Unexpected State Tax Issues
International Companies Must Consider

by Mike Goral and Tatyana Lirtsman

Once a state has asserted that nexus is present and requires a state income tax filing, a taxpayer must then determine how to compute the income tax owed to the state. For most states, the starting point would be to determine how much revenue should be sourced to the taxing state.

I. Sourcing of Income

Sourcing rules are the foundation of both international and domestic tax systems. The principle used to formulate source rules is that income should be sourced in the country that provides governmental services and protections used to derive the income. Based on an economic nexus between the income and a particular country, that policy is usually carried out by associating income with a geographic source.

In the international arena, tax treaties require a permanent establishment threshold before the source country can impose a tax. However, foreign companies conducting business in the United States without forming a PE may be surprised to learn that income can be included in a state’s unitary combined income tax return, regardless of the protections supported by a U.S. tax treaty. As a result, the sourcing rules are a product of balancing complex sets of conflicting principles, concerns, and claims as they apply to particular income types.

No U.S. state tries to measure intrastate profits of multinational enterprises by requiring separate accounting. Instead, states use some variety of a formula to distribute U.S. profits to the state. Historically, the formula is based on the fraction of U.S. assets, sales, and payroll that is located or carried out within the state. No country applies a similar formula to calculate taxes or formulate the profits of a multinational enterprise that is based on a domestic-source formula. Instead, all other countries use variations of a method based on separate accounting and review practices between related corporations.

In 2002 the European Commission recommended that affiliated countries use formula apportionment techniques to tax multinational companies. That deviation from standard separate accounting methods to a transfer pricing approach was an attempt to reduce the costs and biases associated with auditing transfer prices. However, switching to a formula apportionment system affects the after-tax profits of multinationals and the tax revenue paid by domestic and foreign firms. As a result, most countries use separate accounting methods to source income to their jurisdictions.

2Id.
4Brown, supra note 1.
6Id.
7Id.
9Id.
10Id.
II. Apportionment of Income

The Uniform Division of Income for Tax Purposes Act, approved in July 1957 and adopted by more than 20 states, was designed to promote uniformity among states.\(^6\) It incorporated what was essentially the existing practice in 1957 in numerous states: an equally weighted, three-factor formula of property, payroll, and sales. UDITPA also distinguished income as either business income, which is apportioned using the formula, or nonbusiness income, which is allocated in total to a particular state.

In 1967 the Multistate Tax Compact was created by incorporating UDITPA as its centerpiece. Established to improve the fairness, efficiency, and effectiveness of state tax systems, the compact applied to interstate and international commerce. It also played an important role in preserving state tax sovereignty.

Based on the UDITPA and compact principles, some states follow an equally weighted, three-factor apportionment formula to calculate the percentage of a corporation’s total taxable income to be allocated to the taxing state. Other states give greater weight to sales activity than property and payroll. Today, single-sales-factor apportionment is the trend among states.

For multinational companies, that lack of uniformity among states increases the difficulty and related administrative expense of complying with state tax laws. That can also expose corporate organizations to a wide range of tax liabilities and result in an effective tax greater than 100 percent of their net income at one level, to net income that completely escapes state-level taxation at the other level. The potential combination of a state asserting a tax return filings requirement based merely on a foreign corporation having a specific level of sales in a state — along with single-sales-factor apportionment and U.S. treaties not binding the state — could result in substantial state income tax liability for some foreign companies.

III. Reporting

Formula apportionment is used by most states to tax foreign companies, but the states use substantially diverse factors to calculate apportionment. Common factors include property, payroll, and sales, but those are not uniformly defined by the states. Some states start with federal taxable income and then make adjustments to determine the apportionable tax base, but other state formulas begin with gross income. That lack of starting point consistency further complicates administering state tax returns.\(^6\)

There are significant differences in how states determine the tax base. Most states use federal taxable income as the starting point to determine state income tax liability. With so much attention being paid to companies moving their headquarters to a foreign country in a tax inversion plan, it is possible that many states will decouple from the federal taxable income figure as a starting point. Similar to how states decoupled from the federal treatment of bonus depreciation, some states will find that if the federal tax liability is reduced through a tax inversion, they may be forced to change their starting point to something other than federal taxable income.

Some states require an addback of a foreign corporation’s income that is otherwise exempt from federal tax, whereas other states may require federal taxable income to be calculated on a pro forma basis as if a treaty did not apply.

However, a pro forma return may not resolve state issues. Alabama, for example, is among the few states that permit a deduction for federal taxes paid. If only a pro forma federal return is prepared, would a taxpayer still get that deduction even if no federal return is actually filed?

In contrast, New Jersey requires an addback of most taxes imposed on corporations, including federal taxes paid or accrued. Again, if a federal tax return is not actually filed, would New Jersey still require a foreign taxpayer to add back federal taxes imputed on a pro forma federal tax return?\(^6\)

Other states use different methods to impose other business taxes in lieu of a corporate income tax.\(^4\) Washington imposes the business and occupancy tax\(^5\) and Ohio imposes the commercial activities tax,\(^6\) both of which are measured on gross receipts. Texas imposes a margin tax\(^7\) measured by gross receipts less one of three deductions, and until December 31, 2007, Michigan imposed the single business tax,\(^8\) which has been described as a VAT.\(^9\) Finally,
states such as Louisiana and North Carolina impose net-worth-based franchise taxes in addition to their corporate income taxes.

IV. Reporting Methods

Another complication for foreign corporations is that states do not uniformly define how a company or group of companies should be included on the state tax return. States traditionally have used one of three reporting methods: separate company, unitary combined, and consolidated.

1. Separate Company Method

Each taxable entity is treated as a stand-alone taxpayer and files its own tax as a separate taxpayer. Each corporation’s tie with a particular state is determined based on its activities independent of other related companies’ activities. The corporation’s income is separately computed and then reported to the state based on the proportion of the corporation’s in-state activities. Separate company filing method states include Delaware and Pennsylvania.

In general, consolidated or combined filing is not allowed in a state that uses the separate company method. However, as with many state tax issues, a rule may change. Some traditionally separate company filing states — including Massachusetts, Michigan, New York, Texas, Vermont, and West Virginia — have moved away from it and now either require combined filing or allow a combined tax return filing.

2. Unitary Combined Method

Companies with a similar ownership structure, centralized management, functional integration, economies of scale, and common departments providing services to the other members of a commonly owned group are often considered to be members of a unitary group. Under a unitary combined reporting method, there is a disregard for separate legal entities. In general, under combined reporting, the taxpayer multiplies the total group’s income by an apportionment percentage that is based on factors (usually property, payroll, and sales — or sometimes just sales) as a fraction, with the numerator including in-state factors and the denominator including those factors everywhere. That raises another issue when determining what the total denominator should include: total U.S. factors or total worldwide factors?

3. Unitary Combined Water’s-Edge Election

That question has led some states to allow taxpayers to make a water’s-edge election. Under that filing method, all members of the unitary group that are incorporated outside the United States and conduct most of their business outside the United States are excluded from the unitary combined return.

In California, qualified taxpayers can make a water’s-edge election on a timely filed original return, but that election is an 84-month commitment that cannot be changed during that period. Historically, a California water’s-edge election was essentially a contractual arrangement between the taxpayer and the state. For tax years beginning on or after January 1, 2003, the contract form has been converted into a statutory election.

What will surprise many foreign taxpayers is that according to California law, a water’s-edge combined report includes a foreign corporation’s income to the extent of its effectively connected income, as defined by IRC section 971, simply because California does not recognize provisions of U.S. tax treaties. California includes any income from a controlled foreign corporation to the extent its subpart F income exceeds its earnings and profits in the California water’s-edge combined income tax return. The risk exists that a single entity’s presence or a single sales factor in a U.S. state such as California could bring the income of a global group of affiliated entities within the taxing power of a U.S. state. Federal authorities have acknowledged that risk. As far back as the Carter administration, the U.S. Treasury Department has said that the conflict between states’ worldwide combination and apportionment practices — along with rules applied by the U.S. and international practices — could have serious implications.

The debates continue between corporate officials and the states. Corporations generally oppose worldwide combined reporting, arguing that it is an unconstitutional imposition of state taxes on foreign-source income, it undermines foreign commerce, it increases the risk of international double taxation, and it creates substantial administrative burdens. However, states maintain that worldwide combined reporting does not constitute taxation of foreign-source income.

---

21See N.C. Gen. Stat. section 105-114 et seq.
26Walters et al., supra note 25.
but simply calculates an individual state’s share of a multinational corporation’s total income using the factors that contributed most of the earned income.\textsuperscript{29}

4. Consolidated Method

Some states permit or require a consolidated return filing. Although rules differ, most states allow a consolidated filing if the parent corporation owns 80 percent of the total stock value and 80 percent of the total voting power in at least one of the affiliated companies. Unlike the unitary combined method, most states base their requirements to file a consolidated return on an ownership test rather than the unitary factors required under a unitary filing. Other companies in the combined group can be owned by either the parent or a subsidiary as long as the ownership total obtains the 80 percent threshold. Consolidated filing may also be allowed or required when separate filing doesn’t fully reflect a company’s income or activities. Moreover, a state may require a consolidated return when members of the consolidated group all have nexus with the state.

States that use consolidated return filings include Oklahoma, Kansas, and Florida.\textsuperscript{30} In general, when a taxpayer files a consolidated return, each corporation must calculate its state taxable income separately on its own factors and then combine the separate taxable income figures for one total income on which the tax will be computed. If an election is made, it is usually irrevocable for all future tax years unless the group cannot file a consolidated federal tax return or the state taxing authority releases the affiliated group of corporations from the election.

Finally, some states require a federal consolidated return filing in order to file a consolidated state return. If a federal return is not actually filed because a pro forma return is prepared, could a non-U.S. corporate taxpayer file a state consolidated return?

V. Conclusion

State tax systems’ lack of uniformity can be confusing, disruptive, and expensive. Non-U.S. companies that conduct limited business activities in the United States may be protected from federal income tax liability because of foreign tax treaties. Those companies, however, may have enough nexus to allow states to impose their taxing jurisdiction over them and require them to file state income tax returns. Any international company planning to do business in the United States should consider the state tax consequences. State income tax rules are complex for domestic companies, but they can be particularly difficult for foreign companies to comprehend. Therefore, caution is advised for foreign corporations conducting any business in the United States. That especially holds true for U.S. companies contemplating the use of a tax inversion to reduce federal tax liabilities, which may result in an unintended increase in state tax liabilities.

\textsuperscript{29}Id. at 33-36.