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American State and Local Taxes for Businesses Headquartered Abroad: Know What You Do Not Know—'The Big Three'

BY DAVID A. FRUCHTMAN

European, Asian, and other foreign-based businesses selling goods and services in the United States seek to capture a part of the world's largest consumer market; however, these businesses need to be aware of the tax dangers presented by each of the 50 states.

Unfortunately, many foreign businesses do not know of these dangers.

Foreign-based businesses need to be aware of the tax dangers presented by each of the 50 states.

Based on experience, what follows are the three most important state tax unknowns.

The Lack of a Permanent Establishment Is Irrelevant

Many foreign business and foreign tax professionals believe that a business that does not have a permanent establishment in the United States is not subject to taxation in the United States. Unfortunately, they are wrong where state taxes are concerned.

The United States' tax treaties with other countries provide that a business must have a ''permanent establishment'' in a foreign country before the business is subject to that country's taxes on income or capital. These treaties define ''permanent establishment'' as requiring a ''fixed place of business.''[1]

However, the concept of a permanent establishment is irrelevant to state taxation (unless, as rarely occurs, the state chooses to apply such a standard).[2] For state tax purposes, if a business has an employee or representative in a state on company business—even if that presence is temporary—the business is likely to have tax presence in the state under the U.S. Constitution as interpreted and applied by the U.S. Supreme Court and state supreme courts.[3] If such a presence is established,

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[1] A typical definition provides that ''the term permanent establishment means a fixed place of business of an enterprise through which the business is wholly or partially carried on.'' This or another definition also requiring a ''fixed place of business'' is contained in the United States' tax treaties with the United Kingdom, Germany, France, Russia, Israel, Japan, Korea, China, and other countries.

[2] See e.g., Florida Technical Assistance Advisement 03C1-003 (Sept. 3, 2003). See also *In the Matter of Westward Seafoods Inc.*, Alaska Office of Tax Appeals, 35-OTA-2000 (Jan. 6, 2004), and *In the Matter of the Appeal of Galvantech Inc.*, California State Board of Equalization Case No. 288289 (Feb. 1, 2006), both of which analyze tax presence in circumstances mirroring that being discussed in this article and reach their holdings without applying a permanent establishment standard. As noted in the text, the states can adopt a permanent establishment standard for taxation, but rarely do so. See e.g., Massachusetts, which uses a permanent establishment standard in limited circumstances relating to its corporate income tax. Mass. G.L. c. 63, Section 32B(c)(3)(iv); see also Massachusetts Technical Information Release No. 10-16 (April 4, 2011). Significantly, even if a state adopts a permanent establishment standard for its income tax, that standard does not necessarily apply to other taxes imposed by the state (e.g., sales and use taxes).

[3] See e.g., *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (holding that, for sales tax purposes at least, tax presence of a business in a state may exist only if the business has a physical presence in the state). An in-state physical presence need not be fixed or permanent, and state courts have held that tax presence can be created by the transitory presence of an employee who is attempting to make a market for the business's goods or services. See e.g., *Orvis Company Inc. v. Tax Appeals Tribunal*, 86 N.Y.2d 165 (1995). Moreover, tax presence can be created by the activities of non-employee representatives. See e.g., *Scripto Inc. v. Carson*, 362 U.S. 207 (1960). While the cases discussed above involve tax presence for sales

the business will be subject to state and local income, franchise, sales, use, and other taxes. (An income tax exception might be available for businesses selling only tangible personal property.[4])

It is essential that foreign businesses understand that the points of contact required to establish state tax presence are far less substantial than those required under a permanent establishment threshold. Such points of contact include having in-state employees, agents, or representatives doing anything (even on a temporary basis) that creates a market for the business's goods or services. They also include repair or other service activities performed in a state on a business's behalf, or the business's ownership or rental of property located in the state.

It is essential that businesses avoid creating state tax presence accidently.

Of course, businesses exist to make sales and to make a profit, and they regularly conclude that the value of their activities in a state exceeds the cost of the state's taxes and tax compliance requirements. But, with state and local sales tax rates often exceeding 7.5 percent of gross sales, and with state income taxes as high as 10 percent of taxable income, it is essential that businesses avoid creating state tax presence accidently.

The Income Tax Treaty Between the U.S. And a Foreign Home Country Is Irrelevant

Many foreign business and tax professionals mistakenly believe that their resident country's income tax treaty with the United States, by which double taxation is to be avoided (or largely reduced), also protects them from American state and local taxation. It does not.

In fact, the treaties are limited to federal taxes.[5] Therefore, for businesses that have tax presence, the states may impose income, franchise, sales, use, and other taxes independent of the federal government's ability to impose its income tax. And, in general, the measure of state taxes due is not affected by international tax treaties.

For income tax purposes, a business entity that has tax presence in a state may be subject to tax on all of the business's worldwide income. Likewise, if a corporation has tax presence in a state, some or all of its affiliates worldwide might be included in the measure of state income taxes due.[6] This potentially includes foreign affiliates lacking any direct connection with the state, and it can occur even if foreign affiliates' resident country has a tax treaty with the United States.

When a business or corporate group is required to file on a worldwide basis, the income apportionment computation will include information about its worldwide property, payroll, and sales. Even if the resulting amount of state income taxes is small, the cost to gather and organize the information can be significant.[7] For obvious reasons, foreign businesses are likely to view a tax filing requirement in a state 3,000 to 15,000 miles away as an unjust burden.

Moreover, any state income tax due may be small in comparison to the foreign business's liability for uncollected sales and use taxes.

For these reasons and others, it is essential that foreign businesses not be lulled into thinking that all American taxes are covered by tax treaties with the United States.

Owners and Employees Can Be Personally Liable for a Business's State Taxes

There is a widely held belief that shareholders, partners, officers, managers, etc. of legitimate businesses cannot be held liable for the business's unpaid taxes. Unfortunately, that belief is incorrect. Likewise, a technique sometimes considered by business planners of terminating a company to eliminate exposure for state tax liabilities can damage the business's owners and management by shifting the liability for the business's unpaid state taxes to them personally.

When a business fails to pay sales taxes, use taxes, or other trust fund taxes (that is, taxes that the business is required to collect from another taxpayer and then remit to a state), state law frequently permits the collection of the taxes from individuals at the business who were in a position to know about and correct the business's failure to collect and remit such taxes.[8]

Research reveals that between January 2010 and July 2012, no fewer than 17 states litigated this issue against such responsible persons, and that several of the states issued more than one of these decisions. Moreover, the

tax purposes, it is very important to note that there is an even lower standard for a business to be taxable in a state for income tax purposes. See e.g., *Lanco Inc. v. Director, Division of Taxation*, 188 N.J. 380 (2006) (finding income tax presence from the generation of in-state revenues from licensed trademarks and other intangible property, and holding that ''We therefore affirm the Appellate Division's determination that the Director constitutionally may apply the Corporation Business Tax notwithstanding a taxpayer's lack of a physical presence in New Jersey'').

[4] Under federal Pub. L. No. 86-272 (15 U.S.C. Section 381(a)), a business will not be subject to a net income tax of a state in which it is not incorporated if its activities in the state are limited to the solicitation of the sale of tangible personal property, with acceptance or rejection of all orders occurring outside of the state and shipment or delivery of the property occurring from a point outside of the state.

[5] The treaties provide (with some variation in language) that ''The taxes which are the subject of this Convention are: In the case of the United States, the Federal income taxes imposed by the Internal Revenue Code . . . .''

[6] The constitutionality of worldwide combined reporting as applied to foreign entities was litigated at the U.S. Supreme Court in *Barclays Bank PLC v. California Franchise Tax Board*, 512 U.S. 298 (1994). The court held that the U.S. Constitution does not impede worldwide application of California's corporate franchise (income) tax.

[7] The U.S. Supreme Court rejected Barclays Bank's ''vigorous'' argument that the compliance burden and additional expense required by worldwide combined reporting made this reporting methodology unconstitutional. *Barclays* at 312-314.

[8] See e.g., California (Cal. Rev. & Tax. Cd. Section 6829 and Cal. Code Regs. 1702.5); Texas (Tex. Tax Code Ann. Section 111.0611); New York (N.Y. Tax Law Section 1133 and NYCRR 532.3); Florida (Fla. Stat. Section 213.29); and Illinois (35 ILCS 735/3-7).

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states usually won these cases. And, significantly, the reported decisions are a small minority of these collection actions; most disputes are resolved quietly.

Conclusion

All 50 of the United States impose tax on a business's income, sales of goods, or both. Unfortunately, state taxes involve rules different from the federal taxes administered by the Internal Revenue Service. This can result in state tax presence where there is no federal tax presence. And, without regard to any treaty restrictions on federal taxation, such tax presence can also result in an unsatisfied sales tax collection obligation in earlier periods and a liability for state income taxes (potentially determined on a worldwide basis).

If a business determines that it has a liability for prior periods' state sales, income, or other taxes, it is likely to need the assistance of tax counsel to correct the problem quickly and as quietly as possible. While a discussion of the possible approaches to such a resolution is beyond the scope of this article, some possible approaches are described in ''Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground'' (42 DTR J-1, 3/3/11).

And, of course, businesses having an exposure for state taxes should undertake a tax planning program to reduce future periods' tax liabilities.