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State Tax Considerations for Foreign Companies With Inbound U.S. Investments

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Most U.S.-based taxpayers are aware that the United States has many state and local taxing jurisdictions.

Not only are these taxes imposed at different levels of government (state, county, and city) and special taxing districts, the types of taxes imposed by these jurisdictions are exceedingly diverse (e.g., income, net worth, sales and use, gross receipts, property). As most other countries approach tax administration from a federal or national level, non-U.S. taxpayers generally are surprised by the degree of complexity involved in complying with the U.S. state and local tax regimes.

From a U.S. inbound perspective, most foreign companies rely on bilateral tax treaties for guidance on the federal tax consequences of their U.S. activities. Under most tax treaties, foreign companies are subject to federal tax if their U.S. business activities rise to the level of a "permanent establishment." However, there is a distinction between the standards for federal treaty protection for foreign companies and the standards for state tax nexus that subject a foreign company to tax in a particular state. Understanding the difference between these standards is crucial for foreign companies in managing their state tax risks and liabilities. This distinction is further complicated by the lack of uniformity and guidance provided by states in how treaty-protected foreign companies should be taxed.

Generally, the first step in this type of analysis is to determine whether a state can impose a tax measured by income, gross receipts, or net worth on a foreign company that has no permanent establishment and is otherwise exempt by treaty from federal tax. An inquiry of this nature usually consists of two components: (1) whether the foreign company has sufficient in-state contacts to be subject to a state income, gross-receipts, or net-worth tax; and (2) whether the company would incur a tax liability if it were subject to tax.

Doing Business and Nexus

Generally, a foreign company's state tax filing obligations depend on whether the company is doing business or has nexus in the state or local jurisdiction imposing the tax. The determination of what constitutes doing business is generally based on the U.S. Constitution's Due Process and Commerce Clauses, which require a sufficient connection or nexus with the taxing state.

Traditionally, nexus required some physical presence in the state (see *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)). However, the current trend has many states taking a more expansive view of nexus. Commonly referred to as economic nexus, this standard is moving beyond the traditional view of nexus toward a standard in which physical presence is not required as long as there is an economic connection to the state. Under this expanded approach, a foreign company that derives royalties from the licensing of intangible property from a customer in a state that has adopted market-sourcing rules would be taxable in that state, regardless of whether the licensor is physically present in the state.

For instance, a Washington state ruling held 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 in the state. The ruling also determined that a tax treaty between the United States and Germany implicitly permits states to tax royalties (Wash. Dep't of Rev., App. Div., Det. No. 15-0251, 35 WTD 230 (decided 9/11/15, published 5/31/16)).

For companies performing service activities, states have been fairly consistent in ruling that out-of-state companies should not be able to avoid imposition of state taxes by contracting with in-state third parties to conduct company business instead of sending in company employees. When the in-state party performs service activities, its classification as an independent contractor, representative, or agent usually has little consequence on the nexus determination. Under these interpretations, a foreign company using an independent contractor to perform in-state services will be viewed as doing business and having a tax reporting responsibility in most states.

Foreign companies that engage only in sales solicitation of tangible personal property encounter the issue of whether a state will extend the protection afforded under the *Interstate Income Tax Act*, P.L. 86-272, to non-U.S. entities. P.L. 86-272 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. Foreign commerce is not mentioned. As a result, it is generally understood that P.L. 86-272 applies only to interstate commerce.

Nevertheless, states can apply P.L. 86-272 protection by policy or regulation to foreign commerce in the same manner as applied to interstate commerce. Responses to the Bloomberg BNA "2017 Survey of State Tax Departments" indicated that 28 states apply P.L. 86-272 protection to foreign commerce. Responses from 12 states indicated that they do not extend those protections.

Federal tax rules apply a different nexus standard to treaty-protected foreign companies. The United States has bilateral income tax treaties that contain a permanent establishment provision, under which the business profits of a foreign corporation are exempt from federal income tax to the extent that its business activities do not rise to the level of a permanent establishment. U.S. treaty provisions do not apply for state tax purposes; there is some likelihood that a foreign company could have nexus for state tax purposes given the difference between the two standards.

State Corporate Income Tax

State income tax calculations generally adopt federal taxable income as a starting point for determining state taxable income and the corresponding tax liability. Sec. 894 provides an exclusion from income for foreign businesses entitled to treaty benefits. Absent any state modification that specifically disallows the Sec. 894 exemption, federal taxable income will drive the calculation of state taxable income. Because a treaty-protected foreign company will have zero federal taxable income, its state tax computation will likely begin with zero.

In contrast to the previous example, where the state begins with federal taxable income, some states require businesses to compute state taxable income on a pro forma basis “as if” the company had taxable income under the Code. (According to the Bloomberg “BNA” 2017 Survey of State Tax Departments,” responses from 15 states indicated that they do not permit the federal tax treaty exemption for state tax purposes.) In this instance, the foreign company could have state income tax liabilities even though it has no federal taxable income. Furthermore, some states (e.g., California, New Jersey, New York, and Oregon) have enacted laws that would add back a foreign corporation’s business income that is “effectively connected” income, regardless of whether it is excluded under an applicable tax treaty.

To the extent that a foreign corporation is subject to state tax, it will need to complete a pro forma federal tax return to prepare state tax returns. Most states would expect a pro forma federal tax return, Form 1120-F, “U.S. Income Tax Return of a Foreign Corporation,” which is based on amounts attributable to U.S. activities. But there are exceptions to this rule, and a state may request pro forma federal returns on a worldwide basis.

Non-U.S. businesses should be aware that it is possible for inbound companies without a federal income tax liability to nonetheless have state income tax filing responsibilities and concomitant liabilities.

Gross-Receipts Tax

A few states have enacted taxes measured by gross receipts or modified gross receipts to replace traditional income taxes. For example, Texas imposes a franchise tax commonly referred to as the Texas margin tax. Under this tax methodology, companies are subject to tax on Texas modified gross receipts, which are gross receipts modified by one of four options: (1) cost of goods sold; (2) compensation expense; (3) $1 million; or (4) a 30 percent-of-gross-receipts deduction.

Similarly, Ohio enacted the commercial activity tax, a gross-receipts tax based on Ohio-situs gross receipts. Also included in this category would be the Washington state business and occupation tax, a business privilege tax measured by Washington-situs sales.

To the extent that a foreign company has Washington or Ohio sales, the economic nexus standard is taken to a new level through the use of a bright-line test. Under this method, a company would have a filing requirement if annual sales exceed a certain threshold. Lastly, the protections under P.L. 86-272 do not apply to gross-receipts taxes.

Net-Worth Tax

Nearly half of U.S. states impose a franchise tax based on the company's apportioned net worth. The tax is reported using several scenarios: (1) The net-worth tax is reported on the income tax return and is a component of total tax due; (2) the net-worth tax is reported on the income tax return but is assessed only if the net-worth tax is greater than the income tax; or (3) a separate return is used to report and remit the tax, either to that state's department of revenue or to that state's secretary of state.

Net-worth taxes are measured by amounts reported on the taxpayer's balance sheet. No clear guidance exists regarding whether the balance sheet should be based on a U.S. balance sheet as reported on a Form 1120-F or on worldwide amounts. Most states offer little to no guidance on this topic. As with gross-receipts taxes, P.L. 86-272 protection does not apply to net-worth taxes.

Sales and Use Taxes

Most non-U.S. businesses are familiar with value-added taxes (VAT). VAT is a tax on each transfer of property along with a credit for previous transfers of that same property. Sales and use taxes are imposed only on the end user and are typically imposed at higher rates. Forty-six states impose a sales tax. Furthermore, many county, city, and special taxing jurisdictions also impose sales tax. There are more than 9,000 sales tax jurisdictions in the United States. Generally, sales taxes are imposed on each legal entity, regardless of whether it is separately regarded for income tax purposes. Again, sales taxes do not fall under the P.L. 86-272 protection, and they typically are not protected by income tax treaties.

State-Based Expertise Recommended

In terms of both tax types and jurisdictions, U.S. state and local tax complexity can present traps for unwary foreign businesses with U.S. inbound investment or operations. Thus, any significantly large U.S. inbound companies should consult with U.S.-based state practitioners.

Learn More

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