Grant Thornton

A pinch of SALT:
Do I need to file state and local tax?

If you're confused about whether your Canadian business needs to pay US state and local taxes (SALT), you're not alone. After all, each of the 51 states (counting Washington, DC) has different tax rules, tax regimes and tax rates—creating some real compliance challenges.

The key is to take a proactive stance to your SALT obligations. Grant Thornton can help. In this article, we set out a high-level state tax roadmap for determining your filing obligations, and we invite you to contact us to discuss how these complex rules may apply to your business in particular.

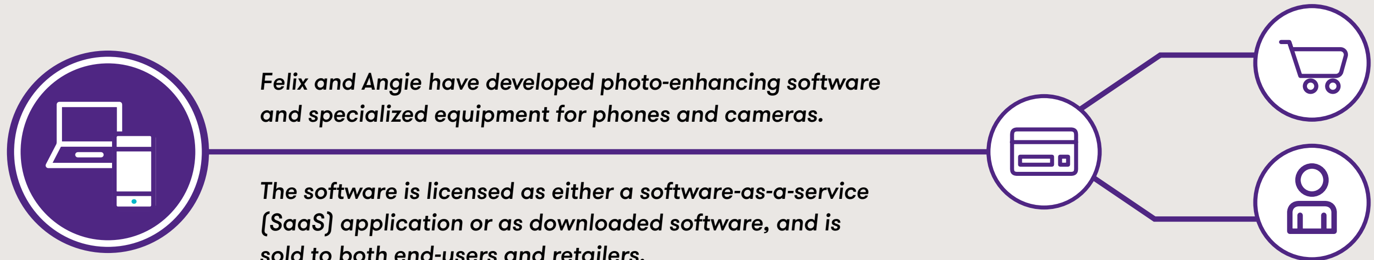
The good news is, if selling into the United States, some up-front planning can help manage tax compliance and effective tax rates. The bad news is that ignoring your SALT obligations can expose your business to penalties and interest that keep accumulating the longer you leave it, which ultimately negatively affects your financial statements. Certain SALT-exposures can be passed on as a successor's liability to anyone who acquires or inherits your business, leaving the new owner with unaddressed tax liabilities and reducing the value of your company. It can also leave you out-of-pocket by requiring you to pay sales tax that you owe for prior periods, even if you never collected it.

If you're entering into or growing in the US market, the best way to protect your business is by gaining an understanding of US SALT rules. A couple of highlights to note: First, by filing your state income taxes on time, you can generally claim those paid taxes as a foreign tax credit on your Canadian return—avoiding double taxation. Second, by voluntarily repaying any unaddressed tax exposures from previous periods, instead of waiting to get a notice from a state, you may even be able to catch up on unpaid taxes without paying penalties. We will expand more on these topics in future articles.

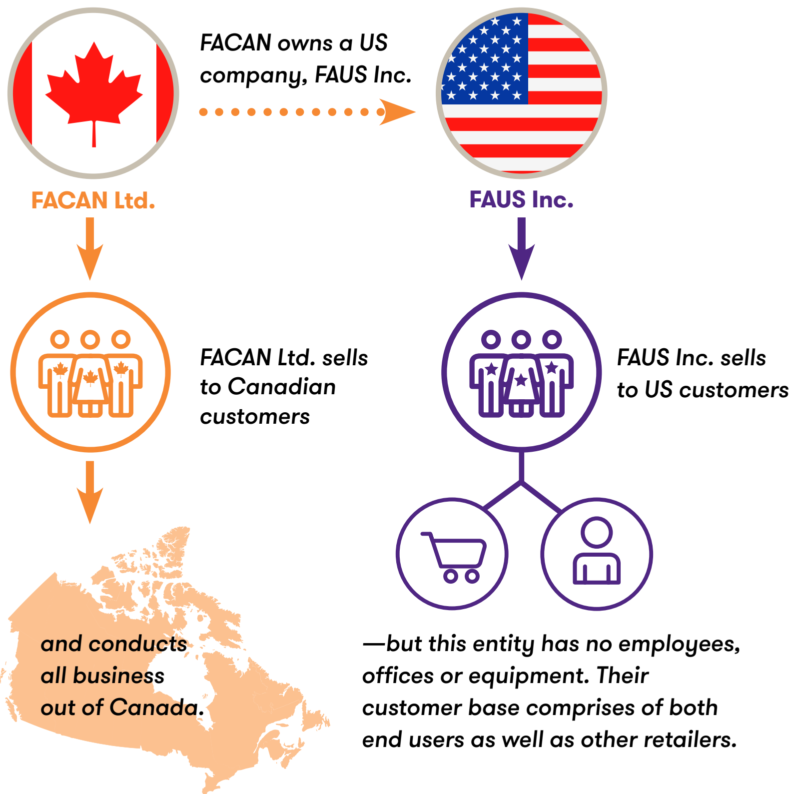
Do you owe state and local taxes?

Before you can determine if your business is responsible for US state and local taxes, you first need to understand when you have nexus, what it means to have a taxable presence and whether you owe any taxes.

To help make it real, let's consider the case of Felix and Angie.



Felix and Angie own a Canadian company, FACAN Ltd.



Over the past eight years, FAUS has made annual gross sales of approximately

$800,000

in Texas and New York, and

$400,000

in California

FAUS also has an independent contractor soliciting sales in Texas and California, but no other presence in the United States beyond that.

To determine if they have SALT obligations and, if so, how to address them, Felix and Angie need to know if they have nexus in any of the states where they do business.

What is nexus?

Although you may think of nexus as a card that lets you skip long security lines at the airport, in the world of SALT, nexus actually refers to the connection between a state and a business. If your business has nexus (or, in other words, a minimum connection) to a particular state, it's considered to have a taxable presence in that state and will be required to file a tax return. Nexus comes into play when out-of-state companies, or other legal persons make sales into, or otherwise do business in, a particular state. For Felix and Angie, this means that FACAN and/or FAUS may have nexus in Texas, New York, and/or California.

The states' taxing powers are limited by the US Constitution, which says states can't impose taxes in a way that discriminates against out-of-state businesses. There are also federal laws and court cases that set out further parameters on what states can and can't do with their taxing powers. Despite this, it's generally understood within the SALT community that the states can—and do—exercise their sovereign powers to the greatest extent possible when it comes to taxation.

As a result of the states' broad taxing powers, the definition of what constitutes nexus differs from state to state. Yet one rule holds true: no state (or Washington, DC, which we count as a state here) is bound by any tax treaty entered into by the federal government and other countries. That means the Canada-US Income Tax Treaty (the Treaty) has no bearing on state taxes unless a state voluntarily chooses to follow its rules.

Even if a Canadian company doesn't have a permanent establishment (PE) for federal tax purposes, it can certainly have nexus for state tax purposes. Generally speaking, under the Treaty, if your business sells into the United States but you don't have a PE, you don't have to report US taxable income; you just have to file an information return with the IRS claiming Treaty-benefits. Under state law, however, you may owe taxes even if you have no PE.

To further complicate matters, nexus definitions not only differ between states, but also within states. For example, the same state will often have one set of nexus rules for its business taxes and another set of nexus rules for its sales and use taxes. Counting 51 states, that means you need to keep track of 102 sets of nexus rules to determine if you're required to set up US compliance processes, file state tax returns and potentially pay taxes in the jurisdictions where you do business or generate revenue.

You don't need a physical presence to owe state and local taxes

A lot of businesses assume they're exempt from state and local taxes if they don't have a physical presence in the United States. That's because nexus without physical presence is a new development and often catches businesses off-guard.

Before a state can require a foreign business to file a tax return, there needs to be a minimum contact and substantial nexus between the business and the state. Traditionally, this has been interpreted to mean that a foreign business must have a physical presence within the state. This generally means having people or property within the state, either permanently or temporarily. Renting office space, storing inventory or employing people within the state are great examples. Physical presence nexus can also be established if out-of-state employees, independent contractors or agents visit the state for business purposes. There are typically no bright-line tests for how many days of visits will satisfy a minimum contact with a state, so it's always a good idea to keep a travel log.

More recently, however, the concept of "economic nexus" has evolved to encompass new standards. Economic nexus looks at intent to assess if a company is directing efforts to exploit a state's economic market. In simple terms, this means that if your business has intangible property used in the state, or sells services or products into the state remotely, it may be considered to have nexus in that state even if it has no tangible physical presence there. Under this test, it's enough to have intangibles used within the state, or to be above a certain sales volume threshold, to have nexus.

On the plus side, there is limited protection. A federal public law passed in 1959[1] says that, if certain criteria are met, a business does not have nexus even if it has met a state's statutory nexus standard. Given the vintage of the law, however, it should come as no surprise that it generally only applies to out-of-state sellers that enter the state to solicit sales of tangible personal property, not services or intangibles. Three additional important points:

1. this law only protects against net income taxes;
2. not all states extend this protection to non-US businesses; and
3. states are not consistent about whether software, SaaS or other technologies fall within the definition of "tangible personal property".

So a business employee soliciting sales of SaaS could be protected in one state but not another, depending on the state's specific definition of tangible personal property (if any).

What does this mean for Felix and Angie? Because they separated their business geographically, FACAN has no sales or physical presence in the United States—so there shouldn't be nexus for their Canadian company. However, that's not the case for FAUS.

For state income tax purposes, even though FAUS is below California's economic nexus sales threshold of $500,000 (annually adjusted for inflation), it has physical presence nexus in California through the independent contractor soliciting sales there. Additionally, the federal law likely doesn't protect FAUS from nexus in California because the state doesn't define electronic access to software as tangible personal property.

1 P.L. 86-272

The same is true in Texas. Texas doesn't have a nexus sales threshold standard for its business tax,[2] but FAUS utilizes independent contractors in that state which attributes nexus to FAUS. FAUS is below the $1,000,000 sales threshold in New York, so it shouldn't have income tax nexus there since it otherwise doesn't have any physical presence in the state.

The impact of Wayfair: Remote sales volumes matter for sales and use tax

Although physical presence within a state isn't necessary to establish nexus for business tax purposes, up until June 2018, it was necessary to establish nexus for sales and use tax purposes. That all changed with the case of South Dakota v. Wayfair, Inc. where the US Supreme Court declared that the physical presence requirement is outdated—giving states the ability to impose economic nexus standards for sales and use taxes as well. Many states celebrated by quickly passing nexus laws aimed at foreign sellers. Now, over 40 states have "Wayfair-nexus" rules currently in, or about to come into, effect.

Similar to the economic nexus standard for income tax purposes, Wayfair-nexus looks at a remote seller's sales and/or transactional volume in a state—but the standards for the two tax types are not the same. While state laws in this area are still evolving, the general Wayfair-nexus standard appears to establish nexus if sales into a state exceed $100,000 or more than 200 transactions within a 12-month period. There are many state-specific permutations to this standard. For example, some states don't have a transactional threshold, some only count retail sales and some only count sales of tangible personal property (which may or may not include access to software, depending on state definitions). Clearly, the administrative burden has skyrocketed to stay compliant with all these rules, but keeping track of sales into each state is a good start.

Notably, triggering nexus for sales and use tax purposes doesn't only come with the obligation to file a tax return. It also requires the collection and remittance of sales tax. If tax isn't collected, your business could be out-of-pocket for the sales tax in the event of an audit if you can't recoup it from previous customers.

FAUS NEXUS	CALIFORNIA	NEW YORK	TEXAS
Income/ business tax	✓	x	✓
Sales and use tax	✓	✓	✓

Felix and Angie need to pay attention to these sales and use tax nexus rules too. The independent contractor in California establishes nexus for FAUS in that state for sales and use tax purposes, even though its sales are below the $500,000 Wayfair-nexus threshold. Its sales are also above the $500,000 threshold in Texas and New York. That means FAUS has nexus for sales and use tax purposes in all three states where it generates revenue, requiring it to collect and remit sales tax in each state and to file the appropriate returns.

2 As this article was being published, Texas announced a proposed nexus sales threshold of $500,000 for its business franchise tax. If proposed amendments are adopted as final, this new nexus standard will be applicable to Texas franchise tax reports due on or after January 1, 2020.

Taking SALT seriously

The US market represents a significant growth opportunity for many Canadian businesses, but it may also trigger unanticipated tax consequences. That's especially true as the Canada-US Income Tax Treaty doesn't exempt businesses from state and local tax laws. If your company has any type of nexus with US states, you may need to file business tax and/or sales and use tax returns, collect and remit taxes on your sales to state and local tax authorities.

We continually monitor legislative changes, industry trends and economic policy to support the business community and are committed to providing you with the most up-to-date advice so you can grow with confidence. We can help you assess if you have SALT obligations in any US state and work with you to access relevant voluntary disclosure programs that may allow you to remit outstanding taxes without penalty. Additionally, our team can assist and support with related Canadian sales tax issues and concerns.

To understand how these complex laws may affect your business, contact our SALT specialist Sophia Nilsson, or your Grant Thornton advisor.

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