

## *Tax Advisory Bulletin*

**Date: November 2008**

**Re: U.S. State Taxes for Canadians Doing Business in the U.S.**

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If you are a company that generates U.S. source income, you need to be aware of certain U.S. state tax issues. This tax advisory highlights some recent developments in this area.<sup>1</sup>

Where U.S. related activities are minimal, a Canadian company may not be considered to be carrying on a U.S. business under U.S. domestic rules. In this case, the company would not be subject to U.S. federal income tax. In other circumstances, the Canadian company may be considered to be carrying on business in the U.S. In these cases, the Canada-U.S. Tax Treaty ("Treaty") provides that these companies will not be subject to U.S. federal tax unless the Canadian company has a "permanent establishment" ("PE") in the U.S. In many situations, Canadian companies can arrange their affairs to ensure that no PE exists in the U.S. In these cases, certain U.S. filings may have to be filed with the federal U.S. tax authorities. These filings require the Canadian companies to disclose their reliance on the PE exemption contained in the Treaty.

The problem, however, relates to U.S. state taxes. Individual states in the U.S. are not bound by the Treaty. Each state has its own set of tax rules. Many Canadian businesses may therefore be subject to tax in one or more states as a result of business activities in those states. To further complicate matters, different states apply different rules as to what constitutes taxable business activities (or "nexus") within the state. Common activities that may create sufficient nexus may include bank accounts, collection activities, trade shows, certain drop shipment arrangements, consigned inventory, contracted service agents and installation work. While these activities alone will not normally create a PE for U.S. federal tax purposes, they may create a U.S. state tax liability.

Related issues also arise from a Canadian tax perspective. If state income tax is levied, the tax may be claimed as a foreign business tax credit against Canadian income taxes. However, the small business tax rate would not apply to the same income in Canada. Also, if U.S. state tax is levied at a time when the taxation year is statute barred in Canada, no relief would be available in Canada.

In addition to income taxes, the states are also looking to increase their sales tax revenues. A Canadian company that sells to a U. S. state and has some physical presence or nexus in the state, will generally be required to register and collect sales tax in that state. The activity threshold to have

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<sup>1</sup> We are not U.S. tax advisors. The comments contained herein are intended to be general in nature. To that extent that any of the issues noted in this summary apply to your circumstances, U.S. tax counsel should be consulted in order to properly address a particular situation.

a nexus for sales tax purposes appears to be lower than the threshold for income taxes. Sales calls and employee visits themselves may create this nexus.

The state authorities have also become better and more imaginative at identifying out-of-state taxpayers. The states are now looking at customs documentation, traffic tickets for vehicles registered to out-of-state companies and, of course, vendor listings for out-of-state vendors, which are easily obtained during the course of audits of local businesses. In terms of collection, the states can seize property such as inventory or equipment physically present in the state.