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Spotlight on SALT: The Global Reach of State Unitary Tax Regimes

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A foreign corporation doing business in the U.S. may be surprised to learn that its income can still be included in a State's "unitary combined report" of income. Even though operating in the U.S. through subsidiary corporations, a foreign corporation should not assume that it has no State corporate income tax exposure simply because it may be protected by a United States tax treaty.

What is Unitary Combination?

Twenty-four of the 47 States that impose income tax on corporations employ the "unitary combined reporting" method of taxation. Under unitary combined reporting, a commonly owned and controlled group of corporations that are engaged in a "unitary business" combine all of their business incomes and apportionment factors (generally, some average of property, payroll, and sales sourced to the taxing State over property, payroll, and sales everywhere) and apportion a single combined amount of income (or loss) to the taxing State using the group's combined apportionment factor. Definitions of what constitutes a "unitary business" vary based on statute, regulation and case law.

At one time, a few States used "worldwide unitary combined reporting" (application of unitary combination to a worldwide group of unitary corporations, not just to those organized or operating in the U.S.). Worldwide unitary taxation came under assault in the 1980s and 1990s. In recent years, unitary combined reporting has seen a resurgence, as Vermont (2006), New York (2007), Michigan and Texas (2008), and Massachusetts, West Virginia, and Wisconsin (2009) have jumped on the bandwagon. Although "worldwide unitary combined reporting" was upheld, at least by 1994, as constitutional by the U.S. Supreme Court, so-called "waters-edge combined reporting" is now the norm.

In general, a "water's-edge combined report" includes only those members of the unitary group that are U.S. corporations. However, the contours of the water's-edge group do not always end at the water's-edge.

The Exposure Risk to Foreign Corporations Presented by Unitary Combination

In general, a foreign corporation is subject to U.S. federal income tax only on its income that is "effectively connected with the conduct of a trade or business" in the U.S. (ECI), and certain other income derived from U.S. sources. However, the U.S. is a party to tax treaties with 65 other nations, including Australia, Canada, China, France, Germany, India, Ireland, Israel, Japan, Mexico, and the United Kingdom. While all tax treaties vary in certain respects, a foreign corporation that is a resident of a U.S. treaty country partner is generally only taxable on its U.S. business profits if it has a "permanent establishment" in the U.S. (generally, a "fixed place of business").

Tax treaties do not apply to U.S. States, with the general exception of tax treaty non-discrimination articles, and those potential situations where the actions of the State would prevent the U.S. from "speaking with one voice" when regulating foreign commerce. In fact, the tax jurisdiction principles applied by States are far different than the permanent establishment concept. Further, in the past when presented with the argument the U.S. Supreme Court has held that "worldwide unitary combination" did not violate the Foreign Commerce Clause and did not prevent the U.S. from "speaking with one voice." Therefore, a foreign corporation may find

itself or its income subject to State income tax, even though the foreign corporation considered itself to be tax treaty protected or not engaged in a U.S. trade or business under a treaty or U.S. federal income tax principles.

The spread of unitary combined reporting regimes broadens the risk of subjecting a foreign corporation's income subject to State income taxation, particularly when unique State apportionment factor sourcing and jurisdictional rules are taken into account. From a survey of four States, two common exposure risks are evident and one or both of these may also apply in the other 20 States that employ unitary combined reporting.

The "80/20 rule"

California applies the more common "80/20 rule" – that is, if 20 percent or more of the average of a foreign corporation's property, payroll, and sales are within the U.S. (not just California), then all of its income and apportionment factors are included in a California water's-edge combined report. Although California will follow U.S. tax treaty provisions, this is only to the extent a tax treaty limits taxation of a foreign corporation's ECI. A U.S. tax treaty does not turn off California's "80/20 rule."

Massachusetts and Texas go one better. They also apply an 80/20 rule, but include U.S. territories, possessions and areas where the U.S. has asserted jurisdiction with respect to exploration or development of natural resources as jurisdictions to determine if the average of U.S. apportionment factors are 20 percent or more. (Unlike California and Massachusetts, Texas only averages property and payroll, or gross receipts if the foreign corporation has no property and payroll.) Further, a foreign corporation, regardless of its U.S. apportionment factors, is included in a Massachusetts unitary combined report if more than 20 percent of its gross income is from licensing intangible property or service-related activities to Massachusetts combined group members. An example in Massachusetts regulations also extends this treatment to intercompany financing provided by a foreign corporation.

Wisconsin takes a different twist on the 80/20 rule. Rather than using average U.S. apportionment factors, Wisconsin includes a foreign corporation in a unitary combined report if 80 percent or more of its worldwide income is not "active foreign business income," as described in Internal Revenue Code § 861(c)(1)(B).

Economic Presence

A leading trend in State legislatures and courts is to assert income tax jurisdiction over a corporation that has no physical presence in a State – but rather has only an economic presence usually by licensing intangible property for use in the State, extending credit to State residents and other types of financing activities. Economic presence "nexus" presents particular risks for a foreign corporation. First, the corporation may be taxable in a number of non-unitary States based on an economic presence. The resulting State tax filing and income apportionment could trip the 80/20 rule for unitary States where U.S. subsidiaries operate. Second, more unitary combined reporting States are adopting economic presence "nexus" to target foreign corporations. For example, Wisconsin includes as "nexus-creating activities" licensing intangible property for use in Wisconsin.

Wisconsin is not content with economic presence nexus, however. A foreign corporation with 80 percent or more "active foreign business income" that is unitary with a group of U.S. corporations filing a Wisconsin combined report will be deemed to have nexus with Wisconsin. Although its income and factors would be excluded from the Wisconsin combined report, it would be required to file its own Wisconsin tax return, but report only its U.S. source income and apportionment factors.

Summary

Unitary combined reporting, income apportionment, and State tax jurisdiction can present surprising consequences for foreign corporations. As illustrated by Wisconsin, State unitary tax regimes can also produce

constitutionally suspect results. Plus, not every State treats partnerships or limited liability companies as pass through entities for tax purposes; and, even if a foreign corporation has no State taxable income liability, it may still be subject to franchise taxes on its net worth.

Foreign corporations should proactively address their potential unitary exposure and vigorously defend their interests on audit. If you would like to discuss the matters addressed in this Alert, please contact one of the members of our Tax Department.