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TAX UPDATE

Know the U.S. state sales and use tax rules – and keep the states from biting into too much of your profits



Food and beverage producers, distributors and wholesalers that sell to U.S. customers need to be familiar with U.S. state sales and use tax compliance obligations in order to avoid unforeseen tax exposure. This article focuses on some nuances of such tax compliance relevant to the Canadian food and beverage industry. In addition, this article updates recent judicial and legislative developments pertaining to state tax incentives.

Overview – Sales and Use Tax

Forty-five states and more than 7,000 local jurisdictions impose sales and use taxes. When doing business with U.S. customers, neglecting or not knowing the applicable sales and use tax rules can be costly.

Complying with sales and use tax laws is sometimes complex. In most states, compliance is facilitated by filing a single tax return that covers the state and all local jurisdiction taxes. In some states, local sales and use taxes are administered by local authorities that require additional local tax filings. Filing sales and use tax returns may be obligatory or prudent even if no tax is due.

A Canadian company with a minimal physical presence in a state may have sales and use tax compliance obligations. The in-state presence of an out-of-state company's property, employees, independent agents or representatives can create a filing obligation. For example, a Halifax food processor that engages an independent sales representative to solicit sales to supermarkets in Pennsylvania must comply with Pennsylvania sales and use tax rules.

Determination of which state's sales and use tax laws apply is critical. The answer is relatively obvious when a sale takes place and the purchaser takes possession at the seller's storefront. An out-of-state seller should generally consider the tax laws in effect at the destination where goods are shipped.

Use taxes generally apply where sales tax was not paid to the "use" state at the time of purchase. Assume a California resident purchases a taxable item in Nevada and pays Nevada sales tax at the point of purchase. Upon return to California, she must self-assess and remit use tax to California for the use of the item in California, although California may allow credit for the Nevada tax paid.

Exemptions

Some sales are exempt from sales and use tax. Two exemptions applicable to Canadian food and beverage companies include sales for resale and sales of food products.

Sales of goods for resale are generally not taxable. However, all but a handful of states require a purchaser claiming exemption to provide the seller with a valid resale exemption certificate. The potential tax exposure for sellers who do not obtain resale exemption certificates can be substantial. Sellers should not ship goods sold for resale prior to obtaining resale exemption certificates from customers.

For example, a Manitoba frozen confection manufacturer selling ice cream to a distributor in Idaho, who in turn sells

the ice cream to grocery stores, should secure a valid Idaho resale exemption certificate before shipment.

In the event of an audit, a tax examiner may provide additional time to obtain certificates that are not on file. Canadian sellers should not plan for such discretion. In any event, certificates may not be available from all past customers. In our example, Idaho could assess sales tax directly against the Manitoba manufacturer if it fails to present certificates supporting claimed exemptions.

States' taxability of food products varies widely. For example, some states consider candy to be a non-taxable food product while others may consider it taxable. In a few states, all food products may be exempt from sales tax. Since food products exemptions vary widely from state to state, Canadian sellers are advised to obtain valid resale exemption certificates from all customers so as to avoid unnecessary sales tax exposure.

Update on state tax incentives

Canadian companies looking to expand in the U.S. by building new facilities or acquiring existing facilities or companies should be aware of ongoing litigation and legislative action that may limit the availability of state provided tax incentives.

In September 2004, a U.S. Federal Court of Appeals ruled in *Cuno v. DaimlerChrysler* that the State of Ohio manufacturing investment tax credit (ITC) violated the Commerce Clause of the U.S. Constitution. In this case, Ohio and the City of Toledo entered into an agreement with Daimler-Chrysler to construct a vehicle assembly plant in exchange for an estimated US\$280 million in tax incentives, including a non-refundable ITC to be used against DaimlerChrysler's Ohio franchise tax for purchase of new manufacturing equipment installed in Ohio. The city of Toledo also granted a personal property

tax exemption for establishing a facility and preserving employment in an economically depressed area.

The Federal Court of Appeals unanimously held that the ITC was unconstitutional because it coerced in-state taxpayers to further invest in Ohio to the detriment of investment in other states. Ohio taxpayers that made in-state investments could claim ITC and obtain Ohio tax benefits but received no similar Ohio tax benefits for investments made outside of Ohio. After the September decision, the Ohio Department of Taxation advised taxpayers to continue to claim the ITC pending further review by the U.S. Supreme Court. Petitions seeking such review were filed in June

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2005 and further review by the U.S. Supreme Court may be pending. The original September 2004 decision is stayed until such time that the U.S. Supreme Court ultimately disposes of the case.

Unless overturned by the U.S. Supreme Court, the decision by the Federal Court of Appeals will be binding in Ohio, Tennessee, Michigan and Kentucky and potentially in other states. If upheld, it is not clear whether Cuno will apply to all taxpayers or just to DaimlerChrysler – or whether it will be enforced retroactively or prospectively. Similar litigation challenging tax incentives granted by other states is pending in other states, including North Carolina and Oklahoma.

In June 2005, Ohio enacted broad-sweeping tax reform measures which in part respond to Cuno by suspending the ITC for taxable years ending on or after July 1, 2005. ITC only applies to property purchased before June 30, 2005 and installed in Ohio before June 30, 2006. Unused ITC at June 30, 2005 may be convertible into grants that may be used to reduce Ohio franchise tax liability for tax years ending after June 30, 2005. Other states are reviewing available incentives from a constitutional and cost-benefit

perspective.

These developments suggest that state tax incentives, credits in particular, have an uncertain future. Noncredit incentives may withstand current scrutiny such as state provided project financing or infrastructure subsidies for road access and water and sewer lines.

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