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Panelists: U.S. States' Approach to Nexus And Apportionment—Oddity or New Trend?

Physical presence is the accepted model for determining taxing jurisdiction in U.S. federal and international tax systems. However, as panelists at the recent Forum on State Tax Considerations for International Tax Reform noted, U.S. states have broadened their definition of what constitutes nexus to include a mere economic presence.

Another key difference between U.S. states and the international community is the states' adoption of formulary apportionment in lieu of the OECD approach to attributing income, Separate Entity Accounting (SEA).

An important question emerging from the discussion is whether the U.S. states' approach to issues such as nexus and apportionment of income serve as a model or as a cautionary tale for the international community.

Evolution of Nexus Standards in the United States. The ''substantial nexus'' standard of the commerce clause of the U.S. Constitution has historically been interpreted as ''physical presence.'' Similarly, the due process clause requires that there be some minimum connection between a state and what it seeks to tax. However, as Joe Huddleston of the Multistate Tax Commission (MTC) noted, in the early 20th century, as integrated telegraph and railroad networks emerged and the U.S. economy became increasingly consumption-based, the physical presence standard for determining the tax base became impractical. As a result, more states adopted the view that a taxpayer's ''purposeful availment'' of the marketplace, *i.e.* its economic presence, constituted nexus. This standard has repeatedly been upheld by state appellate courts, though the U.S. Supreme Court has not opined on this issue.

Economic Nexus. States that adhere to the economic nexus standard take the position that nexus can be triggered merely by making sales into the state; owning property or maintaining a payroll is not required. Therefore, neither a permanent establishment, nor other physical presence, is necessary to trigger nexus. As Huddleston observed, this broad state-standard captures foreign corporations that are not subject to tax under the more restrictive federal nexus standard.

Nexus for Non-U.S. Entities. While U.S. states have moved towards an economic nexus standard, U.S. international tax treaties still rely upon the presence of a permanent establishment to determine whether a foreign corporation is subject to U.S. tax. The dual nexus standards creates confusion since multinational corporations doing business in the U.S. may be subject to tax for state income tax purposes, but not for federal income tax purposes.

As Peter Barnes of Caplin & Drysdale and Diann Smith of McDermott, Will & Emery, LLP noted, two landmark cases in the early 1990s, *ITEL v. Huddleston*, 507 U.S. 60 (1993) and *Barclays Bank v. The Franchise Tax Board*, 512 U.S. 298 (1994), are responsible for this dichotomy. In *ITEL*and *Barclays* the court ruled that income tax treaties are expressly applicable only to federal income taxes and do not apply to state taxes. As a result, a foreign corporation may store goods in the U.S. without triggering federal tax. However, the foreign corporation may still be responsible for state taxes.

This raises a number of policy considerations for foreign multinationals conducting business in the United States, the panelists observed. In the international tax world, physical presence is still the cornerstone of what constitutes a permanent establishment. Smith pointed out that this standard is more restrictive than state economic nexus standards. The open ended nature of economic nexus can create compliance headaches for foreign corporations, she said. Furthermore, as Doug Lindholm, the executive director for the Council On State Taxation (COST) said, this double standard may impede the ability of the U.S. to speak with one voice.

Joanne Weiner of George Washington University countered that states should not be subject to U.S. tax treaties since they are not involved in the negotiation process. Ultimately, Huddleston concluded that the states definition of what constitutes nexus is more responsive to today's marketplace and the international community has not evolved its nexus standard to encompass the activities of corporations that may not meet the traditional physical presence standard, but do meet a less restrictive economic nexus standard.

Formulary Apportionment. As more multinational corporations accept that in an increasingly global marketplace, the issue is no longer whether nexus with a particular jurisdiction exists. Rather, as Barnes stated, the question becomes what portion of income is attributable to a particular jurisdiction. The various methods employed by the states to determine the amount of income tax owed by an out-of-state corporation gives rise to several issues.

An Outdated Apportionment Formula. In order to determine the amount of income attributable to state jurisdictions, historically most U.S. states used a three factor formula: property, payroll, and sales. However, as Smith noted, this formula is outdated and does not reflect today's market. For example, property is defined to include only real and tangible property; it does not include intangible property, which is becoming increasingly important.

At the same time, as a means of removing disincentives for corporations to locate employees or property within their jurisdiction, most states have shifted towards a weighted sales factor or single sales factor formula.

As Huddleston noted, the single sales factor formula is not supported by the MTC; the MTC supports the traditional three-factor formula as the fairest approach. While this approach creates a system in which ''corporations that are not using the state's infrastructure may be taxed as much as corporations that place a burden on state infrastructure, if their sales are equal,'' said Smith.

Another complication arises from computing the amount of sales of services or intangibles that should be included within the numerator of the sales factor. States are increasingly moving away from taxation based on the location of where the cost of performance arose; instead, states impose tax based on the location of the market where the benefit was received.

Problems With the Single Sales Factor Approach. Additionally, Smith noted that as states move away from a cost of performance approach and towards a market-based standard, the term ''market'' has not been uniformly defined. This creates a risk of double taxation. Even though states may use a market standard, ''this is not the end of the story, [taxpayers] must very carefully look at whether the states have regulations'' on point, said Smith. This becomes a major issue as states seek to enforce the various apportionment formulas and methods for sourcing income.

Another complicating factor for foreign entities is the discretionary powers exercised by state taxing authorities with regard to tax havens, said Lindholm. Montana, Oregon and Maine have enacted laws that enumerate their own list of foreign jurisdictions that are considered tax havens for corporate tax purposes. These states require multinational corporations making the water's edge election to treat income attributable to known tax havens as U.S. income. States may recapture millions of dollars lost to income shifting by enacting such measures. However, as Lindholm noted, this creates a situation which the states are legislating in the international arena and may be creating another set of confusing rules for corporations to comply with.

Potential Solutions. The panelists noted that due to various political factors, it is difficult for the states to come to a consensus on a uniform formula, since each state has different considerations. As Barnes mentioned one possible solution may be the Business Activity Tax Simplification Act of 2013 or ''BATSA.'' BATSA would establish a bright-line standard for when a state can impose a net income tax or other business activity tax on interstate activities. It would define physical presence in a state to exclude a presence of less than 15 days within a jurisdiction's borders or transient business activities. This standard would at the very least help both domestic and foreign corporations determine when they may be subject to tax on a state level.

Another proposed solution is the Mobile Workforce State Income Tax Simplification Act of 2013 (H.R. 1129). This legislation provides that the wages of employees performing job duties in more than one state are only subject to income tax in the state of the employee's residence, and the state within which the employee is present and performing job duties for more than 30 days during the calendar year.

Lessons From the International Community. U.S. states may also be able to learn a valuable lesson on uniformity from the international community. The Value Added System adopted by many countries may serve to provide a uniform tax base and rate at a subnational level, thereby creating uniformity amongst the states, Barnes said. But unlike many countries with a VAT, each local and state jurisdiction often establishes its own tax base. ''The U.S. is a bottom up country. To simply overlay our current system with a VAT would create issues,'' said Huddleston. Barnes countered with the example of Canada as another bottom-up country that was able to solve many of its complex tax issues by implementing a VAT. He did however warn that the VAT comes with its own set of issues and was by no means a panacea to the compliance issues that are created by the various applications of formulary apportionment that exist today.

While panelists discussed various solutions to the issues created by the existing system of determining nexus and income apportionment, they noted that the international community may still be able to learn from the experience of the states. The question remains whether the international community will view the nexus standards and varying methods of apportionment imposed by U.S. states as a proactive approach to a changing marketplace and follow suit, or whether they will view states' approach is an oddity that must be corrected.

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☐ *For a discussion of activities triggering income tax nexus, see 1410 T.M., Limitations on States' Jurisdiction to Impose Net Income Based Taxes, at 1410.03.For further information regarding state allocation and apportionment methods, see 1150-2nd T.M., Income Taxes: Principles of Formulary Apportionment, at 1150.03.*

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