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WAYFAIR AND ITS POTENTIAL INCOME TAX IMPLICATIONS FOR CANADIAN BUSINESSES

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In the United States, each state may impose its own sales tax, which may require a business to collect and remit sales tax on its taxable sales in the state. This sales tax obligation is not limited to US businesses, but may also apply to Canadian businesses. Only 5 states choose not to impose a sales tax, while the remaining 45 states and the District of Columbia impose some rate of sales tax. Until recently, a business had to be physically present within a state before that state could impose a duty on the business to collect and remit sales tax on its taxable sales. This "physical presence" limitation applied to both US and Canadian businesses selling into the US market. However, this changed a little over a year ago with the US Supreme Court's decision in *South Dakota v. Wayfair* (585 US ____, 138 S.Ct. 2080 (2018)). Briefly, in *Wayfair*, the Supreme Court reviewed the physical presence test for sales tax purposes and determined that, given the rise of the digital economy, physical presence was no longer a constitutionally required connection before a state could impose sales tax. At issue in the case was a law passed by South Dakota that required an out-of-state seller, without a physical presence in the state, to collect and remit sales tax to South Dakota if it had either $100,000 of gross revenue from sales to South Dakota customers or more than 200 transactions in the state. The Supreme Court did not rule on whether South Dakota's law was valid, but it did hold that physical presence in a state is no longer required in order to impose a duty to collect and remit sales tax.

Currently, 43 states and the District of Columbia have either passed legislation or enacted an administrative rule, each with its own respective thresholds and effective dates, conforming their sales tax rules to *Wayfair*. One notable exception is Kansas, which recently issued guidance that does not contain a similar transactional threshold, but instead requires all out-of-state sellers to collect and remit sales tax on *all* sales into the state.

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When a Canadian business has a sales tax collection and remittance obligation in the United States, it may also have a state income tax obligation. Similar to sales tax, for a business to have an income tax obligation, the business must have "nexus" with a state, which means that the connection between the business and the state must be substantial enough to permit the state to exercise its taxing jurisdiction over the business. The quality of the connection required for the state to impose income tax varies by state. Some states require that a business be physically present in the state before it imposes income tax, but a majority of the states require only some level of economic nexus with the state. Several of the states follow the model created by the Multistate Tax Commission, which provides that a business has nexus with a state if it has $50,000 of property, $50,000 of payroll, $500,000 in sales, or 25 percent of its total property, total payroll, or total sales in that state. This is sometimes called "factor-presence" nexus.

Most recently, there has been a shift away from this factor- presence nexus. New York, for example, now imposes state income tax on a business if its New York-source gross receipts during the year exceed $1 million. Some states have proposed or enacted legislation with economic nexus thresholds similar to the South Dakota sales tax nexus thresholds the Supreme Court considered in *Wayfair*. For example, Hawaii recently enacted a new income tax nexus standard that subjects a business to Hawaii business tax if it has gross income attributable to the state of more than $100,000 or it engages in 200 or more transactions with the state. Washington also modified its nexus standard for its business and occupation tax; as of January 1, 2020, a business with $100,000 of combined gross receipts per year attributable to the state will be subject to this tax. Other states may also follow suit and adopt lower income tax nexus standards to conform to their sales tax nexus thresholds.

Even if a business has nexus with a state for income tax purposes, it may nonetheless be afforded the protection of Public Law 86-272 (the Interstate Income Act of 1959) under certain circumstances. This federal law prohibits the states from imposing net-income-based tax on an out-of-state business engaged in "interstate commerce" where the in-state activities of the business are limited to the "mere solicitation" of sales. This special treatment applies to an out-of-state seller's sales of tangible personal property only if the seller or its agent solicits the orders, those orders are sent outside the state for approval, and the orders are fulfilled from inventory likewise located outside the state. Most commentators agree that this special treatment would not apply to an out-of-state seller's sales of services. Further, this protection applies only to state income taxes, and thus its application is fairly limited. Even though the protection is available only to those businesses engaged in interstate commerce, most commentators agree that international businesses should also receive the protections of Public Law 86-272.

A Canadian business that does not receive the protection of Public Law 86-272 and has income tax nexus with a state still may not have an income tax obligation in that state. Many states determine taxable income by starting with US federal taxable income, and how the business's federal taxable income is determined will dictate what income the state may tax.

Under US federal law, a non-resident foreign corporation may be subject to federal income tax on income that is "effectively connected with a US trade or business." The Internal Revenue Code does not define "trade or business," but case law has carved out a facts-and-circumstances test that focuses on whether the activities are sufficiently regular, continuous, and substantial. Thus, if a Canadian business is engaged in a US trade or business that is sufficiently regular, continuous, and substantial, it will (absent tax treaty protections) be taxed on the income that is effectively connected to the United States, which includes business income.

However, this is not the whole story. Canada has a tax treaty with the United States ("the Canada-US tax treaty"), which prevents the United States from taxing a Canadian business unless that business has a "permanent establishment" in the United States. A permanent establishment generally requires a fixed place of business, but the activities of a single person on behalf of the business could also create a permanent establishment.

Although this income tax treaty may provide relief for federal tax purposes, *the states are not bound by the Canada-US tax treaty*. However, as explained above, if a state determines income based on federal taxable income, these protections should flow through and provide state income tax benefits.

But one must be careful. Many states do not use US federal taxable income as the starting point for computing the income to be taxed by the state. New York, for example, starts the computation of taxable income by reference to "effectively connected" income, even if that income would not be subject to US federal income taxation because an international treaty applies to it. Furthermore, if a Canadian corporation has a US affiliate taxable in a state, that Canadian corporation may be drawn into taxation in the state as a result of a combined income tax filing, which may include both US and foreign affiliates.

In sum, Canadian businesses with customers or clients in the United States should be diligent about keeping abreast of changing sales tax and income tax rules and continuing to test whether they have both sales tax and income tax nexus in any state in which they have customers or clients. These businesses should also pay special attention to those states that do not use federal taxable income as a starting point for income to be taxed by the state, because they will not be afforded the protections of the Canada-US tax treaty.