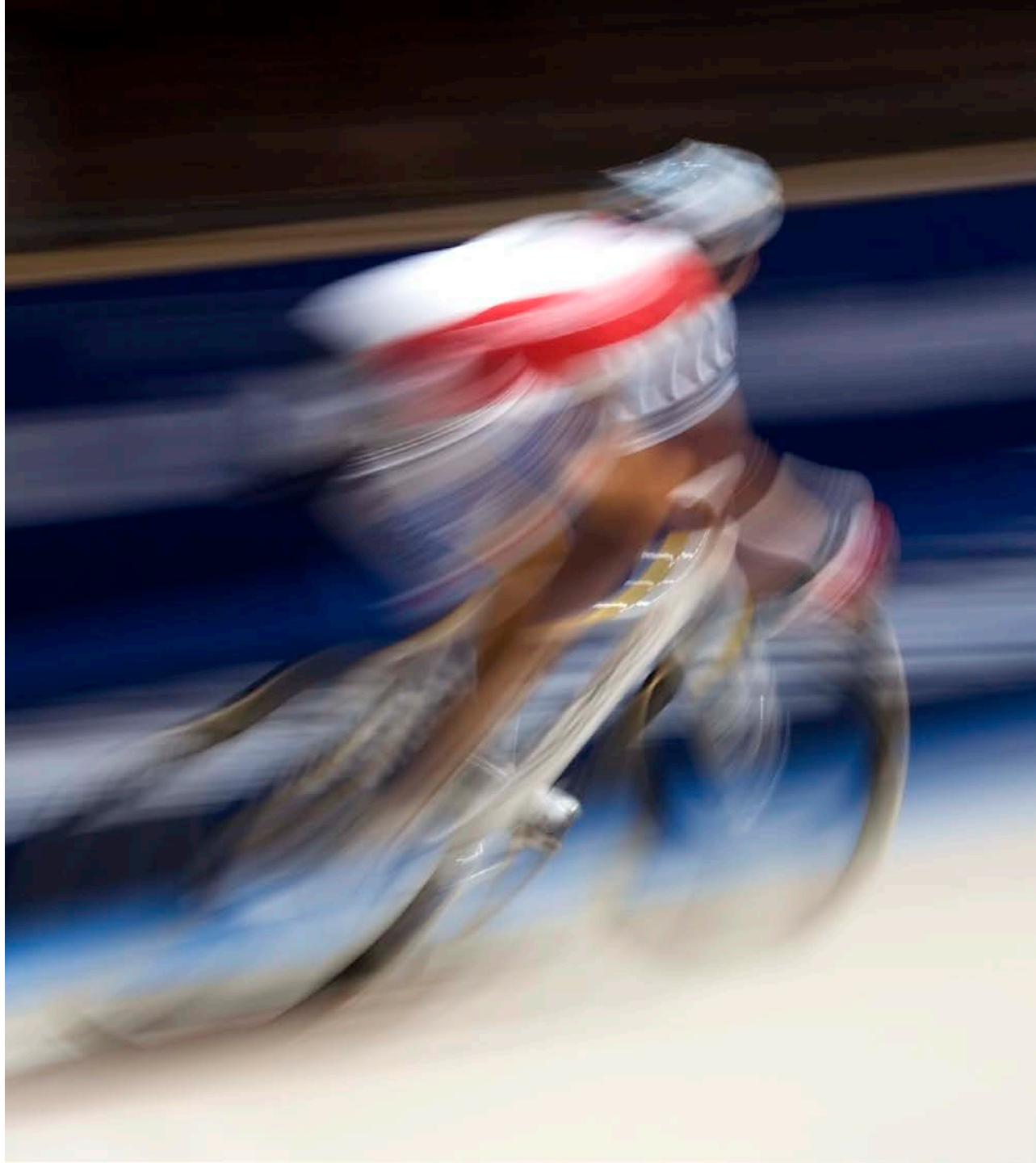




# U.S. State and Local Tax Planning and Issues for Canadian Multinationals

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# Agenda

Contrasting U.S. Federal vs. State Income Taxation

Triggering U.S. Federal taxability in the United States

Role of the Canada/U.S. Income Tax Treaty

Jurisdictional issues

State Tax base

Filing methods and apportionment

State Sales and Use Tax

# Contrasting U.S. Federal vs. State Income Taxation

## Some common misconceptions

I'm protected by the U.S./Canadian Treaty. I don't have to pay tax in the U.S.

I'm not really doing business in the U.S. I sell product/services there, but all title passage occurs in Canada

The states are somewhat the same in taxing my company right?

# Federal tax refresher

## Triggering U.S. Federal taxability in the United States

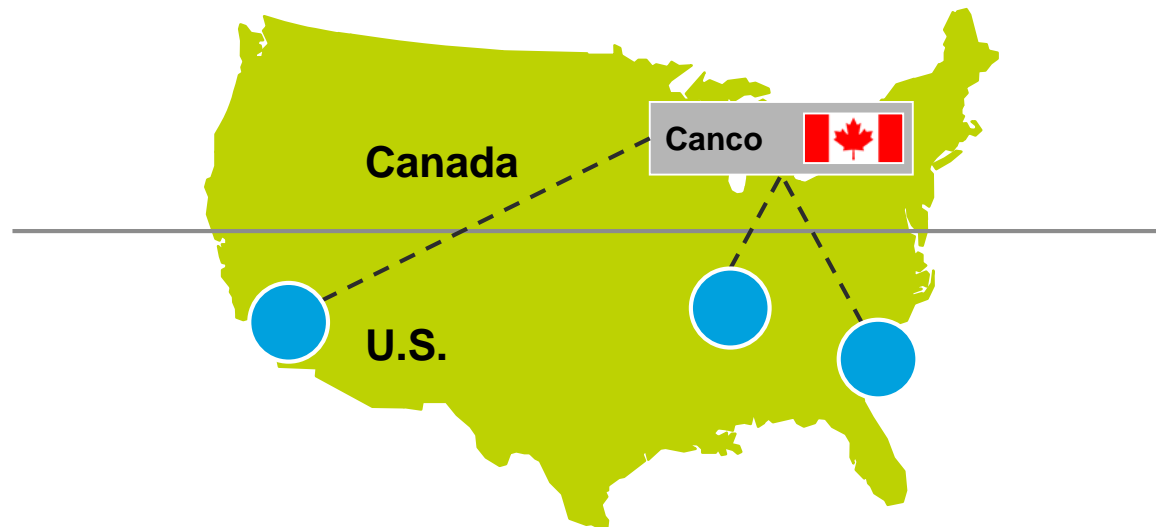
# The conduct of a U. S. trade or business

## Key concepts

Regular, continuous and considerable

Context matters

Agency



\* Triggers a tax return filing obligation \*

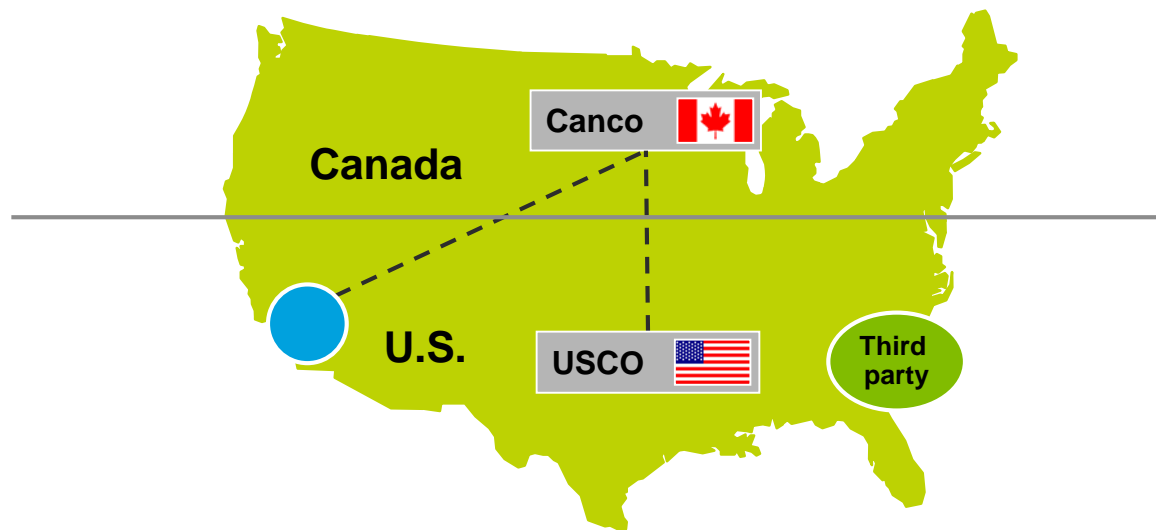
# Agency issues

Employees

Dependent agents

Independent agents

Partnerships, trusts and estates



# The “other” type of U.S. income

**F**ixed

**D**eterminable

**A**nnual

**P**eriodic

Income not connected with  
a U.S. business (but can be)

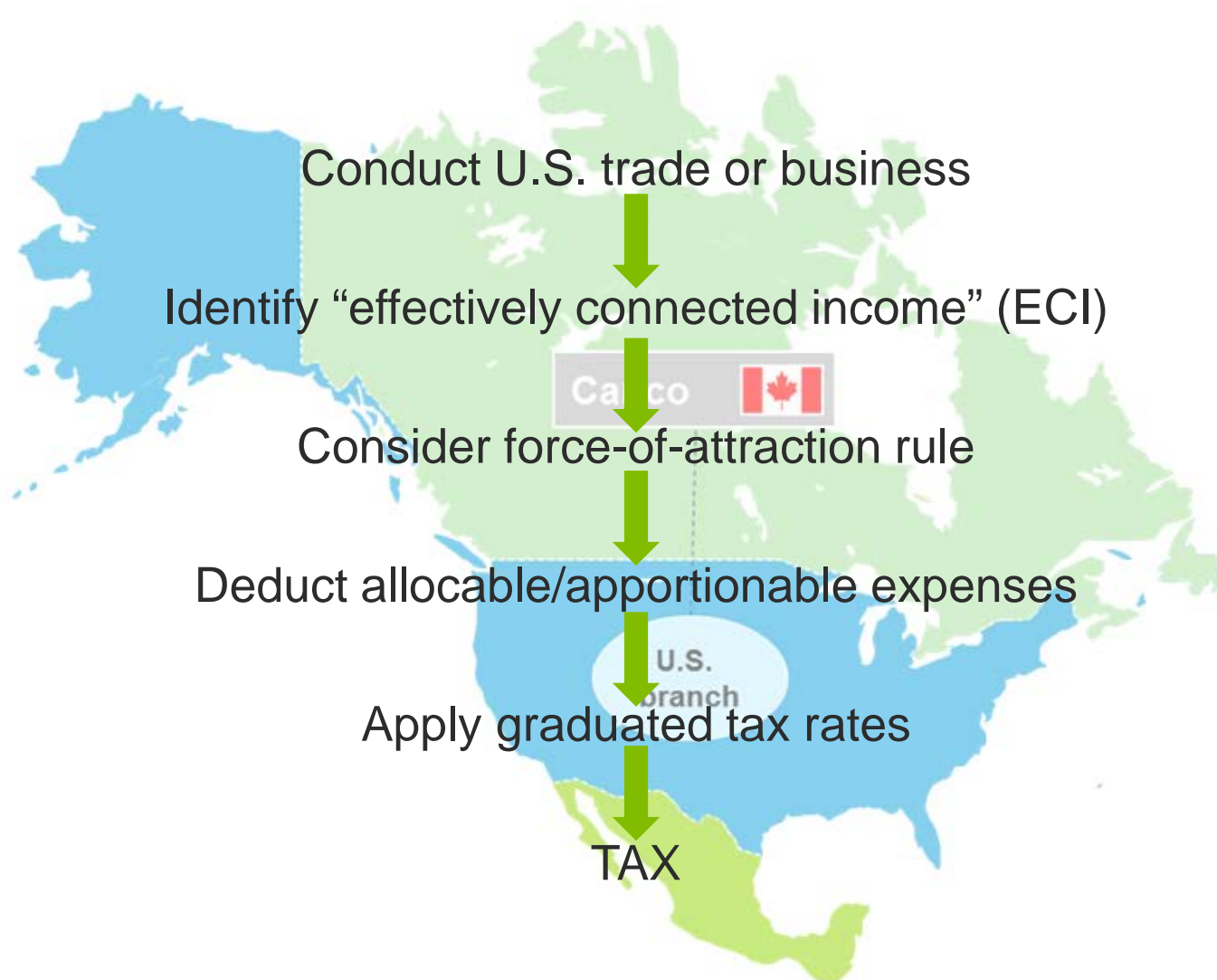


**Gross basis taxation**



**30% tax rate**

# Determining taxability (without treaty)





# Federal tax refresher

## Role of the Canada/U.S. Income Tax Treaty

# Permanent Establishment (PE)

“Fixed place of business”

- Place of management
- Branch
- Office
- Factory
- Workshop
- Mine, oil well or gas well, quarry, etc.

Agency and authority

Services PE

# Permanent establishment exemptions

Building site or construction or installation project (time limits apply)

Facilities for the storage, display or delivery of goods

Maintenance of goods or merchandise for the above, or for processing by another

The purchase of goods or merchandise or collection of information

Advertising, the supply of information or scientific research

# Permanent establishment – common concerns

Executive mobility

The Canadian contract “rubber stamp”

The home office

Computer servers

# State Income Tax

Jurisdictional  
issues



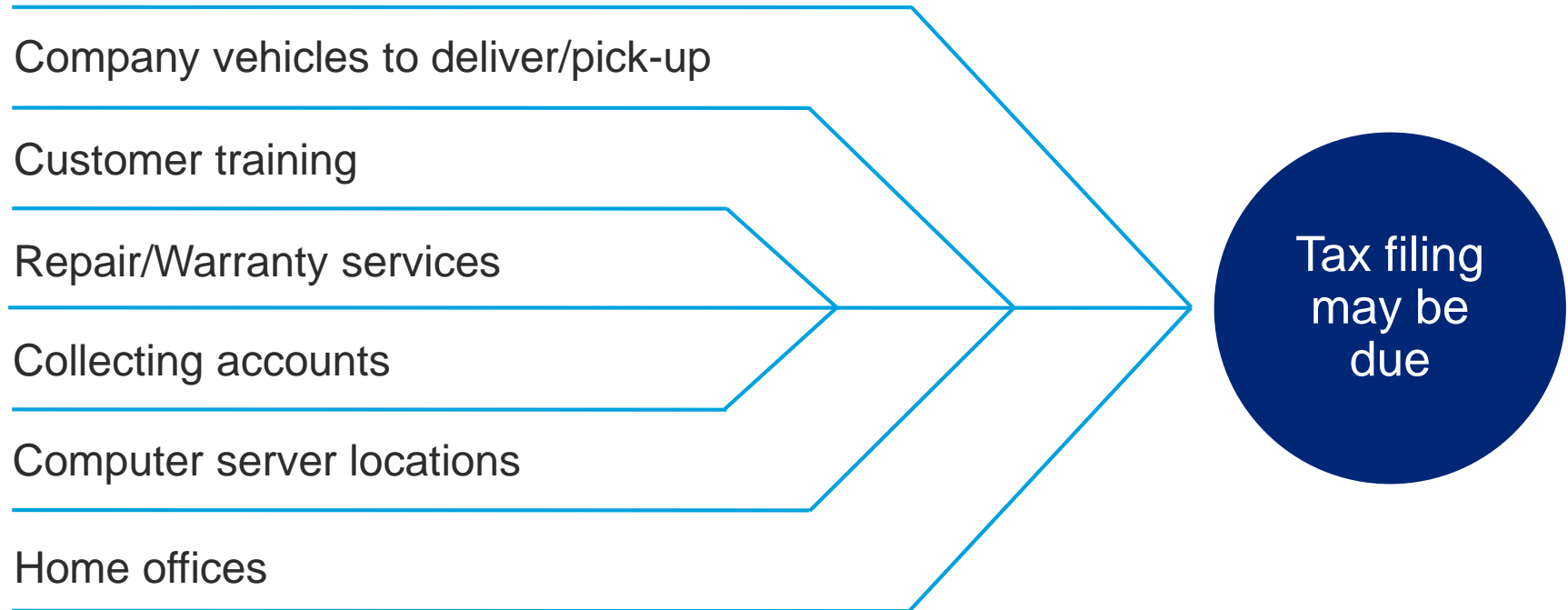
# State Income Tax

## Jurisdictional issues

- Treaty provisions generally do not apply to the states (unless the states voluntarily apply them)
- States generally do not conform with federal permanent establishment rules
  - Employees or property in state generally creates nexus
  - Economic nexus
  - Factor presence nexus
- States have jurisdiction to impose on corporations meeting substantial nexus standards an apportioned income tax that does not discriminate against foreign commerce
- Does P.L. 86-272 apply to foreign commerce?
  - Most states appear to apply P.L. 86-272 to foreign corporations
  - California says: “No”. *Dresser Industries, Inc.*, SBE, 82-SBE-307, June 29, 1982, reh’g denied, October 26, 1983. CA Reg. Sec. 25122(c)

# State Income Tax

## Jurisdictional (Nexus) concerns



# State Tax base



# State Tax base

## Selected items of note – starting point

Many states start with federal taxable income as the starting point for computing state taxable income

- Federal taxable income takes into account the concepts of ECI and PE where a treaty applies
- Without a modification, foreign corporations with no federal taxable income reported on Form 1120F arguably have no state taxable income (but may have minimum tax obligations or net worth tax obligations)
- Some states use ECI as a starting point, but don't respect treaty exemptions
- Without modification, income reported on Form 1120F is generally limited to income earned in the U.S., not worldwide income
- Some states explicitly require worldwide income computations without regard to limitations on taxable income under the IRC or treaties

# State Tax base

## Selected items of note – related party expenses

Generally, a requirement in many states to add back otherwise deductible expenses that arise as a result of certain related company transactions, unless an exception applies, such as if the related member is subject to tax in another state or foreign country

- Commonly applies to related party interest and royalty expenses
- Treaty exception
  - May be part of “subject to tax in another state” exception
  - Some states merely require that payee be located in a treaty country
  - But see “tax haven” discussion in next section
- Generally, a “comprehensive income tax treaty” may be defined as
  - “A convention or agreement, entered into by the U.S. and approved by Congress, with a foreign government for the allocation of all categories of income subject to taxation or the withholding of tax on interest, dividends, and royalties for the prevention of double taxation of the respective nations’ residents and the sharing of information.” – See e.g., GA Code Ann Sec. 47-7-28.3(a)(1)

# State Income Tax

## Filing methods and apportionment



# Filing methods

- Worldwide combined reporting
  - Held constitutional in Container and Barclays Bank, but no state requires worldwide combined reporting without providing water's-edge election
  - However check “default” filing method
  - Could require a conversion of all global income into U.S. federal tax basis with appropriate state modifications
- Water's-edge reporting
  - Elected in several states (e.g., California, Idaho, Massachusetts, Utah)
  - Required in many states (e.g., Illinois, Michigan, Minnesota, Wisconsin)
  - Some states exclude all foreign corporations from their unitary returns filed on a water's-edge basis; however, many states still include foreign corporations under certain circumstances

# Filing methods – foreign entity inclusion

- Some typical rules for inclusion of foreign entities
  - May be included if it is subject to federal income tax or required to file a federal income tax return
  - May be included to the extent of its ECI
  - May be included to the extent of its FDAP income
  - May be included to the extent that 20% or more of its activity is within the U.S.
- Some states will look at the average of the corporation's property and payroll factors (other states may use all three factors)
  - Another approach is whether the corporation has less than 80% active foreign business income

# Filing methods – foreign entity inclusion (cont'd)

- Some states are also including a foreign corporation in the group if it is incorporated or doing business in a “tax haven” jurisdiction
  - In AK, a tax haven jurisdiction is a country that does not impose an income tax, or that imposes an income tax at a rate lower than 90% of the U.S. rate
  - In DC, the definition of a tax haven means a jurisdiction that may have one of statutorily enumerated traits
  - In MT and OR, the list of tax haven countries is set forth by statute and is updated as necessary
  - In WV, the list of tax haven countries is based on the OECD tax haven designations
  - In RI, special tax haven rules effective January 1, 2015
- Perhaps the states are ahead of the international community in the BEPS effort?

# Apportionment

- Overwhelming trend towards sourcing overall taxable income to the state based solely on sales
  - For this purpose, title passage does not matter
  - For tangible property, generally based on ultimate destination of goods
  - For services and intangibles, based on several different methods but moving towards “market” based sourcing
  - Typically only receipts included in the taxable base are included in the sales factor (e.g., could be limited to those making up ECI)
- There are possible wide variations in how the income could be sourced and no requirement that you achieve 100% allocation among the states
- Although still remaining in some states, allocation based on property and payroll is still used

# State sales/use taxes



# Contrasting Canadian vs. U.S. Indirect Taxes

## Some common misconceptions

The states are somewhat the same on taxing transactions right?

I'm protected by the Canadian/U.S. Treaty and/or we don't file income tax returns in the U.S.

My customer will self-assess the use tax so I don't have to worry about it.

# Contrasting Canadian vs. U.S. Indirect Taxes

## Key distinctions

- No input tax credit
- Thousands more tax jurisdictions and rates
- Only one party is taxable, all others must document exemptions
- Character of transaction may matter more since services may not be taxable
- Focused many times on where benefit received not necessarily where title passes or services performed
- Many more possible exemptions if used in business/manufacturing context
- Only about 25% of consumer goods and services and 44% of business inputs are taxed

Most similar to PST regimes in Canada

# Constitutional Nexus

## Quill Corp. v. North Dakota, 504 U.S. 298 (1992)

Held: Physical presence is required

- Quill was a mail-order vendor of office supplies
- Quill did not maintain an office or have any employees in the state and delivered all of its merchandise via U.S. mail or common carrier
- ND asserted that Quill's systematic solicitation in the state through catalogues and advertising flyers created nexus and therefore Quill was required to collect use tax on sales to ND residents
- The U.S. Supreme Court held that although Quill's economic presence in ND satisfied the Due Process Clause "minimum connection test", the Commerce Clause "substantial nexus" test was not satisfied because Quill did not have a physical presence in ND

# Constitutional Nexus

*Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)

Held: It's not just your employees that count

This U.S. Supreme Court case addressed activities of independent contractors, that may create sales tax nexus for a company, requiring it to register and collect sales and use tax from its customers

# Agency Nexus concepts

- Affiliate nexus
  - Nexus asserted for out-of-state entity based on its corporate relationships with one or more related parties (affiliates) in the state or on activities those affiliates may perform on behalf of the remote seller
- Related party nexus statutes
  - Define a seller required to collect tax as someone
    - Who holds a substantial ownership in, or is owned in whole or in substantial part by, a related seller
    - The seller sells the same or a substantially similar line of products as the related seller and does so under the same or a substantially similar business name

# Applying Nexus to your facts

## Common considerations

### Company

- Any employees visit the state - - ever?
- Any offices including home offices in the state?
- Any inventory storage in the state?

### Third Parties

- Any joint venture or channel partners?
- Any in-state representatives to perform your work?
- Any independent salesmen working for you?

### Affiliates

- Any cross promotion of products and services?
- Any fulfilment services on your behalf?
- Do they perform on your contract?

# Sales Tax base

- Most items of tangible personal property are taxable (including software)
- Most services are exempt unless specifically enumerated as a taxable service
  - Examples include information services and data processing
- Numerous exemptions apply such as for non-profits, governmental agencies, research, sales for resale, and manufacturing
  - Definitions and exemptions vary significantly among the states
- Significant new developments surround treatment of SaaS and other technology related services where the states are “catching up” with the speed of business
- Sourcing is generally based on where the product is delivered or benefit received

# Audit administration

## Growing concerns

**Penalties:** The imposition of penalties is becoming automatic and frequently can't be overcome by reasonable cause exceptions

**Exemption certificates:** Quickly finding accurate versions for audit is a challenge without a good system for maintenance

**Tax oversight:** Involving the tax group before the local controller agrees to an audit sample methodology is critical





# Merger & Acquisition activity

## What should you be concerned about?

- Successor liability (stock or asset deals)
- Reserve/Hold back time limits
- Record retention
  - Can you produce an extract from old systems?
  - Invoices, AFEs, PO documents?
- “Casual” or occasional sale rules
- Internal restructurings that may be considered a “sale”

Please remember  
to complete your  
evaluation

# Speaker bios

**Bruce Todd** is a senior advisor leading Deloitte LLP's (Canada) multistate tax practice which includes income and indirect taxes. He operates nationally within Canada serving clients in a number of industries such as technology, manufacturing, services, consumer products, and natural resources. He has practiced in multistate tax for more than 25 years both in the U.S. and Canadian member firms of Deloitte.

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**Dennis Metzler** is the National Leader of the U.S. Tax Services Group for Deloitte & Touche Canada. Since his transfer to Toronto in 1995, Dennis has primarily served Canadian multinational corporations and private equity firms seeking advice on structuring tax-effective investments in the United States. He has extensive experience with income trusts and other cross-border offspring structures that have gained notoriety in Canada, and counseled a wide range of clients on their possible use. Among his clients are many of Canada's most recognized manufacturers, technology businesses, and investment firms.

Dennis has over 28 years of U.S. international tax experience. He spent the first 12 years of his career in Milwaukee, where his focus was primarily planning for U.S.-based multinationals. Dennis was a recognized Firmwide specialist in U.S. tax issues affecting exporters, including DISC/FSC/ETI taxation and foreign tax credit planning. Since relocating to Toronto, Dennis has specialized in U.S. international inbound taxation including debt financing and workouts, treaty utilization and the development of merger/acquisition and repatriation strategies.

Dennis has authored articles on various international tax topics for the Canadian Tax Foundation, The International Tax Journal and other recognized publications. He is a regular lecturer at the firm's advanced international tax schools and conferences, and presenter for Insight, Infonex, CICA, CITE, the Canadian Institute, the Canadian Tax Foundation and The University of Wisconsin-Milwaukee Tax Association.

Dennis received his Bachelor of Science in Accounting (Honors) from the University of Wisconsin Green Bay. He is a Certified Public Accountant (Wisconsin) and a member of both the AICPA and WICPA.

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