State Tax Considerations for Foreign Entities

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If you are a tax professional who addresses state tax matters, how often do you prepare or review a state income tax return for a foreign entity, particularly a foreign entity that either does not file a federal income tax return or files a return and reports that all its income is protected by treaty or otherwise excluded from federal taxation? Do you realize that a foreign entity with no physical presence within the United States, no requirement to file a federal income tax return, and no U.S.-source income for federal tax purposes might still have nexus for state tax purposes and have in-state apportionment factors? How often do you see foreign affiliates included in a unitary combined return that is filed on a water's-edge basis? Finally, even if there are no income tax filing requirements for the foreign entity, have you considered all the other potential state taxes that could apply, including franchise or net worth, gross receipts, and sales or use taxes?

Often when people think about the state tax considerations of foreign operations, their initial focus is on how foreign affiliates might affect the taxation of their U.S. affiliates. For example, a common consideration when computing the state taxable income of a U.S. corporation is whether the state permits a subtraction modification for income, such as from dividends or royalties, derived from foreign affiliates. Another key consideration is the potential application of a state addback statute that could disallow deductions for payments made to foreign affiliates that involve interest expense, intangible fees, management fees, or other related-party charges. While the state tax treatment of those transactions with foreign affiliates can have a direct effect on the taxation of U.S. affiliates, the foreign entities themselves may also be subject to various state tax filing and payment requirements.

When considering state tax issues for a foreign entity, it is natural to focus initially on the potential corporate income tax considerations, particularly as an extension of analyzing whether that entity might be subject to any federal income tax filing requirements. This article provides an overview of the state income tax considerations for foreign entities in the context of six questions:

- How is the foreign entity classified for state income tax filing purposes?
- Does the foreign entity have nexus for state income tax purposes?
- If nexus exists, does the foreign entity have income subject to state tax?
- If the foreign entity has income subject to state tax, does it have in-state apportionment factors?
- Even if the foreign entity does not have income tax nexus, is it required to be included in any state unitary combined filings, and if so, to what extent?
- To what extent may the foreign entity be subject to state taxes other than those based on net income, such as franchise or net worth, gross receipt, or sales or use taxes?

I. Entity Classification

The first step in understanding the state income tax treatment of a foreign entity is to understand how the foreign entity should be classified for state income tax purposes. For example, if the foreign entity is classified as a corporation for federal income tax purposes, will it be classified the same way for state income taxes? In most states, the federal classification of a foreign entity will be respected for state income tax purposes, including the treatment of a foreign entity as either a corporation, partnership, or disregarded entity under the check-the-box regulations. Not all states conform to the federal check-the-box provisions; for example, Texas instead looks to the entity's legal form.[1]

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[1]Tex. Tax Code Ann. section 171.0002; Texas Comptroller of Public Accounts Letter No. 9807627L.

II. Nexus

It is not uncommon to discover that a foreign entity may have nexus for state income tax purposes yet not be required to file a federal income tax return. Under the Internal Revenue Code, a foreign corporation ''engaged in a trade or business within the United States'' is generally required to file a federal income tax return whether or not it owes any federal corporate income tax. In addition, the IRC imposes federal corporate income tax on taxable income of a foreign corporation that is treated as effectively connected with the conduct of a U.S. trade or business within the United States (often referred to as effectively connected income or ECI).[2] An income tax treaty between the United States and the foreign corporation's residence country can reduce the United States federal income tax otherwise imposed by the IRC. For example, the treaty may protect a resident of the foreign country from United States federal corporate income taxation on ECI derived by the resident if the relevant activity within the United States does not rise to the level of a permanent establishment.[3] If the United States activity does constitute a PE, a treaty will typically provide as a general rule that only those profits with the foreign corporation subject to federal tax on the profits attributable to the PE may be taxed by the United States.[4]

An example consistent with many United States treaties in force, the U.S. Model Income Tax Convention of November 15, 2006, defines the term PE in its most general sense as ''a fixed place of business through which the business of an enterprise is wholly or partly carried on.'' However, the following activities are excluded from constituting a PE under the model treaty definition:

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[2]IRC section 882(a). In addition, the IRC generally imposes a tax on foreign corporations equal to 30 percent of the gross amount of income of the foreign corporation from sources in the U.S. where the income is not treated as ECI, and is not gains from the sale or exchange of property (other than certain defined types of gain). *See* IRC section 881(a).

[3]*Cf.* art. 5 (Permanent Establishment), U.S. Model Income Tax Convention of November 15, 2006.

[4]*Cf. id.* at art. 7 (Business Profits).

1. using facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

2. maintaining a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

3. maintaining a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

4. maintaining a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

5. maintaining a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; and

6. maintaining a fixed place of business solely for any combination of the activities mentioned in items 1 through 5, if the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

In contrast to the federal standards, state income tax nexus standards do not focus on whether a foreign entity has a fixed place of business within the state. The level of contacts required to establish nexus can be much less substantial and may not even require a physical presence within the state — that is, no property located in the state nor any employees, agents, or representatives traveling in the state. State nexus may be triggered through a fixed place of business or the ownership or rental of property in the state. Nexus may also be established as the result of the foreign entity having employees, agents, or other representatives performing in the state activities that create a market for the foreign entity's business, even if those activities are temporary. Installation, repair, or other service activities performed in the state, whether directly by the foreign entity or by others on its behalf, could also establish state income tax nexus. In most states, the activities described in items 1 through 6 above, which can be performed within the United States by a foreign entity yet not rise to the level of a PE, would be sufficient to establish nexus.

A growing trend in state taxation is the adoption of nexus standards based on economic nexus principles or bright-line statutory nexus thresholds, both of which extend the reach of state nexus and provide more opportunities for foreign entities to be subject to state income tax filing requirements, even when those entities lack the U.S. connections required for filing a federal income tax return. The expansion of economic and bright-line statutory nexus thresholds is particularly relevant for foreign entities that might lack a physical presence in the state and whose only connection might be sales to customers who are in the state. For example, effective for tax years beginning on or after January 1, 2015, the nexus standard for the New York franchise tax will be broadened so that corporations with sales of $1 million or more during the tax year to New York customers will be subject to tax.[5] In California, corporations are considered to be doing business within the state if there are specified amounts of property, payroll, or sales in the state. For example, for tax years beginning on or after January 1, 2013, California's threshold for sales is $518,162.[6]

When considering whether a foreign entity has the requisite sales activity in a state to satisfy a bright-line statutory nexus threshold, one must account for the state's apportionment sourcing provisions. A foreign entity should pay attention to state tax provisions using market-based sourcing for services and intangible transactions, as well as provisions that source sales of tangible personal property to the ultimate shipping destination regardless of where title transfer occurs (both of which are topics covered in more detail below). In both types of situations, transactions that do not generate U.S.-source income for federal income tax purposes may be considered sales sourced to a particular state for purposes of applying a bright-line statutory nexus threshold.

Finally, P.L. 86-272, enacted under the government's power to regulate interstate commerce, places limits on a state's ability to

[5]N.Y. Tax Law section 209.1(b), as amended by section 5, part A, chapter 59.

[6]Cal. Rev. & Tax. Code section 23101(b)(2)-(4). Note that California also defines doing business as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." Cal. Rev. & Tax. Code section 23101(a).

impose a net income tax. In general, P.L. 86-272 prevents a state from imposing a net income tax on a taxpayer whose only business activities in the state consist of soliciting sales of tangible personal property, where the orders are sent outside the state for approval or rejection, and if approved, are shipped or delivered from outside the state. P.L. 86-272 specifically applies to interstate commerce and does not directly apply to foreign commerce; however, states are free to apply the standards in P.L. 86-272 to business activities involving foreign commerce to ensure that foreign and interstate commerce are treated the same.[7] Many, but not all, states apply the principles of P.L. 86-272 to foreign and interstate commerce equally. Therefore, a foreign entity whose activities in a state would have been protected under P.L. 86-272 if those activities had involved interstate commerce should ask whether that state applies the provisions of P.L. 86-272 to foreign commerce.

III. State Taxable Income

When a foreign entity has nexus for state income tax purposes, it must determine its tax base. In many states, the starting point for determining state taxable income is federal taxable income as defined in the IRC, so one of the first questions to address is whether the foreign entity has any federal taxable income. The IRC provides that taxable income is gross income minus the deductions allowed by chapter 1 of the IRC. In the case of a foreign corporation, gross income generally includes only ECI and U.S. source income that is not ECI and deductions are allowed only for purposes of ECI. If a foreign corporation is engaged in a U.S. trade or business, it may have ECI that gives rise to taxable income. However, if that foreign corporation is a resident of a country with a U.S. income tax treaty, it may be protected from federal tax on any ECI that represents business profits not attributable to a PE in the United States.[8] That protected ECI is often referred to as treaty-exempt income.

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[7] *See* Multistate Tax Commission, "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under L. No. 86-272" (July 27, 2001), in which the commission recommends applying the principles of P.L. 86-272 to foreign commerce.

[8] *See* IRC section 894(a).

However, states generally are not bound by a U.S. income tax treaty because those treaties are limited to federal income tax imposed under the IRC and do not apply to U.S. state and local income taxes.[9] States may directly adopt the federal treaty provisions for state income tax purposes, or indirectly adopt the treaty provisions through their incorporation of federal taxable income. For example, in the absence of a state-specific modification requiring an addition for treaty-exempt income, a foreign entity with no federal taxable income as a result of treaty protections might also have no state taxable income in states that begin their calculation with federal taxable income.

Some states require the inclusion of income exempted by federal treaty. For example, in determining Pennsylvania taxable income, federal taxable income is computed as if the treaty provisions do not apply, which means that any treaty-exempt income must be added back to federal taxable income.[10] Some other states go a step further. Rather than include a modification for treaty-exempt income, they will include in the tax base the full worldwide income of the foreign entity. For example, Oregon includes all income from sources outside the United States that was excluded from the computation of federal taxable income.[11]

Overall, when a foreign entity is calculating its state taxable income, it must begin by determining the nature of the tax base in the state, and in particular whether that base uses federal taxable income with treaty exemptions, without treaty exemptions, or with worldwide taxable income principles.

IV. Apportionment

When a foreign entity has nexus with a state and has income included in the pre-apportioned tax base, the next question to

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[9] *Cf.* art. 2 (Taxes Covered) of the U.S. Model Income Tax Convention of November 15, 2006. An exception to the general principle that income tax treaties can reduce only federal tax appears in the typical ''Non-Discrimination'' article of a treaty, which may apply ''to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.'' *See*, *e.g.*, para. 7 of art. 24 (Non-Discrimination), U.S. Model Income Tax Convention of November 15, 2006.

[10] Pa. Stat. Ann. tit. 72, section 10003.11.

[11] Or. Rev. Stat. section 317.625. *See also*, *e.g.*, N.Y. Tax Law section 208.9(c), which provides for a similar inclusion of worldwide taxable income for tax years ending on or before Dec. 31, 2014.

address is whether that entity has any in-state apportionment factors that could result in its having taxable income apportioned to the state. In the absence of in-state apportionment factors, the foreign entity may be required to file a return but may not have a state income tax liability other than a possible minimum tax amount due.

For foreign entities engaged in the sale of tangible personal property, it is important to recognize that for state apportionment purposes, sales of tangible personal property are generally sourced to the ultimate shipping destination of the goods, regardless where legal title transfer occurs. When determining whether the sale of tangible personal property is U.S.- or foreign-source income for federal income tax purposes, the location of title transfer is relevant.[12] For example, a foreign entity ships goods into the United States. If tax ownership of the goods transfers to the customer before the goods arrive in the United States, the income from the transaction may be foreign source. As a result, even though the foreign entity has sales to U.S. customers, there might be no U.S.-source income, and no ECI for federal income tax purposes, which could lead one to believe there are no U.S. sales to report for state tax purposes. However, because state apportionment rules generally look to the ultimate destination of the goods rather than the location of title transfer, those transactions typically create state destination sales for apportionment purposes even though they might not result in U.S.-source income for federal tax purposes.

Foreign entities engaged in transactions involving services or intangible property must consider the growing number of states adopting market-based sourcing rules for services and income from intangibles. States using market-based sourcing may look to the state where the customer is located, where the benefit of the service is received, or where the intangible property is used in determining where the gross receipts from the transaction should be sourced. That approach deviates from the more historical approaches of looking to where services are actually performed or to where the greater proportion of the income-producing

[12]Treas. reg. section 1.861-7(c).

activity is performed based on the costs of performance. For a foreign entity with little or no physical presence in the United States, services may be performed outside the United States, the management of intangibles may take place outside the United States, and most costs may be incurred outside the United States. Therefore, under historical approaches, gross receipts from those types of services and intangible activities might not have resulted in in-state apportionment factors for the foreign entity. However, the application of market-based sourcing provisions can yield a significantly different apportionment result for foreign entities providing services to U.S. customers or generating gross receipts from intangible property that is being used within the United States.

V. Combined Reporting

Even when a foreign entity does not have nexus with a state, it may still be subject to state taxation through a requirement to be included in a unitary combined return with its U.S. affiliates. If a taxpayer is filing in a state on a worldwide unitary combined return basis, all unitary foreign affiliates should be included in that combined return along with their worldwide income and apportionment factors, regardless of whether the foreign affiliates have U.S. activity or nexus with the state.

When not filing on a worldwide basis, the unitary group generally will be determined on a water's-edge basis. The water's-edge terminology can be a bit misleading because water's-edge unitary combined reports may still include some unitary foreign affiliates, with the rules varying by state. The most common methods for including unitary foreign affiliates in a water's-edge combined return are:

1. foreign entity files a federal income tax return or otherwise has federal taxable income;
2. foreign entity has 20 percent or more U.S. activity;
3. foreign entity is a controlled foreign corporation that generates subpart F income;
4. foreign entity has more than 20 percent of its income derived from intangible or service transactions with other members of the water's-edge group; and
5. foreign entity is located in a tax haven.

Several water's-edge filing states require unitary foreign affiliates that file a federal income tax return or otherwise have income effectively connected with a U.S. trade or business or a PE to be included in the water's-edge return to the extent of that foreign affiliate's federal taxable income. In determining whether a foreign affiliate has federal ECI, some states might make that determination without applying federal treaty provisions. For example, in California, unitary foreign affiliates that have less than 20 percent of their activity in the United States are includable in the water's-edge return to the extent of their income effectively connected to a U.S. trade or business, without application of federal treaty provisions.[13]

Another common provision for including a unitary foreign affiliate in the water's-edge return is if the foreign entity has 20 percent or more U.S. activity. Most states use an apportionment test in determining what constitutes U.S. activity. For example, many states will measure U.S. activity on the basis of a property and payroll factor test, while others will use a three-factor test based on property, payroll, and sales. For states that use sales as part of the U.S. activity test, an important consideration is whether the state uses market-based sourcing for sales of services and intangibles, and destination sourcing for sales of tangible personal property, because those types of provisions could result in U.S. activity for purposes of the apportionment test and yet not result in U.S.-source income for federal tax purposes.

Another important consideration when measuring U.S. activity is understanding how each state defines the term "United States." Some states might limit the definition to the 50 states and the District of Columbia, while others might include U.S. territories or possessions. While most states measure U.S. activity through an apportionment factor test, one exception is Wisconsin, which uses the active foreign business income test in the now-repealed IRC section 861(c)(1)(B).[14]

When a foreign entity satisfies the 20 percent or more U.S. activity test and must be included in the water's-edge return, the

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[13]Cal. Code Regs. tit. 18, section 25110(d)(2)(F)(1)(a).
[14]Wis. Stat. section 71.255(2).

next issue to address in each state is what income the foreign entity must include. For example, is the foreign entity required to include its worldwide taxable income, or is income determined on the basis of federal taxable income, with or without treaty provisions? In California, a foreign entity that satisfies the 20 percent or more U.S. activity test is required to include its entire worldwide income in the water's-edge return.[15] But in Massachusetts, taxable income is limited to federal taxable income, including the application of treaty provisions, so a foreign entity whose income is exempt from federal taxation as a result of a treaty might have that same income exempt for purposes of calculating the taxable income of the Massachusetts water's-edge group.[16]

Some less common provisions relate to the inclusion of CFCs that generate subpart F income, foreign affiliates with more than 20 percent of their income derived from intangible or service transactions, and foreign affiliates located in tax havens. California and West Virginia may fully or partially include a unitary CFC on the basis of the subpart F income attributable to the CFC.[17] A relatively new provision in Massachusetts, West Virginia, and the District of Columbia is the inclusion of foreign affiliates that have more than 20 percent of their income derived from intangible or service transactions with other members of the water's-edge group. When that provision applies, the foreign affiliate's inclusion in the water's-edge group is generally limited to the extent of the income related to the intangible and service-related activities; however, the foreign entity's income might be further limited to the extent it is exempt by federal treaty.[18] Finally, a few states require inclusion of foreign affiliates located in tax havens. Some states have statutes listing tax havens, and foreign affiliates incorporated in one of those designated jurisdictions must be fully included in the water's-edge return. In

[15]Cal. Rev. & Tax. Code section 25110(a)(1)(B); Cal. Code Regs. tit. 18, section 25110(d)(2)(B).

[16]Mass. Gen. L. section 32B(c)(3)(iv).

[17]Cal. Rev. & Tax. Code section 25110(a)(2); W. Va. Code section 11-24-13f(a).

[18]Mass. Regs. Code. 63.32B.2(5)(b)(1); W. Va. Code section 11-24-13f(a); D.C. Code section 47-1810.07(a)(2)(F).

other states, the designation of a particular entity as located in a tax haven may be more subjective and based on the facts and circumstances of each foreign entity and the countries involved.

VI. Non-Income-Based Taxes

Because the federal taxation of a foreign entity is based on income, it is natural to take that analysis one step further and consider potential state income taxes for the foreign entity. But one cannot overlook the fact that at the state level, there are many other types of taxes that could apply to a foreign entity with U.S. activity, including franchise and net worth, gross receipt, and sales and use taxes. Those types of taxes might have their own, and possibly lower, nexus standards than those for state income tax purposes. Further, unlike state income taxes, which are often tied to federal taxable income and may incorporate tax treaties, non-income-based state taxes are generally not tied to federal income tax concepts. Because of those differences, it is common to have a foreign entity with a U.S. connection with filing requirements and potential liabilities for various non-income-based state taxes, yet with no requirements to file a federal income tax return and without any state income tax liabilities.

VII. Closing Thoughts

When evaluating the potential state tax implications of foreign operations, the impact of those operations on the taxation of U.S. affiliates must be considered. However, one must not overlook the potential for the foreign entities themselves to be directly taxed for state tax purposes. The state taxation of foreign entities can be complex, and because of the significant differences between federal and state tax provisions, foreign entities that are not subject to federal income tax filing requirements may unexpectedly be subject to various state tax filing requirements. As the state tax landscape continues to evolve — whether through the expansion of economic and bright-line statutory nexus standards, more states adopting market-based sourcing for sales factor purposes, or the expansion of unitary combined reporting to include foreign entities in water's-edge returns — the potential state tax considerations for foreign entities are likely to become more pronounced and will require further diligence by tax professionals. ■