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HOW US STATE TAX LAWS CAN REACH NON-US BUSINESSES

The issues to consider when looking at US markets

As international business continues to expand, companies based outside of the United States are facing taxation by the country's fifty states. This taxation can come in many forms and can be asserted even if the company has no physical presence within the US. Understanding this tax exposure can minimize risk and protect a company's bottom line.

1. INTRODUCTION

The United States are made up of fifty unique state tax jurisdictions along with thousands of local taxing areas. Within these jurisdictions, businesses can be subjected to a wide variety of taxes such as income taxes, sales taxes, property taxes and employment-related taxes to name a few. When you consider that there is often inconsistency between the various state and local taxing jurisdictions, understanding a company's possible exposure to the almost $ 300 billion [1] of state taxes that were collected in 2012 can be daunting.

Many companies consider doing business outside of their own borders as economic conditions and climates change, and as the ability to conduct international trade improves. While this business may result in significant increases to the bottom line, the possibility of additional tax risk and liability might make these new ventures less palatable or may affect a company's decision regarding where to conduct business.

A non-US company making sales into the United States can usually rely on international tax treaties and review various federal regulations to understand what their US federal tax responsibilities might entail. Typically, however, the fifty US states are not bound by the federal rules and state tax liabilities may exist even if the company has no federal taxable income.

This article outlines: The issues facing non-US companies in relation to state income, sales and franchise taxes; how states can identify foreign activity within their state boundaries; and the risks that companies face along with some risk mitigation processes. Consultation with a state and local tax professional can provide guidance regarding these areas and is an important step prior to finalizing any decisions.

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2. STATE TAXATION AND NEXUS REQUIREMENTS

In order for a state to subject any business to its tax regime, a company has to have established «nexus» with the state. This term usually relates to some minimum connection that has to exist to allow the state to assert its taxes on a particular business. Case law and state statutes and regulations often define this minimum connection by establishing «thresholds». The nexus thresholds can vary from state to state and can also vary depending on the type of tax in question. We'll address this issue for three categories: (2.1) State income taxes, (2.2) franchise taxes and (2.3) sales taxes.

2.1 State Income Taxes. State income taxes are generally those that are based on a company's net income. Whether the income is determined on a separate company or a combined company basis, the non-US corporation's net income related to US activities is calculated. An apportionment factor based on sales, property, payroll or some combination of these determines the percentage of the net income that can be taxed by each state.

A non-US corporation can be held responsible for reporting and paying a state's income taxes if it meets a certain threshold of «doing business» within a state, i.e. it has established nexus. So, even if no US federal income tax return is required based on the company's activities, state specific tax returns may have to be filed. As noted above, each state can establish their own thresholds, but there are some standards that can be applied in this area.

Having a physical presence will almost always exceed the thresholds for establishing income tax nexus with a state. This physical presence may not be enough to exceed the permanent establishment thresholds required for US federal taxation, but can still create state tax filing or payment requirements. A variety of factors can create physical presence:

→ Having inventory in a warehouse or consigned to a customer
→ Employing individuals to solicit sales or perform other functions
→ Contracting with an in-state firm to act as the company's representative on repairs, training or services
→ Having software downloaded onto a customer's system
→ Using third-party paid affiliates to direct web traffic to a company's website (Amazon law).

In order to eliminate the need for physical presence, many states have recently adopted what are referred to as «economic nexus» or «factor presence» thresholds that can attribute nexus to a company. Economic nexus typically comes from directing a company's economic activity toward a particular state's markets, while factor presence nexus comes from achieving some threshold of property, payroll or sales in a state. This threshold is often referred to as a «bright line» test.

In 2002, the Multistate Tax Commission (MTC), which works with states and taxpayers to administer state tax laws, adopted a proposal indicating that substantial nexus is established if a company exceeds certain thresholds during the year:
1) $ 50 000 of property or
2) $ 50 000 of payroll or
3) $ 500 000 of sales or
4) 25% of total property, total payroll or total sales

While the property and payroll aspects of these thresholds still point to a physical presence within a state, the sales threshold requires no such presence. California adopted an economic nexus model for years after 2011 that includes the bright line test for sales. If a company's sales into the state exceed $ 500 000 (adjusted for inflation) or 25% of the company's total sales, that company is deemed to have nexus. This nexus is created whether or not the company has any direct activities occurring within the state. And to determine the sales volume, sales of tangible personal property are attributed to the state based on destination (no matter where title passes to the customer) and services are attributed to the state based on where the customer receives the benefit of the services (with no regard to where the services are actually performed).

A majority of states will claim that their statutes or regulations have an economic nexus aspect, even if they have not established a bright line or factor presence threshold. The basic premise is to look at whether the company is targeting its economic growth activities toward a particular state and, therefore, benefitting from the economic climate of the state. In 2009, for example, Wisconsin expanded its definition of doing business to include «regularly soliciting business from potential customers in Wisconsin» [2]. No physical presence is required to meet this definition.

2.1.1 Federal Protection. There is a federal law, Public Law 86–272 (PL 86–272), that may help to mitigate the income tax burden. This law was enacted in 1959 and prohibits a state from imposing a net income tax if a company's activities are limited to the solicitation of sales of tangible personal property when the orders are approved and filled from outside the state. Under this protection, traveling sales people may not create an income tax nexus even though the company has a physical presence in the state.

There are three concerns related to the application of PL 86–272. The first concern is that this law only applies to the sale of tangible personal property (TPP). No protection is afforded for the solicitation of services, and the definition of a service has been blurred over the last several years. For example, the sale of standard software is normally considered the sale of TPP. If enough revisions or customization of the software is performed by the seller, however, this sale could be deemed to be the sale of services. Care should be taken in applying the law to items being sold.

The second concern is that this protection is not always available to those involved in foreign commerce. Even though the Multistate Tax Commission (MTC) recommends that states apply this protection to non-US corporations, many have not adopted this position. Some states, such as California, Colorado and Texas, specifically exclude non-US corporations from the protections of the law, while others are silent on the matter causing a lack of clarity regarding filing and tax payment requirements.

The final concern is that this protection only applies to taxes based on net income. In response to this limitation, many states have adopted and implemented a variety of «franchise» taxes that could create a tax liability even if the normal income tax would not apply. This is discussed further in the next section.

2.2 State Franchise Taxes. Franchise taxes are typically taxes asserted against a company for the privilege of doing business in a state, for asserting the business's franchise, or to assess a minimum tax. Some common examples are:
→ Washington Business and Occupation Tax, which is a tax on the gross receipts of a company with no deductions for costs
→ Texas Franchise Tax, which is based on a modified gross profit calculation
→ Georgia Net Worth Tax, calculated based on the company's net worth or capital and
→ California Franchise Tax, which is 1,5% of net income with a minimum of $ 800.

The nexus creating activities noted for state income taxes are typically the same for state franchise taxes. Physical presence through property, payroll or the activities of affiliates can create this tax reporting and payment requirement.

The key difference between franchise taxes and the traditional net income tax is that PL 86–272 does not afford protection to a company that exceeds the nexus creating levels. So, even if a state affords protection under the federal law, it will still assert the franchise tax against companies (foreign or domestic) that exceed their established nexus thresholds.

2.3 State Sales Taxes. A company can be required to collect and remit sales tax on their sales of tangible personal property or taxable services if they exceed the state's thresholds for nexus. Sales tax thresholds have historically related to a physical presence in the state through property, employees or representation by another company within the state. De minimis exceptions may be allowed for trade show attendance, but this will depend on a particular state's regulations.

As the states implement a variety of efforts to increase tax collection and compliance, the federal government is attempting to assist them in this process. Congress has been working on legislation called the Main Street Fairness Act or Marketplace Fairness Act for several years. This act would allow state governments to collect sales and use taxes from remote sellers who have no physical presence in the state in exchange for more uniformity in state tax laws. If this law ultimately passes, both domestic and foreign companies would be held to the same standards of collection responsibility and this would put more pressure on non-US companies to comply.

3. IDENTIFYING A NON-US CORPORATION'S ACTIVITY WITHIN A STATE

When working with companies that are considering activity within the US, the biggest challenge is in determining the company's state tax risk based on its sales, customer service model and growth projections. Even if no US federal income tax return is filed and the company has no physical presence in the state, an analysis is important to understand and quantify the risk.

There are several processes that states have implemented to identify companies that are doing business within their borders. State auditors research business connections by:

- → Reviewing import logs from US customs to see who is shipping items into their state
- → Auditing in-state companies and identifying invoices from non-US businesses
- → Requiring companies (especially governmental agencies) to gather information about their vendors
- → Roaming trade shows and conferences to identify attendees and
- → Performing interdepartmental inquiries to identify other licensing or registrations.

One example of the vendor reporting relates to California's Form 587. A company is required to complete Form 587 for any services it has received within the state. If the services are performed by a business that is not registered with California, the customer is required to withhold tax for the portion of the services actually performed within the state. When this withholding is remitted to the state, the vendor can be identified.

In addition, we have found that many states have entered into tax compacts with other states which allow them to share information about audited companies. This often leads to successive state audits once one has been completed.

4. RISKS AND EXPOSURE

Once a state has identified a company that may have a tax filing or payment responsibility, its representatives will often send a nexus questionnaire. This questionnaire will request a wide variety of information and is often worded in a way to assert nexus on a company if care is not taken. We highly recommend having a state tax consultant review the responses prior to returning the questionnaire to the state. In addition, it is important to not ignore these requests as failure to comply could result in an audit or estimated assessments that will need to be defended.

If nexus is asserted by a state, the state can calculate an assessment for all open periods. Since the non-US company has probably never filed a return, there is no statute of limitation protection. This means that the state could assess taxes back to the company's inception. The more typical practice is to assess for a period ranging from three to ten years, depending on the state. And in the absence of specific information, the state can assess taxes based on industry estimates which may exceed the actual liability of the non-US company. These assessments will also include interest and penalties on the full underpayments and possibly late filing penalties as well.

If an assessment is not paid, states can put liens on any property held within the US or put a hold on any funds held in US banking institutions.

One recent strategy that states have been taking is to assert nexus on a non-US corporation through its relationship with a US company. For example, in *J.McIntyre Machinery LTD v. Nicastro*, 131 S. Ct. 2780 (2011), New Jersey asserted that J. McIntyre Machinery, the British machine manufacturer, could be under its jurisdiction because it sold its machines in the state and helped to guide the local dealer's sales efforts. The Supreme Court held that New Jersey could not exercise jurisdiction over the manufacturer when the company had no significant connection to the state. Many state tax consultants had been concerned that this strategy could be applied to state tax assessments, so this case and others have been a positive sign that courts may not accept this nexus connection.

The application of factor presence nexus (2.1) on non-US corporations, especially in relation to the sales threshold, is another area of concern. This concept has not been sufficiently challenged in the courts, though most consider the strategy to be unconstitutional. A few recent cases have dealt with and disallowed income tax application to companies that have no physical presence:

a) *United Parcel Service, Inc. v. Indiana Department of State Revenue*, No. 49T10-0704-TA-24 (Ind. Tax Ct. Sept. 16, 2013) confirmed that Indiana does not apply economic nexus to corporate income tax even though it was applied to the financial institutions tax.

b) *Scioto Insurance Company v. Oklahoma Tax Commission*, 279 P.3d 782 (2012) which disallowed Oklahoma's taxation of an out-of-state company that had no contact with the state except for receiving payments on a contract that had been made outside the state.

While these cases are helpful from a physical presence standpoint, a ruling from the US Supreme Court will probably be the ultimate arbiter on this issue.

5. RISK MITIGATION AND PROTECTIONS

If a non-US company finds itself in the position of having created a taxable presence with one of the fifty states, it is important to consider all opportunities and develop a strategy to mitigate the resulting risk.

Most states have a «voluntary disclosure» process whereby a previously unregistered company can come forward to voluntarily register and pay back taxes. Normally, the company can come forward anonymously, present their particular facts and enter into an agreement with the specific state. This agreement will typically limit the period open to taxation to about 3 to 4 years and eliminate all penalties if not some of the interest. It is important to not register with the state prior to the filing of a voluntary disclosure agreement as that usually eliminates a company's eligibility for the program.

If a non-US company sells tangible personal property on a wholesale basis, it is also important to collect resale certificates from all customers located within the US. If a state audit were to occur, these certificates will at least eliminate a sales tax assessment against the company, which is often the larger part of a company's state tax liability.

6. CONCLUSION

Non-US corporations have many issues to consider when looking at US markets. Establishing a branch office or permanent establishment, transfer-pricing models, US federal income taxes, and shipping logistics are all important considerations. While looking into this opportunity, be sure to add US state and local taxes to the checklist. All fifty states have some kind of tax that could apply to the business and add costs that were unexpected.

While this article has focused on the risk around state income, franchise and sales taxes, most states also implement a variety of other taxes, such as:

- Property taxes based on the ownership of personal property and real property
- Employment taxes, such as income tax withholding, unemployment taxes and workers compensation coverage
- Unclaimed property taxes that are based on each state's escheat laws and
- Real property transfer taxes.

Be sure to consult with someone who specializes in US state and local taxation to ensure that the risks are understood and mitigated where possible. Being aware of these issues will allow a company to prepare and comply where necessary and to reduce risk of exposure and assessment. ■

Notes: **1)** Council on State Taxation, 2012 Study of Total State and Local Business Taxes. **2)** Wisconsin Statute § 71.22(1r).