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Nexus News

State Tax Nexus for Foreign Businesses

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Introduction

For foreign businesses, federal nexus standards of engaging in a trade or business within the United States are based on whether the company has income effectively connected with a U.S. trade or business or has a permanent establishment ("PE") in situations where an income tax treaty applies. State tax nexus standards, on the other hand, until recently generally required only a physical presence within the jurisdiction and, more recently and commonly, now only require an economic presence. A common misconception held by foreign entities is that U.S. income tax treaties and federal PE treaty provisions apply at the state level. Foreign companies with activity in the United States are often surprised that activity that results in no federal liability may in fact trigger state-level taxes.

Even more surprising to foreign entities unfamiliar with our subnational system is that there are no uniform rules among the states as to whether state tax liability attaches. In fact, in some instances significant state tax liabilities may be imposed even if little or no U.S. federal tax obligations exist. To further complicate matters for foreign entities, states generally do not follow U.S. tax treaties, but rather adopt different rules as to whether a state has tax jurisdiction over a company, *i.e.*, whether the company has nexus in the state. The concept of nexus can create confusion within senior management of a non-U.S. parent company, especially when unanticipated disputes arise with various states due to what the foreign entity perceives as very limited activities in that state.

State Nexus Rules Vary Greatly from Federal Nexus Rules

Federal treaty provisions that limit the application of federal tax to foreign corporations that have a PE in the United States do not apply to the states, unless a state voluntarily chooses to apply them. At the federal level, a PE

is a fixed place of business through which the business is conducted, for example, an office or a factory. What foreign entities need to keep in mind and often do not because they simply do not know is that there are activities that may not result in federal reporting responsibilities but nevertheless create state income tax exposure. While U.S. federal taxation generally requires a threshold level of activity of being "engaged in a trade or business" or having a "permanent establishment," mere physical presence in a state, such as having employees or property in the state, generally will create sufficient nexus for state taxation purposes. Thus, a foreign company may not have a permanent establishment in a particular state, but it may have sufficient nexus with that state to become subject to that state's taxes. For instance, some activities not rising to the level of a U.S. PE that can nonetheless create state tax liability include, but are not limited to, examples such as: (i) physical or economic presence; (ii) receiving royalty income from a U.S. source; or (iii) having a certain level of sales into a state. Further complicating this dichotomy, the consequences of not filing returns where a company is subject to tax in a state can be significant. Many states have open statutes of limitation, or extended statutes of limitation, for a state to assess a deficiency in the case of non-filers.

Where Do States Get Their Power If the Feds Can't Tax It?

When the Constitution was ratified, States retained their sovereign power to tax.[1] A state's power to impose a tax, however, is subject to limitations imposed by the U.S. Constitution and the primary constitutional principles that restrict a state's authority to tax are the Due Process and the Commerce Clauses of the U.S. Constitution. The Due Process Clause asks whether it is fair to impose a tax; whereas, the Commerce Clause asks whether the imposition discriminates against or interferes with interstate commerce. Also limiting states' authority to tax pursuant to the Supremecy Clause are federal statutes, such as Public Law ("P.L.") 86-272 (if recognized by the state to apply to foreign commerce); as well as specific state laws, such as a state's "doing business" statutes. Each state has its own law as to when a company, U.S. or foreign, is subject to tax, so the law of each state in which a company is doing business must be consulted, and the results will vary among states.

Constitutional Standards

Under *Complete Auto*,[2] the U.S. Supreme Court established the four-pronged test to determine the validity of state tax on *interstate* commerce under the Commerce Clause. In order for a tax to survive Commerce Clause scrutiny, it must be applied to a taxpayer that has substantial nexus with the taxing state; it must be fairly apportioned; it must not discriminate against *interstate commerce*; and, the tax must be fairly related to the services provided by the state. The Court later held that in addition to a state tax being required to meet the four prongs of the Commerce Clause test set forth in *Complete Auto*, there are two additional requirements that must be met in a foreign commerce situation. Specifically, it must be determined whether the state law creates a substantial risk of international multiple taxation and second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments.[3] If a state tax contravenes either of these precepts, it is unconstitutional under the Foreign Commerce Clause. Thus, a state may not tax foreign entities in such a way as to place a greater burden on the foreign corporation or foreign commerce than domestic commerce nor may it arbitrarily treat the income from a foreign entity different from that of a domestic corporation. Under the Foreign Commerce Clause analysis, the Supreme Court has affirmed that it is the "risk," not the actuality, of multiple taxation that gives rise to a Foreign Commerce Clause objection.

As a broad proposition, the Commerce Clause of the U.S. Constitution, as it applies to both U.S. and foreign companies, requires "substantial nexus" in order for a state to impose a filing obligation and a tax. Having a physical presence in a state, *e.g.*, property or employees, will almost always give rise to nexus to tax. Distinctions between Commerce Clause application in a domestic versus a foreign context lie mainly with the application of the discrimination prong of *Complete Auto* as it is applied in a different manner. When applying the discrimination prong in interstate commerce situations, the focus is on whether there is discrimination against interstate commerce in favor of intrastate (*i.e.*, local) commerce. Whereas, the focus of the Foreign Commerce Clause is whether there is discrimination against foreign commerce in favor of interstate commerce.

In *Kraft General Foods v. Iowa Dep't. of Rev.*,[4] for example, a taxpayer alleged that Iowa's taxation of foreign

dividends violated the Commerce Clause because a full deduction was allowed for dividends from domestic affiliates. The Supreme Court rejected the State's argument that there was no intended discrimination against foreign commerce, holding that "whatever the tax burdens imposed by the Federal Government or by other States, the fact remains that Iowa imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries."

The Impact of P.L. 86-272

P.L. 86-272[5] prohibits the imposition of state income-based taxes against businesses when their activities are limited to the solicitation of sales of tangible personal property and they fulfill the orders from a location outside of the state. First and foremost, we must address the elephant in the state tax room: P.L. 86-272 does not explicitly apply to foreign commerce. Many taxpayers may have thought, erroneously, that they were protected from state taxation through the provisions of P.L. 86-272 only to find out that they were not so protected. Foreign commerce is not mentioned in P.L. 86-272 and, as a result, it is generally understood that it applies only to interstate commerce. Nevertheless, states can choose to apply P.L. 86-272 protection by policy or regulation. The Multistate Tax Commission's *Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272* states that signatory states "will apply the provisions of Public Law 86-272 and of this Statement to business activities conducted in foreign commerce."[6] The majority of states do in fact apply P.L. 86-272 to foreign commerce, but roughly a dozen states, including California,[7] do not.

Reviewing the states' application of P.L. 86-272 through the lens of *Kraft* raises questions as to whether the states' application would be discriminatory. The argument being that with a state such as California that does not afford P.L. 86-272 protection to foreign entities at the state level, California's refusal to do so discriminates between interstate and foreign commerce and is therefore unconstitutional. Pursuant to the Foreign Commerce Clause, a state may not discriminate against foreign commerce in favor of interstate commerce. Here, by failing to extend the protection of P.L. 86-272 to income derived from foreign commerce and extending that protection to interstate commerce, the state is in effect doing so. The counter-argument to that position being that, "it is not the states providing preferential treatment to interstate businesses as opposed to foreign businesses; it is Congress. And it is probably Congress's prerogative to do so."[8]

Regardless of what side of the debate regarding the states' application of P.L. 86-272 to foreign commerce readers may fall on, what is apparent is that, as applied to non-U.S. companies, the application of P.L. 86-272 brings with it potential complications, including: (1) if, after *Wayfair*, virtual connections can create nexus, can virtual connections constitute an "in-state" activity that exceeds solicitation such that the protections of P.L. 86-272 are lost?; (2) if P.L. 86-272 protection only applies when a company's in-state activity is solicitation, will the same protection apply if a company has no activity in a state?; and, (3) will a state apply P.L. 86-272 to foreign commerce?[9] Most importantly, as Christopher Lutz recently pointed out in his in-depth review of P.L. 86-272, "To the extent P.L. 86-272 creates a dynamic in which states are more likely to impose a corporate income tax on a foreign seller (who may even be treaty protected from a federal standpoint) as opposed to an interstate seller, it can only be understood to reach an absurd result."[10]

State tax nexus standards present a significant compliance challenge for foreign companies.

A recent example of a state subjecting a foreign entity to tax in a situation in which the entity was protected by a treaty from federal taxation occurred in Washington State. A Washington ruling held that a German pharmaceutical company had economic nexus in the state due to its receipt of royalties paid when its products were sold in Washington, even though the business had no physical presence there.[11] The Department of Revenue imposed its Business and Occupation Tax on the German company, with no physical presence, because the company received royalties based on Washington sales that exceeded the statutory threshold (about $250,000). The hearing officer rejected a challenge based on the nondiscrimination provision in the 1989 tax treaty between the United States and Germany because of a

finding of no discrimination, *i.e.*, the Washington tax on royalties applied equally to U.S. and foreign companies. The ruling also determined that the tax treaty implicitly permitted states to tax the royalties. Nuances such as these in foreign tax treaties commonly go unnoticed by the foreign companies until they find themselves in a defensive position trying to invoke them. As previously stated, federal tax rules apply a different nexus standard to treaty-protected foreign entities. Federal income tax treaties generally limit a country's ability to tax only those foreign companies that have a PE in the country. However, income tax treaties do not by their terms apply to apply for state tax purposes.

The lack of uniform nexus rules among states, the fact that states generally do not follow U.S. tax treaties, and what are perceived as low economic standards creates a confusing and challenging system for practitioners seeking to comply with their tax obligations.

Economic nexus could be deemed to exist between a state and a company based on the presence of intangible property in a state. For example, the license of trademarks to a company located in a state could be deemed to create nexus for the out-of-state licensor on the basis that the intangibles are "present" in the state. From a state tax perspective, the receipt of interest or dividends by itself generally should not be deemed to create nexus; nor should royalties, unless such royalties are derived from in-state intangible property that is deemed to create "presence" in a state that has adopted an economic nexus rule. However, with more states asserting an "economic nexus" standard, the receipt of interest, dividends, or royalties becomes increasingly susceptible to claims of nexus from those states where such income streams derive.

Economic Nexus

The concept of economic nexus is not new. In fact, on the income tax side the trend has been building for years and has seen many states take a more expansive view of nexus.[12] Prior to *Wayfair*, many states enacted and enforced economic nexus standards for income tax purposes under the belief that the physical presence standard applied only to sales tax. A state generally may impose its tax on an entity to the extent a sufficient "nexus," or taxable connection, exists between the entity and the state. After *Wayfair*,[13] the "taxable connection" has taken new form. Having sales "in a state" now may indicate that a seller is "carrying on a business" there, which could mean that it has some form of connection, whether it be economic, virtual or physical, sufficient to establish a substantial nexus and authorizes the state to require a payment of tax.[14] And although the *Wayfair* decision only explicitly addressed the South Dakota sales tax, the decision removed the physical presence requirement from Commerce Clause consideration, which impacts both state income tax and state sales tax and it was not limited to domestic entities.

States also may assert that a foreign corporation has nexus through the in-state activities of an agent or affiliate. Some states also have applied "economic" nexus or "factor presence" principles and are now being followed in a growing number of states, including California. California[15] has implemented a factor presence test with a threshold of $500,000 of sales attributable to the state creating economic nexus for the out-of-state entity. A factor-presence standard establishes nexus based on a certain level of sales activity into a state even in the absence of physical presence in the state. Other states have different thresholds, such as New York, with a corporate income tax standard of $1 million of sales in the state[16]; and, in Connecticut a taxpayer is deemed to have nexus if it has receipts greater than $500,000 attributable to the state.[17]

Conclusion

State tax nexus standards present a significant compliance challenge for foreign companies. The lack of uniform nexus rules among states, the fact that states generally do not follow U.S. tax treaties, and what are perceived as low economic standards creates a confusing and challenging system for practitioners seeking to comply with their tax obligations.

ENDNOTES

[1] *See McCulloch v. Maryland*, 17 US (4 Wheat.) 316, 425–429 (1819).

[2] *Complete Auto Transit v. Brady*, SCt, 430 US 274 (1977).

[3] *Japan Line Ltd. v. County of Los Angeles*, SCt, 441 US 434 (1979). In *Japan Lines*, an *ad valorem* property tax imposed by the County of Los Angeles on containers owned, based, registered abroad and used by Japanese companies in the international marine shipment of goods was invalidated by the U.S. Supreme Court under the Commerce Clause. The Court first analyzed the tax under the four-prong test of *Complete Auto Transit, Inc. v. Brady*, SCt, 430 US 274 (1974), but then went on to add two additional prongs for foreign commerce clause analysis purposes to the four-prong test of *Complete Auto Transit*. The Court noted that there is no authoritative tribunal capable of ensuring that instruments of commerce are not subject to taxation on more than the full value of the property. Consequently, a fairly apportioned state tax may still cause foreign commerce to be subjected to unconstitutional multiple taxation if the nation of domicile taxes the instrument without apportionment. The Court found that where foreign commerce is implicated, "a more extensive constitutional inquiry is required; and when a state tax implicates foreign commerce, the tax will not survive a constitutional challenge if, (1) notwithstanding apportionment, it creates a substantial risk of international multiple taxation or if it (2) impairs federal uniformity and prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments." *Japan Line*, SCt, 441 US at 451.

[4] *See Kraft General Foods v. Iowa Dep't. of Rev.*, SCt, 505 US 71 (1992), taxpayer alleged that Iowa's taxation of foreign dividends violated the Commerce Clause because a full deduction was allowed for dividends from domestic affiliates. The Court rejected the State's argument that there was no intended discrimination against foreign commerce, holding that "whatever the tax burdens imposed by the Federal Government or by other States, the fact remains that Iowa imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries."

[5] 15 USC §381.

[6] A copy of the MTC's Statement is available online at *www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/StatementofInfoPublicLaw86-272.pdf*.

[7] *See* California Franchise Tax Board Publication 1050, Application and Interpretation of Public Law 86-272 (Rev. 06-2017) (stating that P.L. 86-272 specifically applies, by its terms, to "interstate commerce," which is defined to include commerce between the 50 states and The Commonwealth of Puerto Rico).

[8] *See* Christopher T. Lutz, *What to Do with Public Law 86-272*, State Tax Notes 783 (Aug. 26, 2019).

[9] For a detailed discussion of P.L. 86-272 nexus issues, please refer to the Winter 2018 edition of this column, *Nexus News: The Increased Importance of Due Process Nexus and P.L. 86-272 After the Wayfair Decision*, Journal State Taxation, Winter 2018.

[10] *See* Christopher T. Lutz, *What to Do with Public Law 86-272*, State Tax Notes 784 (Aug. 26, 2019).

[11] Wash. Dep't. of Rev., App. Div., Determination No. 15-0251, 35 WTD 230 (decided 9/11/15; Pub. 5/31/16).

[12] For example, *Tax Comm'r. of W. Va. v. MBNA*, 640 S.E. 226 (W. Va. 2006); *Lanco, Inc. v. Div. of Tax'n.*, 879 A2d 1234 (N.J. Super. Ct. App. Div. 2005).

[13] *South Dakota v. Wayfair*, SCt, 138 SCt 2080, 2099 (2018).

[14] Following *Wayfair*, with physical presence no longer a constitutional standard for state taxation, companies that satisfied state-specified income tax economic nexus standards but were not filing state income tax returns in reliance of a physical presence standard potentially could be subject to taxation for past, present, and future years.

[15] The California Franchise Tax Board ("FTB") recently issued a Notice that discussed how it will treat an otherwise valid water's-edge election when a unitary foreign affiliate of the water's-edge combined group becomes a taxpayer because it is doing business in California due to Rev. & Tax. §23101(b), California's factor presence standard. California Franchise Tax Board Notice 2016-02 (9/9/16). Because of the enactment of the factor presence standards a foreign affiliate of a water's-edge combined group that, at the time of the election, was not doing business in California (and thus could not be included in the group) could be doing business in California. Depending on whether a unitary foreign affiliate is a corporation whose income and apportionment factors would have been properly considered in computing the income of the taxpayers making a water's-edge election, the foreign affiliate may have been required to make an election for the election to be effective. The Notice addresses the treatment the FTB will apply in situations in which a unitary foreign affiliate of a water's-edge combined group could not make an election at the time of a water's-edge election because the affiliate was not subject to tax in California, but after the addition of Rev. & Tax. §23101(b) would have been required to make a water's-edge election for the election to remain effective. The FTB will treat the existing water's-edge election as follows: (1) When a unitary foreign affiliate has income derived from or attributable to sources within the United States both before and after the beginning of a taxable year in which the affiliate becomes a taxpayer solely due to the addition of Rev. & Tax. §23101(b), the deemed election provisions of Rev. & Tax. §25113(b)(4) will apply, *i.e.*, the unitary foreign affiliate will be deemed to have made the election with the other members of the combined reporting group; (2) When a unitary foreign affiliate does not have U.S. income either before or after the beginning of a taxable year in which the unitary foreign affiliate becomes a taxpayer solely due to the addition of Rev. & Tax. §23101(b), the affiliate would never have been includable in the water's-edge combined report despite its status as a taxpayer under Rev. & Tax. §23101(b). However, in order to give effect to the objective intent of the taxpayers' unitary group to maintain an effective water's-edge election, the unitary foreign affiliate will be deemed to have made an election as of the taxable year in which it became a taxpayer. The commencement date of the deemed water's-edge election will be the same as the commencement date of the electing taxpayers of the existing water's-edge combined reporting group. In such circumstances, the foreign affiliate may be included in the group return of the existing water's-edge combined reporting group for administrative convenience; (3) When a unitary foreign affiliate does not have U.S. income before, but has U.S. income after, the beginning of a taxable year in which the affiliate becomes a taxpayer solely as a result of the addition of Rev. & Tax. §23101(b), the unitary foreign affiliate will be deemed to have made an election as of the taxable year in which it becomes a taxpayer. The commencement date of the deemed water's-edge election will be the same as the commencement date of the electing taxpayers of the existing water's-edge combined reporting group.

[16] N.Y. Tax Law Sec. 209.1(b).

[17] *See* Connecticut Department of Revenue Services Information Publication 2010 (29.1) (Dec. 28, 2010).

