Special points of interest:

- Premiere edition of Cross-Border Tax Insight
- Introduction to U.S. Multistate Tax
- U.S. Immigration issues

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Cross-Border Tax Insight
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NORTH AMERICAN TAX SERVICES

Cross-Border Tax Insight

Welcome to *Cross-Border Tax Insight* *(Tax Newsletter)*

Are you a Canadian tax, legal, or financial professional? Would you like to learn more about U.S. tax issues that may impact your clients that are currently resident in Canada? How does the Canada-U.S. Tax Convention impact a taxpayer's specific situation? How and when does U.S. estate tax apply? What are the differences between U.S. and Canadian tax treatment in a certain area? With more and more cross-border transactions occurring on a day-to-day basis – not only do tax professionals need in-depth knowledge in specific areas, they also need general knowledge in a broad range of areas. They need to be able to resort to specialists. They need to address issues. Firstly, they need to identify such issues.

I am hoping that you will benefit from the contents of my newsletter, and that you will look forward to the next issue. In the future, the newsletter will only be sent via e-mail as a .pdf file. Thus, you will need an Adobe Acrobat reader to read it. If you don't currently have such a reader on your computer – you can download one from the following Web site address: www.adobe.com.

If you feel someone in your office, or a colleague, could benefit from *Cross-Border Tax Insight* - please have them forward an e-mail address to me with the words "subscribe to newsletter" in the e-mail subject line.

If there are specific areas of interest about which you would like to learn more – please write to me, so that I can consider that area in an upcoming issue. By the way, your input is very important to me. Please tell me what you think of the material presented. If you have comments or questions – please contact me. Enjoy !

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Editor of **Cross-Border Tax Insight, 2000 © NATS**

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Multistate Taxation: An Introduction

Estimates indicate that nearly 50 percent of tax dollars paid by businesses in the U.S. go towards state and local tax authorities. Business taxpayers may have to consider other types of taxes too: county-level wheel tax on business vehicles, sales or use tax on asset purchases, and franchise taxes with respect to the privilege of doing business in a specific state or states. Clearly, part of a business's overall tax strategy must take into account state and local income taxes.

Business Location Considerations

In general, businesses that operate in a multistate environment have non-tax reasons as to where to situate plants and distribution centres. Businesses typically care about the following factors when making such logistical decisions: largest markets, skilled and reasonably priced labour, location of suppliers, and highway and airport facilities.

Conversely, businesses may have taken tax reasons into account when deciding on a specific location for their business. Occasionally, a taxpayer's various operations (manufacturing, wholesaling, sales, retailing, and credit operations) may be placed in various specific states to benefit from specific economic incentives created by local politicians. Consequently, and of little surprise, tax rules have grown exponentially, due to local and state politicians.

"Nearly 50 % of tax dollars paid by businesses in the U.S. go towards state and local tax authorities".

Each jurisdiction in which an entity is subject to tax represents an increase in compliance costs. In addition, it is interesting to note that the extent of aggressiveness of enforcement of various state tax departments varies from state to state.

Overview of State Taxation

Not all states that impose income tax on corporations label it as such, rather, some states refer to tax on corporate income as franchise tax, business tax, license tax, or business profits tax. Only a few states have adopted some form of Alternative Minimum Tax for corporations.

Prior to selecting a destination state for a company's operations or for a specific division, the company may want to gain some insight into how it will be taxed in a specific state. Unfortunately, in some cases, bounderies may be blurred with respect to the taxing arm of certain jurisdictions. Consider the following potential situations: How is income from mail orders sourced? What about downloaded software from an Internet site? Should such income be sourced to a specific state? Should sales or income tax apply to sales of movies or liquor while a plane is airborne en route between states? Tough questions, but any available solutions, of course, may be found by examining a specific state's tax code and/or regulations.

Four states impose no corporate income tax at all – Nevada, South Dakota, Washington, and Wyoming. Some states base their corporate tax on gross receipts, while others (for example, Michigan) may use a form of value-added tax.

Basis for State Tax

Accounting periods and methods used by a corporation for state tax purposes must be consistent with those used on the federal tax return. States, however, often apply different rules, in identifying the members of a group filing a consolidated return, and the income of each group member that is subject to tax.

To simplify and encourage compliance with state tax law, most states have adopted the federal income tax base. In other words, they have adopted, for the most part, federal tax provisions governing the definition of income and the allowance of various exemptions, exclusions, and deductions. None of the states, to date, have the Internal Revenue Service or any other U.S. Federal Agency collect tax on their behalves (in contrast to Ontario whose share of tax is collected by CCRA).

Since most states use *Federal Taxable Income* as a starting point, many take advantage of the Internal Revenue Service's audit process. Virtually all of the states require notification (normally within 90 days) of the final settlement of a federal income tax audit. States will then adjust the originally calculated state tax liability accordingly, upon receiving notice of federal tax modifications.

Specifically, 40 states that impose corporate income tax rely on *Federal Taxable Income* (from a company's Federal Tax Form 1120) as a starting point in computing their state taxable income.

These states typically use either: *Taxable Income before Net Operating Losses and Special Deductions* (Form 1120 line 28) or they may use *Taxable Income* itself (Form 1120 line 30).

States whose computation of state taxable income is not linked to the *Federal Taxable Income*, have there own state-specific definitions of gross and taxable income. However, even these states typically adopt most federal income and deduction provisions. Methods of computing state taxable income and specific state tax rates vary from state to state.

Numerous state adjustments or modifications to Federal Taxable Income are made in arriving at *State Taxable Income*. Such modifications are required to reflect differences between state and federal tax statutes, and to exclude income that a state is constitutionally prohibited from taxing. Required state modifications will vary from state to state. However, common subtractions and additions in arriving at *State Taxable Income* do apply to most states. For example, typical state additions include interest income that is not taxed at the federal level, expenses relating to tax-exempt federal bonds, state and franchise taxes that were deducted on the federal corporate tax return, amounts by which federal amortization, depreciation, or depletion exceeds the state permitted amount, and a federal net operating loss.

Typical state deductions applied to *Federal Taxable Income* in arriving at *State Taxable Income* include interest on US obligations that is not taxed at the state level under federal law, expenses relating to municipal bond interest income that is taxable at the state level, deductions for amortization, depreciation or depletion if such amounts exceed the Federal corresponding amounts, dividends received from out-of-state corporations, to the extent included in taxable federal income, and net operating losses as determined for state tax purposes.

State Tax Law and Concept Of Nexus

The state in which a business is incorporated has the jurisdiction to tax, regardless of the volume of the business activity conducted within the state. However, whether a state can tax the income of a business that is incorporated in another state, usually will depend on the relationship (or, specifically the existence or lack of *nexus*) between that corporation and the state.

Nexus, in essence, describes the extent of sufficient business activity that must be present before a taxing jurisdiction has the right to impose tax on an out-of-state entity's income. Typically, sufficient nexus will be present when a corporation derives income from sources within a state, owns or leases property within a state, employs personnel within a state, or has physical or financial capital in the state.

In the next issue, I will cover concepts relating to *nexus* and state tax law, as well as the means by which a corporation conducting business activity in more than one state assigns a portion of its aggregate taxable income to individual states. Stay tuned.

Overview to U.S. Immigration by Canadian Individuals or Businesses

If a Canadian enters the U.S. and earns even **$1,** that person **must have a valid visa.**
There are five basic paths to working legally in the U.S.

A. The Individual

There are three relevant business visas that pertain to the individual: B-1; TN and H-1B. All of these visas are temporary**.**

B-1 Temporary Business Visitors. This visa pertains only to workers who enter the U.S. for short, intermittent stays and are compensated entirely by a Canadian employer. Historically, this has been the path of least resistance, but recent months have seen increasing refusals.

TN (Trade NAFTA). These visas are relatively simple, as they are restricted to NAFTA member countries and applicants who fall within a very specific list of professions. In most cases, a bachelor's degree is necessary. Processing time is brief, as application is made right at the border.

H-1B. These visas apply to workers who do not qualify for either the B-1 or the TN, and should be regarded as a choice of last resort.

B. The Corporation

Many of your clients have already expanded, or are planning to expand into the U.S. If that is the goal, then it is critical that preparation for immigration be simultaneous with planning the new enterprise. One misstep can result in costly delays. It is these visas that will be our focus in future newsletters.

L-1 Intracompany Transferee. If your client incorporates in the U.S. and has an existing Canadian corporation, key personnel who have been employed by the Canadian entity for a minimum of one year can be transferred to get the new company up and running**.** This visa can be extended for a period of up to seven years, can lead to a Green Card, and application is made at the border. All of these factors make this a favoured visa.

E-1 Treaty Traders; E-2 Treaty Investors. These visas are aimed at persons or companies who are either carrying on substantial trade with the U.S. or wish to make a substantial investment and create jobs for U.S. citizens. These visas also lead to Green Cards.

PLEASE WATCH THIS SPACE FOR MORE INFORMATION ON CORPORATE BUSINESS VISAS. IF YOU HAVE ANY QUESTIONS, PLEASE E-MAIL AT THE ADDRESS BELOW, AND I WILL RESPOND EITHER DIRECTLY OR IN THE NEXT ISSUE OF THIS NEWSLETTER.

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US Citizens Living in Canada (or Elsewhere) Should Continue Filing Personal U.S. Tax Returns

It is interesting to note that, despite extensive coverage of the brain *drain phenomenon,* according to the U.S. Census Bureau – in excess of 600,000 U.S. citizens live in Canada. Many of these U.S. citizens living outside of the U.S. are unaware of the requirement to continue filing U.S. personal tax returns, as well as personal tax returns in Canada (or in their chosen country of residence). In sum, put in a different way, approximately one out of every 50 persons in Canada, who is a U.S. citizen should be filing a personal U.S. tax return.

U.S. vs. Canadian personal taxation

American legislators have created a rather complex tax system. Unlike Canada which imposes personal tax on the basis of residency, the U.S. imposes personal tax on the basis of citizenship. Both countries require an individual to report his or her worldwide income, in arriving at taxable income. Fortunately, Washington is signatory to many tax treaties with various countries in the world, including Canada. Such treaties may, in certain circumstances, prevent double taxation.

Determining one's residency for tax purposes.

Canada, according to its domestic law, deems persons to be residents of Canada, providing that they spend more than 183 days of the year here. Nonetheless, the courts in Canada have concluded that individuals may be considered Canadian residents based on such other factors as: one's intentions, regularity and length of visits to Canada, maintenance of a home in Canada, memberships and personal property. In some cases, where there is doubt as to whether a person truly is a non-resident of Canada, the Canada Customs and Revenue Agency (CCRA, formerly Revenue Canada) may request that an individual complete form NR74. The form contains a series of questions, which essentially permits the CCRA to make a determination of residency.

A U.S. citizen living in Canada but maintaining closer connections to the U.S. could, however, be a non-resident for tax purposes. In such a case, tax would be paid to CCRA only on income from Canadian sources, even if significant time is spent in Canada.

Individuals who are required to file in both countries will want to plan carefully, in order to minimize tax in both countries, and also to ensure that double taxation is not applicable.

Relief Available

The Canada-U.S. Tax Treaty establishes which country has the right to tax, depending on the source of the specific income, when both countries would otherwise claim such a right to tax that same income under their respective domestic tax laws. Specifically, income tax paid by a U.S. citizen to the CCRA can be claimed as a *foreign tax credit* on a U.S. return. Since Canada's tax rates are higher than those in the U.S., such a credit would normally eliminate U.S. tax otherwise payable on such income.

Another form of relief for U.S. citizens living in Canada who earn Canadian wages or business income, is the *foreign earned income exclusion* (FEIE). The exclusion permits U.S. citizens to exclude from their U.S. taxable income up to $ U.S. 76,000. To qualify for such an exclusion, two criteria must be met. The first is that the U.S. citizen must have a *tax home* in Canada (i.e. one's main place of employment or business is in Canada). The second criterion requires a U.S. citizen to either pass the *bona fide residence test*, or the *physical presence test.* The *bona fide residence test* requires that an individual live in Canada (or a foreign country) for at least one calendar year. Under the *physical presence test*, one must have been in Canada (or a foreign country) for 330 full days over a period of 12 consecutive months ending with a particular tax year.

Essentially, the FEIE encourages Americans to assume positions abroad. However, the only Americans who benefit from it are those working in countries that have a lower tax rate than that of the U.S. (not Canada!).

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Joseph Soussan, BA, CPA, CGA founded ***North American Tax Services*** in 1998. He obtained his Certified General Accountant's designation in 1997, completed the CICA In-Depth Tax Course in 2000, and obtained a CPA certificate in 1999 (Delaware). His firm is dedicated to providing both U.S. (primarily) and Canadian tax expertise (as applicable to international tax situations), tax–related educational services, and technical writing assistance to Canadian accounting and law firms.

He currently practices exclusively in the areas of both cross-border corporate and personal taxation. He has, to date, provided extensive consulting and compliance services to date to the following firms in Toronto and Montreal: Deloitte and Touche, Ernst and Young, I.T.S.G, Cross-Border Tax Services Inc., Horwath Orenstein LLP, and other local CA firms. If he can be of assistance to your firm, please do not hesitate to contact him (Tel: 416-567-1829).

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