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by Charlie Fischer,
Deloitte Tax LLP

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by Charlie Fischer, National Multistate Tax Services, Deloitte Tax LLP

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Contact: chafischer@deloitte.com, Tel. + 1 314 641 4349

This is the first in a series of ongoing articles by Charlie Fischer of Deloitte Tax LLP focused on US state tax considerations for the international operations of multinational taxpayers, whether headquartered in the US or elsewhere around the world, with a particular focus on state tax considerations for foreign entities.

A growing trend in state taxation is the adoption of bright-line statutory nexus thresholds in determining what it means to be doing business or otherwise have nexus in a state for income or gross receipts tax purposes.[1] In 2002, the Multistate Tax Commission ("MTC") adopted a uniformity proposal with respect to a bright-line statutory nexus for business activity taxes.[2] Under the proposal, "substantial nexus" would be established if any of the following thresholds are exceeded during the tax period:

- USD50,000 of property in the state;
- USD50,000 of payroll in the state;
- USD500,000 of sales in the state; or
- 25 percent of the entity's total property, payroll, or sales are in the state.[3]

Some states that have adopted a factor presence nexus standard have included the threshold amounts proposed by the MTC (*see* the California example discussed below), while others have implemented variations that utilize different threshold amounts, particularly with respect to sales activity within the state. For example, effective for taxable years beginning on or after January 1, 2015, the nexus standard for the New York franchise tax has expanded such that corporations with sales of USD1m or more to New York customers during the taxable year will be subject to tax.[4]

As applied to foreign companies that lack a physical presence within a state that has adopted statutory nexus thresholds, the potential for nexus most typically arises from meeting the sales threshold.[5]

The property threshold may also present state income tax nexus concerns. Foreign companies may store large quantities of inventory in the United States. Because of treaty protection, such storage

may not create a "permanent establishment" or taxable presence for federal income tax purposes. However, treaty protection would be inapplicable in a state that does not follow US treaties or does not automatically conform to federal taxable income. Stored inventory that exceeds that state's property threshold would thus trigger state nexus and potential exposure.[6]

In addition to the nexus considerations, states are trending towards single sales factor apportionment and increasingly adopting market-based sourcing rules for the sale of services and intangibles. These changes in applicable sourcing and apportionment formula rules would generally cause a potential increase in the apportionment and tax liability of foreign companies.

California Example

For tax years beginning on or after January 1, 2011, in addition to California's traditional definition of "doing business" as that of "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit" in the state, a taxpayer is "doing business" in California, and thus subject to the state's franchise tax, if any of four factors are satisfied, including bright-line statutory nexus thresholds based on specified amounts of property, payroll, or sales in the state.[7] With respect to sales, for tax years beginning on or after January 1, 2011, the threshold is whether the taxpayer's sales in California exceed the lesser of USD500,000 or 25 percent of the taxpayer's total sales.[8] The sales threshold is indexed for subsequent tax years, so for taxable years beginning on or after January 1, 2014, the threshold is USD529,562.[9]

Additional California tax law changes have also recently altered the apportionment formula and sourcing rules previously utilized by most taxpayers. For tax years beginning on or after January 1, 2013, all business income from an apportioning trade or business must generally be apportioned to California on the basis of a single sales factor with market-based sourcing required for revenue from sales of other than tangible personal property.[10] The market-based sourcing rules also apply when determining whether the sales threshold is satisfied under California's bright-line statutory nexus rules.[11]

During 2011 and 2012, single sales factor apportionment was elective. Taxpayers not making a single sales factor apportionment election sourced sales of other than tangible personal property under costs of performance rules which generally were more favorable to non-California based taxpayers.[12] The costs of performance rules sourced sales based on the location where the greater costs of the income-producing activity that generated the service or intangible revenue were performed. In contrast, market-based sourcing rules look to where the benefit of the services is received by the customer or generally where the customer uses the intangible property.[13]

Because of these tax law developments, foreign companies with US inbound activities, including those with no physical presence in California, may

now be subject to California franchise tax due to the bright-line, sales-based statutory nexus threshold and may be required to apportion income on the basis of a single sales factor. Also, foreign companies that store inventory in California may be subject to California franchise tax where the property exceeds the state's property-based nexus threshold despite the fact that the foreign company may, by application of a US treaty, avoid imposition of federal income tax.[14]

As a result of these tax law changes, foreign companies may potentially be at higher risk of exposure to the California franchise tax.[15] Foreign companies with US inbound activities may wish to consider the following hypothetical factual scenarios, each of which may require further analysis regarding whether a California franchise tax filing requirement and liability potentially exist:

- A foreign company generates licensing or royalty revenue from California use of intangible property such as patents, trademarks, licenses, royalties, internet games, *etc.* or from the sale of goods into the California market that incorporate such intangible property under a licensing arrangement with the product manufacturer; (*e.g.*, marketing intangible);
- Executives or employees of a foreign company travel to California to perform services for the benefit of the foreign company's US affiliates or customers;
- Executives or employees of a foreign company perform services outside the US and charge their California affiliates or customers for such services;
- A foreign company sells tangible personal property into California to a US affiliate or to a third party;
- A foreign company generates interest income on loans to its California affiliates or customers.

Endnotes

1 Some form of bright-line, non-industry-specific statutory nexus threshold has been adopted in the following states: California (Cal. Rev. & Tax. Code § 23101(b)), Colorado (Colo. Code Regs. § 39-22-301.1(2)(b)), Connecticut (Conn. Gen. Stat. § 12-216a(a), Informational Publication 2010 (29.1)), New York (NY Tax Law § 209.1(b)), Ohio (Ohio Rev. Code § 5751.01(I)), and Washington (Wash. Rev. Code § 82.04.067).

2 For the MTC model statute regarding Factor Presence Nexus Standard for Business Activity Taxes, *see* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

3 The model statute provides that the threshold property, payroll and sales amounts may be adjusted annually to reflect the cumulative percentage change in the consumer price index.

4 NY Tax Law § 209.1(b).

5 Note that 15 US Code § 381 (Public Law 86-272, "PL 86-272") prohibits a state from taxing out-of-state corporations on income from business activity within the state if such activity is limited to "solicitation of orders" for the sale of tangible personal property and the orders are approved and filled from outside the state. Consideration should be given to ascertain whether PL 86-272 protection may potentially still

exist even where a business has otherwise triggered nexus based on a sales threshold nexus standard. In addressing this issue, taxpayers should consider that PL 86-272 protection is compromised where the tangible personal property is shipped from outside the United States, thus characterizing the sale as not arising from an interstate transaction.

6 Ownership of inventory in a state generally triggers "physical presence" nexus regardless of whether a state has adopted bright-line statutory nexus provisions.

7 Cal. Rev. & Tax. Code § 23101(a)-(b).

8 Cal. Rev. & Tax. Code § 23101(b)(2).

9 *Tax News*, California Franchise Tax Board, September 2014.

10 Cal. Rev. & Tax. Code §§ 25128.7, 25136, 25128(c)-(d). Note, however, that market sourcing has been mandatory for tax years beginning on or after January 1, 2011, for taxpayers making a single sales factor election. Note also that the single sales factor requirement does not apply to an apportioning trade or business that is primarily engaged in certain qualified business activities, including banking/financial, extractive, or agricultural.

11 Cal. Rev. & Tax. Code § 23101(b)(2).

12 Cal. Rev. & Tax. Code §§ 25128, 25128.5, and 25136 (effective for tax years beginning before January 1, 2013).

13 Cal. Rev. & Tax. Code § 25136; Cal. Code Regs. tit. 18, § 25136-2.

14 California does not follow United States treaties. *See* Cal. Code Regs. tit. 18 § 25110(d)(2)(F)1.a. *See also Container Corporation of America v. Franchise Tax Board*, 463 US 159, 196 (1983).

15 Similar considerations would exist in other states with bright-line statutory nexus thresholds.