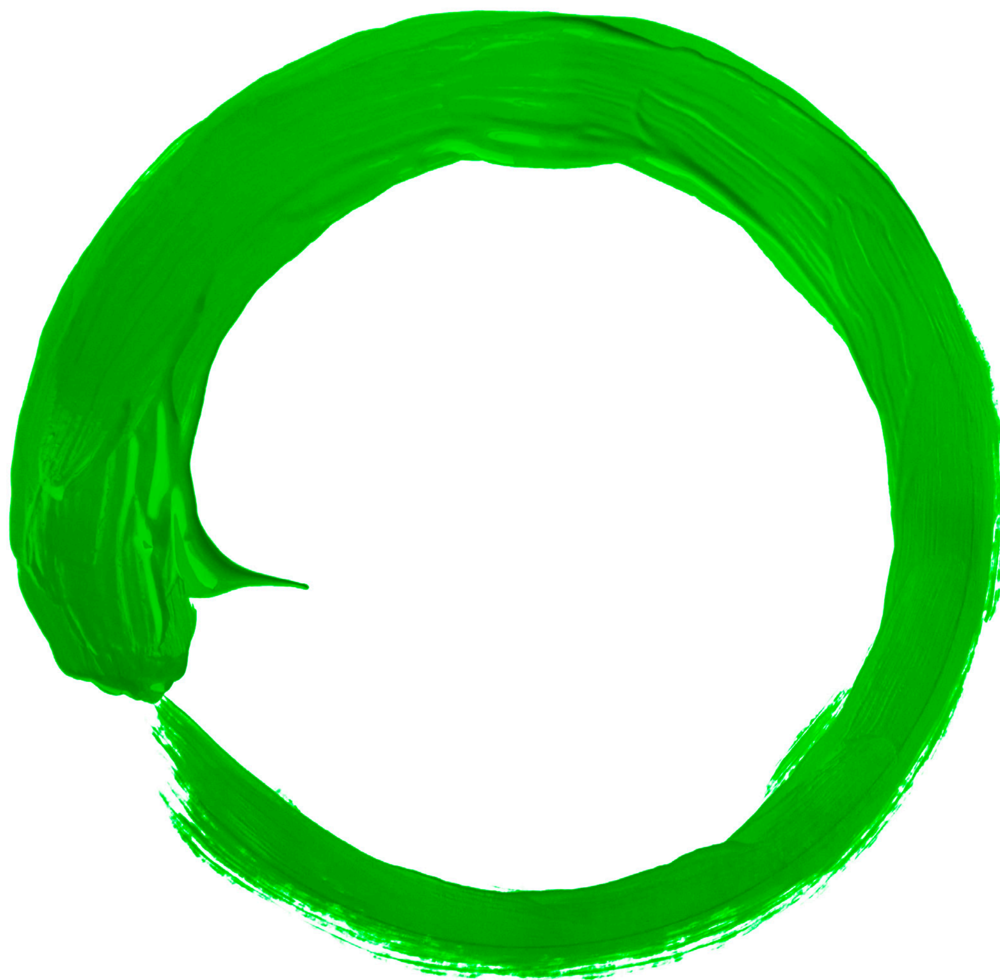
Deloitte.



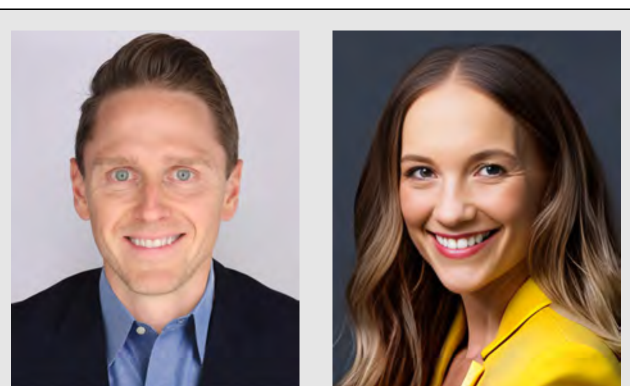
Inside Deloitte

State Mergers and Acquisitions, Part 3: Inbound Considerations

By Tyler Greaves, Grace Taylor, Eira Jones, and Anu Alex, Deloitte Tax LLP

State Mergers and Acquisitions, Part 3: Inbound Considerations

by Tyler Greaves, Grace Taylor, Eira Jones, and Anu Alex



Tyler Greaves Grace Taylor

Eira Jones Anu Alex

Tyler Greaves is a senior manager in Deloitte Tax LLP's Washington National Tax multistate tax group, and Grace Taylor is a senior manager in the firm's national multistate tax services group. Eira Jones is a principal in Deloitte Tax LLP's national global employer services group, and Anu Alex is a principal in the firm's international tax group.

In this installment of Inside Deloitte, the authors discuss the state tax issues for foreign companies entering the U.S. market in the context of mergers and acquisitions.

Copyright 2024 Deloitte Development LLC.
All rights reserved.

In an increasingly globalized economy, foreign entities are expanding their operations into the United States, bringing with them a host of tax considerations that should be carefully navigated in the context of mergers and acquisitions. This article aims to provide tax professionals with an overall understanding of the various state tax nexus and other tax obligations that foreign entities may encounter and should, therefore, be fully vetted as part of due diligence. By the end of this article, tax professionals should be better equipped to evaluate potential targets with primarily foreign operations from a state income tax perspective.[1]

Federal Nexus and Permanent Establishment for Foreign Entities

The concept of federal nexus and creating a permanent establishment are critical in determining a foreign entity's federal tax obligations. U.S. federal nexus determines whether a foreign entity must file a federal income tax return and pay taxes on income effectively connected with its trade or business in the United States.[2] This nexus is established when the entity conducts a trade or business within the United States.[3] However, for entities from countries with an income tax treaty with the United States, the treaty may provide exemptions from federal income taxation on this income, unless the entity has business profits that are attributable to a PE in the United States. Under the United States Model Income Tax Convention of 2016 (model treaty), a PE is defined as "a fixed place of business through

[1] *See* Jacob Aguero et al., "State Mergers and Acquisitions, Part 1: Successor Liability," *Tax Notes State*, Apr. 8, 2024, p. 139; *see also* Youngbok Ko et al., "State Mergers and Acquisitions, Part 2: Non-Income-Tax Types," *Tax Notes State*, July 15, 2024, p. 137.

[2] *See* IRC section 882; *see further* IRS Publication 519 (U.S. Tax Guide for Aliens); *see also* IRS Form 1120-F Instructions (U.S. Income Tax Return of a Foreign Corporation).

[3] *See id.*

For more *Tax Notes® State* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

which the business of an enterprise is wholly or partly carried on" and includes locations like an office, branch, factory, or workshop. However, according to the model treaty, a PE does not include:

a. the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;
b. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;
c. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d. the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
e. the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; [or]
f. the maintenance of a fixed place of business solely for any combination of the activities mentioned in (a) through (e) above, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[4]

Ultimately, the specifics as to what constitutes a PE frequently vary based on the terms of individual tax treaties between the United States and other countries.[5] Therefore, understanding the interplay between domestic tax laws and international tax treaties is essential when contemplating an acquisition of a foreign entity with operations in the United States.

State Nexus Flex on Foreign Entities

When acquiring a foreign entity, the first state income tax consideration involves examining the target's historical filing profile, which consists of determining where the target has established state income tax nexus — that is, where the target has engaged in sufficient business activity in a state to be subject to tax. It is crucial to distinguish between state nexus and its federal analog of PE, as the threshold to establish state income tax nexus is typically lower than that for establishing a PE. As noted, a foreign entity "engaged in a trade or business within the United States" is generally required to file a federal income tax return and pay tax on effectively connected income (ECI) with its U.S. business activities.[6]

Even though the activities articulated in subsections (a) through (f) do not create a PE, a foreign entity engaging in any of this conduct would trigger income tax nexus in most states. Therefore, a foreign entity that avoided creating a PE in the United States may have nonetheless established taxable nexus in certain states and incurred a state income or franchise tax filing obligation. The ineluctable conclusion is that state income tax nexus can be established even without a PE.

In contrast to federal standards, each state's ability to impose a tax on net income is limited by the due process and commerce clauses of the U.S. Constitution, as well as the federal prohibition on taxation under P.L. 86-272.[7] The state income tax nexus standard does not require the same level of activity required of a U.S. trade or business or PE. Instead, it may be met by

[4] *See* U.S. Department of the Treasury, United States Model Income Tax Convention (2016).

[5] For instance, some treaties may include provisions that exclude specific activities, such as preparatory or auxiliary services, from creating a permanent establishment. *See* OECD Model Tax Convention on Income and on Capital, art. 5, para. 4 — Permanent Establishment (2017). The presence of dependent agents who habitually exercise authority to conclude contracts on behalf of the foreign entity can also establish a PE, even in the absence of a fixed physical location. *See id.* Tax treaties often provide relief by preventing double taxation and may offer reduced tax rates or exemptions, but these benefits are contingent on meeting criteria outlined in the treaty. Therefore, understanding the interplay between domestic tax laws and international tax treaties is essential for foreign entities to optimize their tax positions and ensure compliance.

[6] A foreign corporation that has U.S.-source income but is not engaged in a U.S. trade or business may have non-ECI, which may be subject to federal income tax and enforced through withholding. *See* IRC sections 881 and 1442.

[7] Under the due process clause, the U.S. Supreme Court has held that there must exist "some minimum connection, between a state and the person, property or transaction it seeks to tax" and the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." *Quill Corp. v. North Dakota*, 504 U.S. 298, 309 (1992). Further, the Court has ruled that the commerce clause prohibits a state from taxing an out-of-state corporation unless it has a substantial nexus in the state. *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

establishing a sufficient economic presence (for example, factor-presence nexus and economic nexus). Long before the U.S. Supreme Court's *Wayfair* decision, states adopted income tax nexus standards incorporating economic nexus principles and bright-line statutory nexus thresholds, eliminating the need for physical presence in a state to be subject to income tax.[8] *Wayfair* further affirmed that physical presence is not required to establish nexus under the commerce clause if a foreign entity engages in sufficient sales activity directed at in-state customers.[9] With the digital nature of the global economy, companies around the world can have a sufficient economic presence — hence income tax nexus — in a state without having physical presence. It is not uncommon for a foreign entity to establish state income tax nexus, yet not be required to file a federal income tax return.

P.L. 86-272 and Foreign Entities — Take Several Seats

P.L. 86-272, a federal law enacted in 1959, limits the state and local taxation of income from sales of tangible personal property if the taxpayer's only business activities in the state are limited to the solicitation of orders that are approved and shipped from outside the state.[10] P.L. 86-272 is not applicable to taxes not based on net income (for example, gross receipts taxes, franchise taxes, sales and use taxes), and because it limits states' ability to tax companies, state tax authorities typically interpret and apply the law narrowly.[11]

P.L. 86-272 explicitly applies to interstate commerce and does not extend to foreign commerce.[12] As a result, foreign commerce is only afforded the same protections to the extent a state has elected to treat it consistently with interstate commerce.[13] Some states apply P.L. 86-272 principles uniformly to both foreign and interstate commerce, thereby ensuring equitable treatment of similarly situated foreign and domestic companies.[14] However, states lacking guidance on the application of P.L. 86-272 to foreign commerce may assert that activities otherwise protected as interstate commerce are

[8] *South Dakota v. Wayfair Inc.*, 585 U.S. 162 (2018); *see, e.g.*, *Geoffrey Inc. v. South Carolina Tax Commissioner*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993) (South Carolina Supreme Court ruling that the trademark holding company that licensed intangibles for use in South Carolina had nexus for income tax purposes despite lack of tangible property or employees in the state). In 2002, in an effort to create a simple bright-line nexus standard for gross receipts and income taxes, the Multistate Tax Commission adopted a model rule known as factor presence nexus. Under the MTC's model statute, if an out-of-state business exceeds any of the following thresholds, the company would be considered to have substantial nexus for state tax purposes: $50,000 of property; $50,000 of payroll; $500,000 of sales; or 25 percent of total property, payroll, or sales adjusted each year for inflation. Several states adopted the MTC's approach. *See, e.g.*, Cal. Rev. & Tax. Code section 23101(b).

[9] *See Wayfair*, 585 U.S. at 181 (explaining that "between targeted advertising and instant access to most consumers via any internet-enabled device, a business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term.") (internal quotations omitted).

[10] P.L. 86-272, 15 U.S.C. sections 381-384.

[11] *See Uline Inc. v. Commissioner of Revenue*, 10 N.W.3d 170 (Minn. 2024) (holding that distributor's practice of having sales representatives obtain information regarding its competitor's products and business practices served a business purpose independent from the solicitation of orders and was not protected under P.L. 86-272); *see further H&M Bay Inc. v. Division of Taxation*, Dkt. No. 012545-2021 (N.J. Tax Dec. 18, 2023) (concluding that freight-forwarder was not entitled to protection under P.L. 86-272 because entity provided services); *see also Santa Fe National Tobacco Co. v. Department of Revenue*, 25 Or. T.C. 124 (Or. Tax Aug. 23, 2022) (finding that having representatives facilitate placement of orders destroyed the ability to claim protection under P.L. 86-272 because prebooked orders were not considered mere solicitation of sales).

[12] *See Border Pipe Line Co. v. Federal Power Commission*, 171 F.2d 149 (D.C. Cir. 1948) (explaining interstate commerce and foreign commerce are distinct concepts under the U.S. Constitution and that Congress may choose to protect or regulate interstate commerce, but not foreign commerce).

[13] The MTC, whose mission includes promoting consistent administration of tax laws amongst the states, encourages states to apply P.L. 86-272 to foreign commerce to ensure consistent treatment. *See* Statement of Information Concerning Practices of Multistate Tax Commission and Supporting States Under Public Law 86-272 (rev. Aug. 4, 2021) ("MTC's Revised Statement").

[14] *See, e.g.*, Ala. Admin. Code section 810-27-1-.19(8) (stating "Alabama will apply the provisions of Public Law 86-272 and of this rule to business activities conducted in foreign commerce"); *see also* 86 Ill. Admin. Code section 100.3200(c)(8)(B) (stating "Illinois will apply the provisions of [P.L.] 86-272 . . . to business activities conducted in foreign commerce"). Alternatively, California's position is that P.L. 86-272 does not apply to foreign commerce in the context of applying its sales-factor-throwback rule. *See* California Franchise Tax Board, Information Publication No. 1050 (June 1, 2017) (stating "for purposes of [P.L.] 86-272, 'interstate commerce' includes commerce between the 50 states and The Commonwealth of Puerto Rico") and California FTB, "Multistate Audit Manual," section 1240 (stating "immunity provided by Public Law 86-272 is expressly limited to interstate commerce"); *see also* New Mexico Taxation and Revenue Department, "Corporate Income Tax Audit Manual" (May 1, 2007) (noting that P.L. 86-272 "only applies to interstate commerce and not to foreign commerce").

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

unprotected when classified as foreign commerce.

The Multistate Tax Commission recently clarified its interpretation of P.L. 86-272 as it pertains to internet-based activities and adopted a view that further narrows the protections afforded to companies.[15] In revisiting its interpretation of the statute, the MTC attempted to address the question whether business activities conducted by a seller through the internet that extend beyond solicitation are business activities conducted within the taxing state. According to the MTC's Revised Statement, "when a business interacts with a customer via the business's website or app, the business engages in a business activity within the customer's state."[16] Applying this general premise, the MTC provided several examples of activities that are unprotected under P.L. 86-272. For example, the MTC determined that placing cookies onto computers or devices of in-state customers constitutes an in-state business activity, which defeats the business's P.L. 86-272 immunity if the cookies are used in a manner not entirely ancillary to the solicitation of orders for sales of tangible personal property.[17] The MTC also concluded that regularly providing post-sale assistance to in-state customers via electronic chat or email renders any potential immunity under P.L. 86-272 inapplicable.

Only three states have currently implemented aspects of the MTC's Revised Statement as it pertains to internet activities.[18] Nevertheless, additional states are likely to adopt some derivative of these principles in the future — or may attempt to apply these principles on audit. Given the potential for inconsistent state applications of P.L. 86-272 and the narrowing of protections for internet sellers, a buyer of a foreign entity should be cautious of claims of protections against state income taxes under P.L. 86-272 and evaluate the risk of a state asserting nexus.

Determining State Taxable Income: Not So Simple Math

When a foreign entity has established state income tax nexus, the next consideration is the state income tax base. Although many states start with federal taxable income in calculating state taxable income, a foreign entity with no federal taxable income will not necessarily have a state tax base of zero. Understanding the state tax base for a foreign entity is essential when contemplating the acquisition of a foreign entity, as nonconformity to the operative federal income tax rules can result in a positive tax base, which can significantly affect a foreign entity's state tax liabilities.

Generally, a foreign entity is taxed only on its U.S.-source ECI.[19] If a foreign entity is a resident of a country with a U.S. income tax treaty, it may be protected from federal income tax on business profits not attributable to a PE in the United States.[20] However, this treaty protection does not necessarily extend to levying state income taxes.

States may adopt federal treaty provisions for state income tax purposes either directly or indirectly by incorporating federal taxable income. For example, South Carolina begins with federal taxable income after special deductions and excludes from South Carolina taxable income amounts excluded from federal taxable income under a U.S. treaty.[21] However, in states like Michigan, Minnesota, and North Carolina, among

[15] *See* MTC's Revised Statement; *see further* Joe Garrett et al., "The MTC and P.L. 86-272 Protections in the Internet Age," *Tax Notes State*, Aug. 8, 2022, p. 665.

[16] *Id.*

[17] *Id.*

[18] *See* N.Y. Comp. Codes R. & Regs. tit. 20, section 1-2.10; New Jersey Division of Taxation, Technical Bulletin TB-108 (Sept. 5, 2023); Minnesota Department of Revenue, Draft Revenue Notice No. 23-XX, "Corporate Franchise Taxes — Nexus — Internet Activities and Public Law 86-272" (Apr. 2023).

[19] IRC sections 882(a) and 864(c).

[20] IRC section 894(b) (as added by Foreign Investors Tax Act of 1966, P.L. No. 89-809, section 105, 80 Stat. 1539, 1563).

[21] *See* S.C. Code Ann. section 12-6-1200.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes*® *State* content, please visit www.taxnotes.com.

others, there is no addition modification for treaty-exempt income; thus, a foreign entity with treaty-protected income may also have no state taxable income because the income was not included in the foreign entity's federal taxable income.[22]

A few states determine state taxable income without reference to federal taxable income. For example, in Arkansas and Mississippi the starting point for determining state taxable income is gross income as defined by state statute and is not directly linked to federal taxable income.[23] In those same two states, as (i) the starting point is not tied to federal taxable income, and (ii) the state does not explicitly adopt federal treaty protections, a foreign entity would be subject to tax on its apportioned worldwide income notwithstanding treaty protections or whether the business has ECI. A similar result occurs in Hawaii, which begins with federal taxable income as the starting point but generally decouples from subchapter N of the IRC (sections 861 to 999) with some exceptions.[24]

Some states require foreign entities to recalculate federal taxable income as if no treaty is in effect. In other words, these states require a foreign entity's state tax base to be determined based on whether it has ECI with a U.S. trade or business without regard to whether the entity has a PE in the United States. For example, California follows the federal rules to determine a foreign entity's ECI includable in a water's-edge combined report without consideration of federal treaty provisions.[25] Similarly, New York provides that a foreign entity is taxable only on its ECI, and to the extent a foreign entity has treaty-exempt income, its income is subject to taxation if — absent the treaty exemption — the income would be treated as ECI.[26] Alternatively, other states require a foreign entity to include worldwide income, which includes income from sources outside the United States that was excluded from the computation of federal taxable income.[27]

Although a complete discussion of these rules is beyond the scope of this article, there are other ways in which a state can levy an income tax on a foreign entity even if it applies the ECI standard. For example, some states require taxpayers to file on a worldwide basis, including all unitary affiliates (that is, both domestic and foreign) unless a timely-filed, valid water's-edge election is made.[28] Further, foreign entities can be included in a water's-edge combined return in some states

[22] *See* Mich. Comp. Laws sections 206.623(2) and 206.603(3); *see also* Minn. Stat. section 290.01; *see further* N.C. Gen. Stat. sections 105-130.3 and 105-130.2(15). It should also be noted that even in states that explicitly or implicitly follow federal treaty rules or the rules for determining ECI with a U.S. trade or business, some state addition modifications may still result in state taxable income. *See, e.g.*, Letter Ruling IT-2018-01, Georgia DOR (June 20, 2018) (holding "by virtue of the Treaty, if Company had no gross income effectively connected with the conduct of a trade or business in the United States, then it would have no 'taxable income' for purposes of IRC section 11(a). But the Company could still have positive Georgia taxable net income if there are any additions to federal taxable income required by [Ga. Code Ann.] section 48-7-21(b), depending on how the allocation and apportionment provisions of [Ga. Code Ann.] section 48-7-31 apply.").

[23] *See* Ark. Code Ann. section 26-51-404; *see further* Miss. Code Ann. sections 27-7-13 and 27-7-15.

[24] *See* Haw. Rev. Stat. section 235-2.3(b)(35); *see also* Haw. Rev. Stat. section 235-4(d).

[25] Cal. Rev. & Tax. Code sections 23051.5(a), 17024.5(a)(1)(P), 24271(a), and 25110(a)(2)(A)(i); Cal. Code Regs. tit. 18, sections 25110(d)(2)(F)(1)(a), (d)(2)(5).

[26] N.Y. Tax Law section 208(9)(b)(1) (stating "entire net income shall be determined without the exclusion, deduction or credit of . . . in the case of an alien corporation that under any provision of the Internal Revenue Code is not treated as a 'domestic corporation' . . . any income exempt from federal taxable income under any treaty obligation of the United States, but only if such income would be treated as effectively connected in absence of such exemption provided that such treaty obligation does not preclude the taxation of such income by a state, or any income which would be treated as effectively connected if such income were not excluded from gross income pursuant to [the IRC].").

[27] Or. Admin. R. 150-317-0050(3) (for example, Oregon taxable income is determined by calculating a foreign entity's federal taxable income as if the entity was subject to federal income tax and without regard to the U.S. trade or business rules provided under IRC sections 861 through 864); Or. Admin. R. 150-317-0050(2) (Oregon states "for foreign corporations to be exempt from the Oregon corporation excise or income tax, the federal treaty must specifically contain a provision exempting them from state corporation taxes upon or measured by net income.").

[28] *See, e.g.*, Cal. Rev. & Tax. Code sections 25101 and 25110 (stating that for multistate customers the activities attributable to California "shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country."); *see also* Mont. Code Ann. section 15-31-322 (explaining a corporation is required to file its Montana return using the worldwide method, unless it properly elects to use a water's-edge method); *see further* N.D. Cent. Code section 57-38.4-02 (specifying that to the extent combined reporting applies, a corporation is required to file its North Dakota return using the worldwide method, unless it elects to use the water's-edge method).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.

that have adopted inclusionary rules for foreign entities whose average of its property or payroll factors in the United States exceeds 20 percent or that are incorporated in a tax haven jurisdiction.[29]

As these examples demonstrate, the interplay between the state statutes governing the calculation of state taxable income and the federal rules is complex and necessitates a meticulous, state-specific analysis. For a buyer acquiring a foreign entity with income tax nexus in multiple states, there is a risk of inheriting significant historical state income tax liabilities, even when the foreign entity has previously not had income subject to federal income taxation. This risk is pronounced if the target entity and its tax advisers have not performed a thorough state-by-state analysis to determine the state income tax filing requirements in each jurisdiction. However, even if no income tax exposure exists, consideration should be given as to whether a foreign entity has exposure for net worth or equity-based franchise taxes in states where nexus was established.

Interplay Between Payroll Withholding and State Nexus

Identifying the typical triggers for state nexus, including payroll activities, is crucial for understanding historical tax liabilities and compliance gaps associated with the acquisition of a foreign company. State tax agencies frequently use payroll withholding filings as a method to identify whether nexus may be established and potential nonfilings for foreign companies. These filings provide detailed information about the physical presence and business activities of a target's employees in a state, which can demonstrate sufficient physical or economic presence in that jurisdiction. Similarly, triggering state income tax nexus via physical presence or hiring employees in the United States (in a given state) often affects or corresponds to an entity's payroll tax obligations.[30]

Comparing payroll tax considerations with state income tax considerations during due diligence reveals several overlapping areas. Both require a thorough understanding of a target's nexus in various states, which determines certain tax obligations. Common employment tax compliance issues on a transaction include incorrect payroll tax treatment of multistate or multinational workers and using nonstandard approaches to consolidated payroll tax filings, such that employment tax withholding and payroll tax filings are not conducted by the common-law employer. Accurate worker classification also affects both payroll tax and state income tax liabilities, as misclassification can lead to an incorrect filing footprint and payroll tax deficiencies. Depending on the industry, these matters can be significant in the context of the overall transaction. Thus, it is essential to assess a target's compliance with federal and state payroll tax obligations when reviewing state income tax nexus in general. ■

[29] *See*, *e.g.*, Conn. Gen. Stat. section 12-218f(b)(2)-(3) (explaining a combined group that reports income on a water's-edge basis must include the following group members: (i) any member incorporated in the United States or formed under the laws of the United States, any state, the District of Columbia, or any U.S. territory or possession, unless at least 80 percent of both its property and payroll are located outside the United States; (ii) any member, regardless of the place of incorporation or formation, if at least 20 percent of both its property and payroll during the tax year at issue are located in the United States; or (iii) any member incorporated in a tax haven, unless it is demonstrated that such member is incorporated in a tax haven for a legitimate business purpose).

[30] To the extent employees are seconded from a domestic entity and performing services on behalf of a foreign entity, the activities of seconded employees may create state income tax nexus for the foreign entity as well and may also affect the payroll tax obligations.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® State* content, please visit www.taxnotes.com.