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American State and Local Taxes:
Know What You Do Not Know -- "The Big Three"

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Israeli businesses selling goods and services in the United States seek to capture a part of the world's largest consumer market. However, these businesses need to be aware of the tax dangers presented by each of the 50 states. Unfortunately, most Israeli businesses do not know of these dangers.

Based on experience, the following are the three most important state tax unknowns. (Further information about each of these is available at www.statetaxalert.us.)

1. **Lack of a Permanent Establishment is Irrelevant**. Many Israeli business and tax professionals believe that a business that does not have a permanent establishment in the United States is not subject to taxation in the United States. *Unfortunately, they are wrong where state taxes are concerned.*

In fact, the concept of a permanent establishment is irrelevant to state taxation. For state tax purposes, if a business has an employee or representative in a state on company business -- even if that presence is temporary -- the business has tax presence in the state. If such a presence is established, the business will be subject to state and local income, franchise, sales, use and other taxes. (An income tax exception might be available for businesses selling only tangible personal property.)

It is essential that Israeli businesses understand that the contacts required to establish state tax presence are far less substantial than those required under a permanent establishment threshold. These contacts include having in-state employees, agents or representatives doing anything that creates a market for the business's good or services. The contacts can also be created if repair or other service activities are performed in a state on a business's behalf, or by the business's ownership or rental or property located in the state.

Of course, businesses exist to make sales and make a profit, and they regularly conclude that the value of their activities in a state exceed the cost of the state's taxes and tax compliance requirements. But, with state and local sales tax rates often exceeding 7.5% of gross sales, and with state income taxes as high as 10% of taxable income, it is essential that businesses avoid creating state tax presence accidently.

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2. **<u>The Israel-U.S. Income Tax Treaty is Irrelevant</u>**. Many Israeli business and tax professionals mistakenly believe that the Israel-United States income tax treaty protects Israeli businesses from American state and local taxation. It does not.

In fact, the states may impose income, franchise, sales, use and other taxes independent of the federal government's ability to impose its income tax. As indicated above, a state's ability to impose tax on an out-of-state business is determined almost entirely by whether the business has a tax presence in the state. This inquiry into whether there is such a presence is not affected by international tax treaties.

For income tax purposes, if a business has tax presence in a state, the state can tax all of the business's worldwide income. The business must then apportion its income to the state, potentially having to supply information about its worldwide property, payroll and sales. Even if the resulting amount of state income taxes is small, the cost to gather and organize the information can be significant. For obvious reasons, Israeli businesses are likely to view a tax filing requirement in a state 6,000-9,000 miles away as an unjust burden.

Moreover, any state income tax due may be small in comparison to the Israeli business's uncollected sales taxes.

For these reasons and others, it is essential that Israeli businesses not be lulled into thinking that all American taxes are covered by the Israel-U.S. tax treaty.

3. **<u>Business Owners and Employees Can Be Personally Liable For Their Business's State Taxes</u>**.

There is a widely held belief that shareholders, partners, officers, managers, etc. of legitimate businesses cannot be held liable for the business's unpaid taxes. Unfortunately, that belief is incorrect. Likewise, a technique sometimes considered by business planners of terminating a company to eliminate exposure for state tax liabilities can damage the business's owners and management by shifting the liability for the business's unpaid state taxes to them personally.

When a business fails to pay sales taxes, use taxes or other trust fund taxes (that is, taxes that the business is required to collect from another taxpayer and then remit to a state), the states frequently attempt to collect the taxes from individuals at the business who were in a position to know about and correct the business's failure. Research revealed that between January 2010 and 2012, 17 states litigated this issue against such responsible persons, and that several of the states issued more than one of these decisions. Worse still, the states usually won these cases. Moreover, the reported decisions represent a small minority of these collection actions; most disputes are resolved quietly.

<u>Conclusion</u>. All 50 of the United States impose tax on a business's income, sales of goods, or both. Unfortunately, state taxes involve rules different from the federal taxes administered by the Internal Revenue Service. For all of the reasons discussed above, Israeli businesses as well as their owners and managers must ensure that the business is complying with the tax laws of the states in which it has tax presence.