Deloitte.

Inside Deloitte

Foreign companies and state income tax nexus

by Mike Porter, Scott Schiefelbein, J. Snowden Rives, and Doug Sweeney, Deloitte Tax LLP

Foreign Companies and State Income Tax Nexus

by Mike Porter, Scott Schiefelbein, J. Snowden Rives, and Doug Sweeney

Mike Porter is a principal in Deloitte Tax LLP's Multistate Office of Washington National Tax based in Boston. Scott Schiefelbein, who is based in Portland, Oregon, is a senior manager; and J. Snowden Rives, based in Washington, D.C., is a manager in Deloitte's Multistate Office of Washington National Tax. Doug Sweeney was previously employed as a tax consultant in the firm's Multistate Practice in Boston.

In this article, the authors consider the various income tax nexus theories that state tax agencies may apply to companies located outside the United States, as well as other approaches that states may use to tax the income of a foreign company, including worldwide filing regimes, state tax haven laws, and other inclusionary rules for combined filing states.

The authors thank Tom Cornett for his contributions to and review of this article.

I. Introduction

State governments find themselves confronted with the realities of an economy that is more global and integrated. In that environment, reliable network connections often pose greater operational challenges than do international borders relative to the sale and delivery of services, intangibles, and digital products. Because of the internet, companies anywhere in the world can have a business presence in a state without ever setting foot inside the state's borders.

The nature of the global economy can pose challenges for state governments as they seek to tax foreign companies that are engaged in a substantial amount of commerce with in-state customers. Some states use doing business statutes and income-sourcing methods that were enacted decades ago when the U.S. economy largely revolved around manufacturing, resource extraction, and more localized and in-person delivery of services. Those 20th-century taxing provisions did not contemplate a multinational business selling products and services through the internet. The perception that substantial tax revenue is lost through a state's limited ability to tax foreign companies and that such businesses are not paying their fair share of taxes has become a rallying cry in many state capitols in recent years.[1] Concerns at the state level with revenue loss are exacerbated by the anticipated slowdown in state tax revenue collections over the next several years.[2]

The first state income tax consideration when examining a particular business is whether nexus has been established in the state — that is, has the company engaged in sufficient business activity in the state to be subject to its taxing jurisdiction? Absent nexus, the state lacks the authority to tax the business. As a general matter, states often assert nexus as aggressively as possible, bound only by the requirements of the U.S. Constitution.

The aggressive application of state nexus standards may surprise foreign companies that may be under the impression that the existence of a tax treaty between their home jurisdiction and the United States avoids state income tax. As this article will describe, however, the states are generally not parties to U.S. tax treaties. As a result, taxpayers that have structured their affairs to avoid creating a permanent establishment in the United States for federal income tax purposes may have nonetheless established a taxable nexus with various states and possibly incurred a state income tax liability.[3] Taxable presence in the states can be created in a variety of ways, many of which differ markedly from the federal PE test. And notwithstanding nexus, a foreign company must also be aware of the rules in various states targeted at some types of foreign activity, including worldwide filing regimes, state tax haven laws, and other inclusionary rules for combined filing states.

This article will examine those various issues and how they apply to foreign companies, particularly those with substantial inbound transactions in the United States. While a company doing business in a particular state may be subject to that state's taxing jurisdiction, a careful taxpayer

---

[1] Robert Schroeder, "Americans' Top Tax Complaint: Corporations 'Don't Pay Their Fair Share,'" MarketWatch.com (Mar. 20, 2015).

[2] Lucy Dadayan and Donald J. Boyd, "Softening Third-Quarter Growth in State Taxes, Weak Forecasts for Fiscal 2016 and 2017," The Nelson A. Rockefeller Institute of Government, No. 102 (Mar. 2016).

[3] Foreign companies doing business in the U.S. may also create nexus with state and local taxing jurisdictions for sales and use tax purposes. Those taxes raise additional nexus considerations that are beyond the scope of this article.

that closely evaluates the various state provisions can potentially mitigate expensive missteps.

II. Federal Tax Treaties and the Interplay With State Income Taxation

Not surprisingly, the focus of many foreign companies considering expansion into the U.S. is compliance with federal income tax laws. In addition to being one of the largest markets for products and services, the Unites States also imposes a top federal income tax rate of 35 percent — among the highest in the world.[4] Accordingly, many foreign companies will initially evaluate the applicable tax treaty with the United States and whether that treaty shields some or all of their income from federal income taxation.

In many cases, the associated federal tax benefits can be substantial. While a thorough discussion of those rules is beyond the scope of this article, in many cases the treaty can result in the foreign corporation paying federal income tax only on income that is effectively connected with a U.S. trade or business and that is attributable to a PE in the United States.[5] Effectively connected income is generally considered income from sources within the United States connected with the conduct of a trade or business engaged in by a foreign corporation in the United States. A PE is broadly defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on" and can include such locations as an office, place of management, workshop, or factory.[6] Considering the vast increase in internet-based transactions that do not require a fixed place of business in a market, the requirement that a taxpayer have a PE in a jurisdiction before being subject to income tax provides broad protection from federal taxation for a significant number of foreign companies.

Such treaty protection, however, does not necessarily extend to the levy of state corporate income taxes. States are generally not parties to or bound by federal income tax treaties absent state legislation to that effect.[7] Accordingly, a foreign company that assumes federal income tax protection offered by a treaty automatically extends to state corporate income taxes may be at risk of non-compliance with state taxes. That tendency may be reinforced by the fact that many countries do not have a multi-tiered tax structure of federal, state, and even local corporate income taxes as exists in the U.S.

In some states, the existence of a U.S. tax treaty may offer a practical defense against state corporate income taxes even if the state is not a party to the treaty. For instance, Florida,[8] Georgia,[9] and North Carolina[10] provide that the starting point for computing state taxable income is taxable income as defined in the IRC. In such states, the income tax statutes make no reference to adding back income or otherwise taxing income that was subject to treaty protection. The treaty-protected income is effectively shielded from state income tax because the income was not in the foreign corporation's federal taxable income starting point.

Other states, such as Colorado[11] and Oregon,[12] require taxpayers to recalculate the foreign entity's federal taxable income as if no treaty was in effect. Also, some states provide that the foreign income and treaty protection depends on whether the income is effectively connected with a U.S. trade or business. For example, California,[13] New York,[14] and Pennsylvania[15] each adopt the treaty approach and only tax income that is effectively connected with a U.S. trade or business, without regard to whether the company has a PE in the United States.

In other states, the calculation is more complex. In Massachusetts, if a combined return is filed on a water's-edge basis, the income of a foreign corporation that is exempt from U.S. federal income tax by virtue of a federal income tax treaty is expressly excluded from the water's-edge unitary combined return. However, Massachusetts only considers the income exempt from tax if the treaty eliminates all income from tax. Merely reducing the rate to be applied to the federal income (such as reducing the withholding rate under IRC section 881 on U.S.-source interest income from 30 percent to 15 percent) does not render the income exempt from federal taxation and so the income would be subject to Massachusetts taxation.[16]

A more detailed analysis of the complex interplay between the states and federal tax treaties is beyond the scope of this article. Diligent foreign companies should conduct a careful state-by-state analysis to accurately determine how income of a foreign company is computed.

---

[4]Deloitte Tax LLP, Corporate International Tax Rates 2016 — International Tax (Mar. 2016), *available at* http://bit.ly/2bqnI5X.

[5]*See* U.S. Model Income Tax Convention of November 15, 2006, article 2 (taxes covered) [hereinafter, Model Treaty]; and IRC section 894. For a more detailed discussion of federal income tax treaties and their treatment of taxable income of foreign corporations, see Charles Fischer, "State Tax Considerations for Foreign Entities," *U.S. State Tax Considerations for International Tax Reform*, p. 129 (Tax Analysts (2014)).

[6]Model Treaty, article 5 (PE).

[7]Model Treaty, article 2 (taxes covered).

[8]Florida Department of Revenue, Tech. Assist. Advisement No. 86(C)1-006 (Dec. 17, 1986).

[9]Ga. Code Ann. section 48-7-21.

[10]N.C. Gen. Stat. section 105-130.2(15).

[11]*Hewlett-Packard Co. v. State Department of Revenue*, 749 P.2d 400 (Colo. 1988).

[12]Or. Admin. R. 150-317.010(10)-(B).

[13]Cal. Code Regs. tit. 18, section 25110(d)(2)(F)1.

[14]N.Y. Tax Law section 208.9(b), as amended by section 4, Part A, Chapter 59, Laws of 2014.

[15]72 Pa. Stat. Ann. section 10003.11.

[16]Massachusetts Department of Revenue, Tech. Information Release 10-16 (Apr. 4, 2011).

III. State Income Tax Nexus

Before a state may tax a business activity, nexus — the necessary connection between the entity that produces the taxable income and the taxing jurisdiction — must exist.[17] Absent more restrictive state laws, a state's ability to establish nexus is constrained by the due process and commerce clauses of the U.S. Constitution. The U.S. Supreme Court has held that the due process clause requires there be a minimal connection between a taxpayer's interstate activities and the taxing state, and that the commerce clause requires substantial nexus between the taxing state and the taxed activity.[18] Many states have asserted their ability to tax activity to the fullest extent allowed by the Constitution, and a thorough awareness of those approaches is important for foreign companies.[19]

A. Permanent Establishment Distinguished From State Income Tax Nexus

A foreign company may have nexus with a state, and thus be required to pay tax to that state, even though it is not required to file a federal income tax return. A foreign corporation is generally required to file a federal income tax return when it is "engaged in a trade or business" in the United States, and as previously discussed it will generally have to pay federal taxes on the income the IRC treats as effectively connected with the conduct of a business within the U.S.[20] Also, for foreign corporations located in countries with a U.S. income tax treaty, federal income tax obligations are largely based on the PE test. As discussed previously, a PE is broadly defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on."[21] Therefore, the focus of the federal standard is generally on whether a foreign corporation has a fixed place of business with the United States.

For state income tax purpose, nexus is the threshold for a business to be subject to the taxing jurisdiction of the state. As opposed to PE, which generally requires a fixed place of business, nexus is potentially triggered by the existence of any physical (or even economic) presence of a foreign company in a state. Accordingly, while some activities of a foreign company may not rise to the level of a PE for federal income tax purposes, they may establish nexus for state income tax purposes. For example, the federal definition of PE in some treaties contains several exceptions, such as displaying merchandise or maintaining a purchasing facility.[22] States, by contrast, would generally view those activities — including owning shipping containers in ports and storing inventory in a warehouse — as establishing a physical presence in the jurisdiction sufficient to allow the state to impose an income tax.[23] Further, the presence of employees, representatives, and agents performing business activities in the state, even on a temporary basis, is typically sufficient to establish nexus.[24] That dichotomy — in which some activities are protected for federal tax purposes and not protected for state tax purposes — is important for foreign companies to understand.

B. Economic Presence Nexus

In addition to in-state activities that have traditionally created physical presence nexus, some states have enacted economic presence nexus standards following the decision in *Geoffrey Inc. v. South Carolina Tax Commissioner*.[25] In *Geoffrey*, the South Carolina Supreme Court ruled that an out-of-state trademark holding company, which licensed its intangibles for use in the state, had nexus for income tax purposes despite the lack of any tangible property or employees.[26] The corporation, Toys R Us Inc., had created a Delaware holding company named Geoffrey Inc., which owned numerous trademarks and names, including the eponymous giraffe mascot.[27] South Carolina asserted that Geoffrey Inc. was subject to its income tax, while the company countered that such an imposition of tax violated both the due process and commerce clauses.[28] The state supreme court dismissed both of Geoffrey Inc.'s constitutional arguments, holding that the receipt of money from the in-state company for the purposeful licensing of trademarks satisfied the minimum connection requirement of the due process clause, and that the presence of intangible property alone was enough to satisfy the commerce clause's substantial nexus requirements.[29] That decision gave rise to what is now referred to as the economic presence nexus principle, which refers to the concept that a state can levy an income tax in the absence of any physical presence in the state if the business purposefully directs its business activities to the state and exploits the in-state market.

Following *Geoffrey*, many states have enacted statutes (or interpreted their existing statutes) to assert some form of

---

[17] *See Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 219-20 (1980).

[18] *See* U.S. Const. Amend. XIV, section 1 (due process clause applicable to states); U.S. Const. Art. I, section 8, cl. 3 (commerce clause); *see also Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977); and *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992).

[19] *See, e.g.*, Mass. Gen. Laws ch. 63, section 39; 830 C.M.R. 63.39.1 ("The [Massachusetts DOR] Commissioner will construe [the Massachusetts nexus statute], as asserting the tax jurisdiction of Massachusetts to the extent permitted by the Constitution and laws of the [U.S.]").

[20] IRC section 882(a).

[21] Model Treaty, article 5 (PE).

[22] *Id.*

[23] *See, e.g.*, N.Y. Tax Law section 209(1).

[24] *See, for example*, *Scripto v. Carson*, 362 U.S. 207 (1960), in which the U.S. Supreme Court held that the in-state presence of independent contractors soliciting sales for an out-of-state taxpayer was sufficient to create nexus and that the distinction between employees and independent contractors for that purpose was "without constitutional significance."

[25] 437 S.E. 2d 13, S.C., *cert. denied*, 114 S. Ct. 550 (1993).

[26] *Geoffrey*, 437 S.E.2d 13.

[27] *Id.* at 15.

[28] *Id.* at 15-16.

[29] *Id.* at 16, 18.

economic presence nexus standard, including for gross receipts taxes.[30] Those standards come in different forms, including, for example, a requirement that a company need only to conduct active solicitation in the state or have "a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state."[31]

More recently, numerous states have adopted so-called factor-based economic presence nexus rules in an attempt to provide a bright-line standard by which economic presence nexus is triggered. The Multistate Tax Commission adopted a uniformity proposal in 2002 regarding such factor-based nexus rules,[32] and nine states have enacted legislation modeled on the MTC's proposal.[33] The MTC model standards provide that substantial nexus would be created in a given state if any of the following levels are exceeded during the course of a tax period: $50,000 of property; $50,000 of payroll; $500,000 of sales; or 25 percent of the entity's total property, payroll, or sales are in the state.[34] Some states such as California have adopted the MTC's suggested thresholds, while other states such as New York have adopted different amounts.[35]

When evaluating whether a foreign company has the requisite sales activity in a state to satisfy a bright-line statutory nexus threshold, one must also be cognizant of state apportionment sourcing rules. Of particular note are economic presence nexus states (such as California and New York) that apply customer or market-based sourcing rules to sales of services and intangibles and source sales of tangible personal property to the ultimate shipping destination regardless of where title transfer occurs. In those states, transactions that may not generate U.S.-source income for federal income tax purposes could be considered sales sourced to a particular state for state income tax purposes. That could result in a foreign corporation without any physical presence in the United States triggering a state's factor-based nexus standard by exceeding the statutory sales factor threshold.

C. Agency and Independent Contractor Nexus

A foreign company may also have income tax nexus in a state through the presence of agents or independent contractors performing activities on its behalf. That is a potential pitfall for foreign companies that wish to engage in business activity in a state but seek to do so without their own employees traveling to the United States for work.

A formal agent-principal relationship need not exist for a state to assert nexus, as the agency relationship between an in-state third-party and an out-of-state company may be inferred from the facts and circumstances. In one recent case, the California Court of Appeal imputed an agency relationship between two separate corporations that were working together to finance motorcycle purchases in the state. In *Harley-Davidson Inc. v. Franchise Tax Board*, a bank affiliated with the motorcycle company would extend loans to customers.[36] Those loans were then sold to Harley-Davidson Credit Corp. (HDCC), which securitized them and sold them to two special purpose entities (SPEs).[37] HDCC did not have any employees in California but had out-of-state employees who serviced the loans and occasionally entered California for collection purposes.[38] The SPEs, on the other hand, had no employees anywhere.[39] The court held that HDCC was the SPEs' agent — and thus the SPEs were physically present in the state for income tax nexus purposes — because of numerous factors, including the overlap of membership between the two entities' boards, and the fact that the SPEs acted only through HDCC's employees.[40] The court further ruled that the imputation of nexus on the SPEs satisfied both the due process and commerce clauses in part because HDCC's actions enhanced the SPEs' ability to create and maintain a market for its business in California.[41]

The potential for creating nexus through independent contractors may arise through many different business activities. In another recent decision, *Ann Sacks Tile and Stone Inc. v. Department of Revenue,* the Oregon Tax Court held that an independent contractor's performance of warranty services in Oregon on behalf of an out-of-state company created nexus for the out-of-state company for Oregon corporate excise tax purposes and were not protected under P.L. 86-272 (discussed *infra*).[42]

The MTC shares a similar view on that issue. In Nexus Program Bulletin 95-1, the MTC concluded in 1995 that

---

[30] *See, e.g.*, Or. Admin. R. 150-317.010(3)(d) (providing that nexus may be generated through receiving "significant gross receipts attributable to customers in Oregon"); Ohio Rev. Code section 5751.01(H)-(I) (providing that a taxpayer has established a taxable "bright-line presence" in Ohio through, inter alia, generating Ohio gross receipts of at least $500,000 during the tax year); and Wash. Rev. Code section 82.04.067 (providing that for taxpayers earning apportionable income, nexus is established if the taxpayer had more than $267,000 in Washington sales in the immediately preceding year).

[31] Mich. Comp. Laws section 206.621 (the active solicitation standard); and Conn. Gen. Stat. section 12-216a(a) (the "purposeful direction" standard).

[32] *See* MTC, "Factor Presence Nexus Standard for Business Activity Taxes" (Oct. 17, 2002).

[33] The nine states are Alabama, California, Colorado, Connecticut, New York, Ohio, Tennessee, Virginia, and Washington.

[34] *See* MTC, "Factor Presence Nexus Standard for Business Activity Taxes" (Oct. 17, 2002).

[35] N.Y. Tax Law section 209(1) and N.Y. Comp. Code R. & Regs. tit. 20 section 1-3.2 (imposing tax on corporations deriving more than $1 million in receipts from state).

[36] *Harley-Davidson,* 237 Cal. App. 4th at 218. Although this case does not involve a foreign company, the agency principles at issue would be equally applicable to a foreign company.

[37] *Id.*

[38] *Id.* at 209-210.

[39] *Id.* at 210-211.

[40] *Id.* at 215-216.

[41] *Id.* at 217-219.

[42] *Ann Sacks Tile and Stone Inc. v. Department of Revenue*, 20 Or. Tax. 337 (Or. T.C. 2011). Similar to *Harley-Davidson*, this decision does not involve a foreign company but the principles would apply equally in that case.

in-state warranty services provided by independent third parties on behalf of an out- of-state corporation establish a taxable presence in the state for the corporation that does not have any property or payroll in the state.[43] Approximately two dozen states and the District of Columbia initially signed on to that analysis.[44]

In addition to warranty services, a foreign company should be aware of other potential nexus "foot-faults" that may arise through the use of independent contractors or affiliates to conduct any of the following business activities in a state:

- installation;
- training;
- technical assistance or services;
- resolving customer complaints; and
- hiring, training, or supervising personnel.[45]

D. P.L. 86-272

In 1959 Congress enacted a law commonly referred to as P.L. 86-272 to address business concerns following a U.S. Supreme Court decision that had upheld a state's ability to tax companies based solely on its in-state sales activities.[46] P.L. 86-272 prevents a state from imposing a net income tax on a taxpayer whose only in-state activity consists of the solicitation of orders for sales of tangible personal property, if the orders are sent out of state for approval and are fulfilled by shipment or delivery from outside the state.[47]

Because P.L. 86-272 limits a state's ability to tax, states generally interpret its provisions quite narrowly. By its terms, P.L. 86-272 only applies to interstate commerce and does not expressly apply to foreign commerce.[48] Accordingly, states have adopted their own views on whether to apply the provisions of P.L. 86-272 to foreign and interstate commerce equally. The MTC has encouraged states to apply P.L. 86-272 to foreign commerce to ensure consistent treatment of interstate and foreign commerce, and some states do so.[49] But some states do not, most notably California.[50] With the potential for inconsistent treatment from one state to the next, foreign companies should evaluate whether their activities in a particular state that would ordinarily be protected under P.L. 86-272 if conducted in interstate commerce remain so when conducted as an element of foreign commerce.

Even in states that extend P.L. 86-272 protection to foreign commerce, foreign companies must be mindful that the P.L. 86-272 safe harbor from state income taxation only extends to the solicitation of orders for sales of tangible personal property; it does *not* protect in-state solicitation associated with the leasing of tangible personal property, sales of services, sale or lease of real property, or the sale or license of intangibles.[51] Examples of in-state activities that typically do not fall within P.L.-86-272 safe harbors would include a foreign company that licenses its manufacturing intangible property to a U.S. entity and earns a royalty based on U.S. sales or a foreign company providing website hosting services to a U.S. customer base.

IV. Potential Consequences of State Income Tax Nexus Determinations

If a foreign company has established nexus for income tax purposes in a particular state, efforts should be undertaken to estimate the amount of the unpaid income tax liabilities (along with corresponding interest and penalties). In that regard, the number of years for which the company has potential exposure should be evaluated. Some states will require a company to file returns for all years for which it has established nexus while others may limit the lookback period.[52] Also, consideration should be given to whether the foreign company or its affiliates have exposure of the following areas in any affected jurisdiction:

- net worth or equity-based franchise taxes;
- sales, use, and other indirect taxes;
- payroll/unemployment taxes;
- city or local jurisdiction business income/franchise taxes;
- state and local licensing requirements; and
- other miscellaneous taxes and assessments such as transit taxes and unclaimed property assessments.

---

[43] *See, e.g.*, MTC, Nexus Program Bulletin NB 95-1 (Sept. 10, 1996) ("The industry practice of providing in-state warranty repair services through third party repair service providers . . . creates constitutional nexus"). Those principles will apply equally to domestic and foreign companies.

[44] *See* John C. Blasé and John W. Westmoreland, "Guilt by Third Party Association? Contesting Sales and Use Tax Audits Based on 'Attributable Nexus' Theory," *State Tax Notes*, Sept. 29, 1997, p. 827, n. 3.

[45] MTC, "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272" (July 27, 2001).

[46] *See Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 454-55 (1959).

[47] 15 U.S.C. section 381(a) (codification of P.L. 86-272). P.L. 86-272 does not limit a state's ability to impose other types of taxes such as gross receipts taxes, franchise taxes not measured by net income, and sales and use taxes.

[48] *Id.*

[49] *See* MTC, *supra* note 45. *See, e.g.,* Ill. Admin. Code tit. 86, section 100.9720(c)(8)(B) (stating Illinois "will apply the provisions of P.L. 86-272 . . . to business activities conducted in foreign commerce").

[50] *See* Cal. Franchise Tax Bd., Multistate Audit Manual section 1240 (stating P.L. 86-272 will not apply to purely foreign commerce as long as taxpayer has constitutional nexus with California); *see also Appeal of Dresser Industries Inc*. 82-SBE-307 (Cal. State Bd. of Equalization, June 29, 1982).

[51] 15 U.S.C. section 381(a) (protecting only solicitation for sales of tangible personal property).

[52] *E.g.*, Massachusetts will generally require a foreign corporation that has failed to file required returns to file returns for the most recent seven years. Technical Information Release 11-1.

In many cases, the determination that nexus was established is not made until several years after the fact, at which point a substantial assessment of tax, interest, and penalties has accrued. In such circumstances, foreign companies should explore whether the liability could be mitigated through participation in state amnesty programs or by entering into voluntary disclosure agreements with the state taxing agencies. Those agreements generally require that the company make a detailed submission to the taxing agency, including a representation that the company is not under audit and has not been contacted by the taxing agency, in exchange for a limitation in the number of prior years that may be subject to tax and a waiver of associated penalties. The agreements can encompass other taxes as well (for example, gross receipts taxes or sales and use taxes).

V. Other Ways State Income Tax May Be Imposed On Foreign Companies

While foreign companies should be aware of the differences in the concept of income tax nexus that may exist from state to state, a foreign company must also be cognizant that states can seek to levy income tax on the activities of a foreign company in other ways.

A small number of states provide that taxpayers may file on a worldwide basis, which would generally require the inclusion of all commonly owned unitary affiliates in the combined return, regardless of the country of incorporation.[53] For some states, such as California,[54] Idaho,[55] and Montana,[56] the use of worldwide filing is mandatory unless a water's-edge election is properly filed with the state. In general, the burden is on the taxpayer to file a timely and accurate water's-edge election, and failure to do so generally results in a mandatory worldwide filing obligation. Accordingly, a foreign taxpayer with domestic affiliates filing a unitary return in such states may find itself in a state worldwide filing return simply because a water's-edge election was not sought or received by its domestic affiliates. Inclusion in a unitary return could result in the foreign corporation's income being subject to state taxation through inclusion in the combined tax base, loss of deductions for expenses paid to related parties, and increased audit scrutiny.

In some circumstances, foreign corporations can also be in a unitary tax return even if the combined filing group appears to be based on a water's-edge method. For example, some states, such as California[57] and Massachusetts,[58] have adopted inclusionary 80/20 rules that provide that foreign corporations must be in the state unitary return if the average of its property, payroll, and sales factors within the U.S. is 20 percent or more. Those rules do not require that those factors be present in the specific taxing state, merely in the United States. Thus, a foreign taxpayer without material apportionment presence in either California or Massachusetts could be required to be in the water's-edge unitary returns in both states, provided the 20 percent threshold is met.

Still other states have enacted statutes that require taxpayers to include tax haven affiliates in the state's water's-edge return. A detailed review of state tax haven laws is beyond the scope of this article, but those laws may require some foreign affiliates to be in a state income tax return even though they have engaged in no direct activity in the taxing state.[59] Seven jurisdictions — Alaska,[60] Connecticut,[61] the District of Columbia,[62] Montana,[63] Oregon,[64] Rhode Island,[65] and West Virginia[66] — have enacted tax haven laws, and more states are considering similar legislation. While those provisions may not technically create nexus in those states for a foreign company, they may have the practical effect of subjecting the affected foreign company's income to state income taxation.

VI. Conclusion

In an increasingly global economy, a business organized overseas must pay close attention to its potential exposure to U.S. state (and local) income taxes. Many foreign countries do not have a federalist system similar to the United States that imposes multiple tiers of federal, state, and even local business taxation, and thus a foreign company's tax personnel may not be well-versed in the nuances of state and local income taxes in the U.S. That awareness gap may also be reinforced by a false sense of security that state and local income tax issues are addressed in a consistent fashion with federal income tax under an applicable income tax treaty. As this article has outlined, states have various tools at their disposal to tax foreign companies conducting business in the United States, and the potential reach of those provisions can be both broad and varying depending on the state in question. ■

---

[53]Those states include Alaska for oil and gas corporations, California, Connecticut, the District of Columbia, Idaho, Massachusetts, Montana, North Dakota, Ohio (Commercial Activities Tax), Rhode Island, Utah, and West Virginia.

[54]Cal. Rev. & Tax. Code section 25110.

[55]Idaho Code Ann. section 63-3027B.

[56]Mont. Code Ann. section 15-31-322.

[57]Cal. Rev. & Tax. Code section 25110(a)(1)(B).

[58]Mass. Gen. Laws c. 63, section 32B(c)(3)(i), (ii); 830 Code Mass. Regs. 63.32B.2(5)(b)1.a, b.

[59]*See, e.g.*, Schiefelbein, "State Tax Haven Laws — Expanding the Water's-Edge Group," *State Tax Notes*, Nov. 2, 2015, p. 367.

[60]Alaska Stat. section 43.20.145(a)(5).

[61]Conn. Gen. Stat. section 12-213, 222.

[62]D.C. Code section 47-1810.07.

[63]Mont. Code Ann. section 15-31-322.

[64]Or. Rev. Stat. section 317.715.

[65]R.I. Gen. Laws section 44-11-1(8).

[66]W.Va. Code section 11-24-13f(a)(7).