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Yet, it is No. 1 destination for expansion plans



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Going global isn't just for big businesses – successful small businesses often look outside Canada for markets to fuel their growth. More than half of the Canadian private companies KPMG Enterprise recently surveyed said foreign operations were important to their companies' overall growth strategy.

For the most part, this means doing business in the United States, Canada's largest and closest trading partner.

Almost 300 of the companies surveyed were already doing business outside Canada or were planning to do so. Of these companies, 88 percent are selling or exporting goods or services into the United States and 79 percent use non-Canadian vendors and distributors in that country. Only 42 percent actually have offices, stores, plants or facilities outside Canada.

Despite the economic downturn, the majority of companies said they plan to expand their presence in foreign markets in the next five years, with the United States being their No. 1 destination.

The companies represented a wide range of industries in all regions of Canada. Two-thirds of the private companies surveyed had annual revenues of less than \$50-million. Three-quarters had fewer than 250 employees.

Canadian companies doing business in the United States need to be wary of the inevitable U.S. federal and state tax consequences. Beside federal and state income taxes, most states and some 14,000 local jurisdictions depend heavily

on revenue from sales and use taxes on the sale and/or use of various goods and services.

Even if companies don't have physical facilities in the United States, like the majority of companies surveyed, they can be subject to one or more federal, state or local taxing regimes. Penalties for non-compliance often exceed 50 percent of the tax due.

To be subject to U.S. federal income tax, a company based outside the United States, generally has to have a "permanent establishment" in the country. Although this includes bricks-and-mortar places of business such as offices and factories, a sales representative or agent can create a permanent establishment if he or she can conclude contracts in the U.S. Recent changes to the U.S.-Canada tax treaty lower the threshold for projects in the U.S. to create a permanent establishment.

Once it reaches the permanent establishment threshold, a non-U.S.-based company will be subject to U.S. federal tax on income effectively connected with that permanent establishment. Such branch reporting can be complicated.

Activities in the United States that do not create a permanent establishment nevertheless can obligate a company to file a U.S. federal income tax return. The company will have to obtain a U.S. taxpayer identification number from the Internal Revenue Service.

States use a similar concept loosely called "nexus" to determine the minimum contact necessary for the state to impose its various taxes on an out-of-state company. Different state taxes can have differing nexus standards. Recently, many states have followed a trend to lower the nexus bar.

An actual in-state physical presence created with inventory or other property as well as by employees, independent agents, representatives or contractors, has been traditionally required for state sales tax nexus. Today, some states, such as New York, assert that some types of virtual presence through the Internet can be enough to create nexus. Also, many states assert that the presence of intellectual property such as a trademark creates nexus for income tax.

Some of the newer state tax regimes, such as those in Ohio and Michigan, even disregard any requirement of an in-state presence but rather focus on out-of-state activities targeted at customers in the state.

State sales-and-use tax compliance can be more difficult and expensive than income taxes given the large number of taxing jurisdictions involved. Fortunately, in some states, one return covers both the state and local sales-and-use taxes. In others, such as Colorado and Louisiana, companies must file local sales and use tax returns independently of state returns.

Once an out-of-state company satisfies the nexus standard for sales and use tax, the burden of collecting taxes on purchasers or sellers of taxable goods and services begins. Noncompliance effectively converts a customer's tax into the vendor's tax.

For all federal, state and local tax regimes, tax returns may be required even if no tax is due. Filing tax returns generally starts the limitation period under which the tax authorities can examine a company's books. Fortunately, Canadian firms can generally credit U.S. federal and state income taxes paid against their Canadian corporate income taxes but the same cannot be said for sales-and-use and other taxes that are not based on income.

Whether Canadian companies are expanding in the United States with their own business or buying other companies, they should consider U.S. federal and state taxes before proceeding. With a market of more than 300 million potential customers, doing business there can be necessary for large or small Canadian companies.

Understanding the federal and state tax compliances that come with that market can mitigate exposure to unforeseen tax traps and contribute to profitability.

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KPMG Enterprise is a network of professionals devoted exclusively to serving the needs of private companies in Canada. For further information about how KPMG Enterprise can help private companies, visit www.kpmg.ca/enterprise.