CORPORATE TAX CENTRE NEWSLETTER SERIES

AMERI-CAN TAX TALK NEWSLETTER

JUNE 2014

AN ANALYSIS OF US STATE TAXATION APPLIED UNDER THE CANADA-US TAX TREATY

Mark Feigenbaum, CPA, CA

When consulting on cross-border taxation we often just analyze federal taxation in both Canada and US. Practitioners typically look at the combined provincial and federal rates in Canada, compare or add it to the US federal rates, and calculate the offsetting foreign tax credits to create a total worldwide tax rate.

An important consideration in any tax analysis is US state taxation. Unfortunately for difficulty's sake, especially if making a quick calculation, there are 50 states and the District of Columbia that each have their own separate set of laws. A normal tax practitioner setting up an office in one of the states probably has most of their clients based in that particular state, so they become quite proficient with state taxation in their individual home state, and maybe a neighboring state or two. A good cross border tax practitioner will need to be somewhat of an expert in most, if not all, of the jurisdictions as clients from Canada may seek advice about operating in many US states.

Let's look at some of the basics in US State taxation. States tax an individual based on residency, and normally on worldwide income. Again, when mentioning "normally", there are 51 separate laws to keep in mind. Residency rules are different than the federal law (183 days based on the sum of: 100% of days of this year + 1/3 days of last year + 1/6 days of prior year) whereas many states have more of a domicile (intent) based test to determine residency.

For non-residents and part year residents of a state, an individual may be taxable to that state if they have a connection to it (a term called "nexus"). That connection varies from state to state, but generally if one is physically present (i.e. standing) in that state when performing a service (or working in that state), renting real property, or selling real property in that state, then there is a connection to that state and one might be liable to state tax even as a non-resident of that state.

The Canada-US Tax Treaty might help mitigate the taxation to the US in some instances. For example, if one performs services in the US for less than 183 days and their salary is paid by a Canadian company, then their income can be elected not to be taxed in the US (Article XV). For state taxation, the states may or may not necessarily follow the Canada-US treaty. In the above example, if the employee worked in Oregon, and made the mentioned Treaty election, they could be exempt for US federal and state taxation. If that same employee worked 5 days in California, they would have to file a California tax return for those 5 days worked, as California is a state (of which there are several) that does not follow the Canada-US tax treaty.

Another interesting difference amongst the states is how any foreign tax credits can be applied. At the state level, "foreign" can mean foreign from Canada and foreign from other states. For a normal situation where a US person lives in the US in a particular state who works or has nexus to another state and pays tax to that state would generally get credit to that home state, but there are limitations to that credit, and there are sometimes special deals between neighboring states or tri-state agreements which need to be considered.

There are some selected states which have some unique credit computations that need to be considered when doing any analysis for clients who have nexus to any states. Again, each of the 51 jurisdictions has their own manner to compute tax, it is not just as simple as finding out the rate and adding it on to the federal rate. Also, consider that state taxes are deductible for federal tax purposes, subject to normal limitations.

New York State provides a credit to individuals for taxes paid to a Canadian province. However, this credit can only be used to the extent that it was not taken for federal tax purposes (i.e. on the federal Form 1116). This is a fact that should be considered when planning Canadian tax if one is deciding between using the non-resident surtax or having a Canadian PE and paying tax to a province in Canada. In New York, as in a number of other jurisdictions, one has to consider local taxes as well. New York City imposes a city tax in addition to the state tax. Compare this to North Carolina that permits foreign tax credits to be used from Canada even though they were used already for federal purposes.

There are several states with no individual state income tax, and a few states with tax only on investment income such as dividends. Those states are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. One important thing to note about Florida, as it is a popular state when planning on purchasing property, is that they do have a corporate income tax. If rental property is purchased individually there is no state tax, but if purchased in a domestic or foreign corporation the corporation could be subject to income tax.

California has a quite complex tax calculation. They do not permit any foreign tax credit from Canada (which actually sounds fairly easy). Oddly enough though they do permit a foreign tax credit from a resident neighboring state (like Arizona) if they performed services in California even though they were non-resident of California when they performed those services.

I will share an example of a neighboring state agreement: A resident of Virginia who performs services in the District of Columbia (in this case an athlete). Under normal general state tax rules, they would pay worldwide tax in Virginia and pay tax in DC and get a credit in Virginia for the taxes paid to DC. However under a unique two state agreement, they pay worldwide tax in Virginia despite having tax withheld in DC and claim a special refund for the tax paid in DC, as opposed to taking a credit for the DC tax. Once again you need to be aware of all the states and their individual rules.

These are just a few examples of the different state nuances that should be considered when looking at any cross border tax analysis.

For more information, please contact:

Mark Feigenbaum, a US Attorney, CPA, and CA, practicing in Thornhill, Ontario specializing in cross-border taxation for individuals primarily in the sports, entertainment and music industries, and individuals moving to and from the U.S., businesses expanding to the U.S., estate planning, U.S. immigration, and tax litigation.

He can be contacted at mark@feigenbaumlaw.com or **905-695-1269**.