller is doing business in their state, they typically send the company a nexus questionnaire. The questionnaire is usually several pages long and contains questions regarding the in-state activities of the business.

Extreme caution should be used when responding to these types of questionnaires, as any positive answer will usually lead the state to claim that the company has nexus. The questionnaire should be completed by someone who knows the business, especially the scope of the business operations within the state in question. It is almost impossible to avoid responding to the questionnaire, as the state will continue to generate progressively stronger requests until a response is received. If the state has not received a response after several attempts, it will simply issue a jeopardy assessment, which is the state's calculation of the tax they think the business owes, plus interest and penalties.

Proactive measures

If you believe that your business has nexus in a state and you have not already been contacted by that state, there are a number of options available to bring your company into compliance with state tax laws.

Most states offer voluntary disclosure programs whereby a business can come forward anonymously through a third party and negotiate a settlement of its past-due liabilities. These programs typically feature limited look-back periods and offer other inducements (such as no penalties) to encourage businesses to voluntarily come forward. Additionally, states periodically offer amnesty programs, which are similar to voluntary disclosure programs but are only available for a limited period of time. Simply registering with the state is not a good option if the company has been doing business in the state for a number of years, as registering may prompt questions about the company's activities prior to the date of registration.

While there appear to be many potential state-tax pitfalls, careful planning can reduce the risk of unpaid tax liabilities. If a potential liability already exists, taking action before the company is contacted by a state will generally yield a more favorable result. Even when the burden of compliance seems overwhelming, a strategic plan can be implemented to bring the cost and burden of compliance under control.

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