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Practitioners' Corner

U.S. State Tax Traps for Italian Investors

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Consider the steps an Italian corporation would take to expand its business in the United States. Before making a direct investment or forming its own subsidiary, the investor is likely to enter the U.S. market via the services of third-party commission agents or distributors. With the Italy-U.S. income tax treaty setting the existence of a permanent establishment as a threshold of taxation by the United States, the Italian business can structure its U.S. activities to avoid maintaining a U.S. PE. The company's management then believes the Italian corporation has protected itself from U.S. taxation on income and the burdens of U.S. tax compliance.

Not so fast. U.S. states are not parties to the Italy-U.S. income tax treaty entered into by the U.S. federal government and are therefore not bound by it. States operate their tax systems independently from the federal government. This independence results in many taxes with little uniformity between jurisdictions.

True, treaties have the same status as U.S. federal law, and they can preempt inconsistent law of the states under the Supremacy Clause of the U.S. Constitution. Nevertheless, U.S. policy has traditionally been not to infringe on states' taxing authority with tax treaties. Consequently, article 2 of the Italy-U.S. treaty provides that it applies only to federal income taxes and not to taxes imposed by the states.

So, when an Italian company believes it has protected itself from U.S. federal taxation, it could still be exposed to state taxation.[1] And if the managers of the Italian company believe that states can assert their taxing jurisdiction over foreign companies only when those companies have a substantial physical presence (for example, an office) in a state, they are wrong again.

Nexus vs. PE

In the state context, the concept of PE is replaced by the concept of nexus. Nexus "thresholds" are significantly lower than the minimum contact that constitutes a U.S. PE of an Italian company under the Italy-U.S. treaty. Activities with as little penetration as hiring independent agents, attending trade shows, concluding contracts, and maintaining inventory may — depending on the state — result in nexus. Similarly, a non-U.S. corporation generating royalty income may, in some states and local jurisdictions, be deemed to have nexus when the underlying intangible is exploited in those jurisdictions.

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[1]Even though, under the treaty, no credit is available in Italy for taxes paid to U.S. local jurisdictions, Italian taxpayers may choose to be taxed under Italian domestic law, which generally allows the creditability of any taxes paid on foreign income as long as they are "definitive." *See Testo Unico delle Imposte sui Redditi*, article 165.

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For agents, U.S. federal law provides some relief. In P.L. 86-272, Congress provided that a state cannot impose an income tax on an out-of-state corporation whose sole activity in the state is the mere solicitation of sales. For that exception to apply, the foreign corporation's activities in the state must be limited to solicitation of orders by employees or representatives in the state for sales of tangible personal property. The orders must be sent outside the state for approval or rejection. Also, when the orders are approved, they must be filled by shipment or delivery from a point outside the state and delivered in-state by a common carrier.

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However, P.L. 86-272 does not explicitly apply to corporations incorporated outside the United States; each state holds the power to extend, or deny, that protection to non-U.S. corporations. Some states (for example, California) have explicitly denied P.L. 86-272 protection to non-U.S. corporations.

Other states (for example, Tennessee) have found that because P.L. 86-272 applies only to state taxes measured by net income, that provision is not applicable to franchise taxes that are measured by the net worth of the taxpayer.

The National Nexus Program

The different threshold for taxation under the PE and nexus concepts may expose to state tax liabilities not only an Italian corporation, but also U.S. subsidiaries of Italian corporations that operate unregistered in states different from their state of incorporation. That exposure should not be taken lightly. If a corporation has never filed a tax return in a state, that state might be able to assess taxes indefinitely to the date nexus was first established with the state, which could be many years back.

The Multistate Tax Commission's National Nexus Program, however, offers an interesting solution. The National Nexus Program operates a voluntary disclosure program that allows companies to resolve potential tax liabilities simultaneously with multiple states. Through this program, companies may approach a large number of states anonymously to propose settlement of potential state tax liabilities arising from past activities within those states. Taxpayers benefit by resolving potential state tax disputes before the state issues prior-year assessments of taxes, interest, and penalties.

Nexus and Taxable Income

State and local statutes vary widely on the definitions of nexus and taxable income. Those variations and inconsistencies create both planning opportunities and traps for the unwary.

Consider, for example, an Italian fashion purveyor (ITCO) that desires to maintain an inventory of its products in New Jersey to ensure faster deliveries.

The maintenance of a stock of goods or merchandise solely for storage, display, or delivery does not rise to the level of a PE under article 5 of the Italy-U.S. treaty. Accordingly, ITCO will not incur any federal income tax liability.

However, ITCO will be subject to New Jersey income tax if it stores merchandise inventory in that state. New Jersey imposes a tax on entire net income allocated and apportioned thereto on corporations doing business in New Jersey. New Jersey law provides that a corporation that "regularly maintains a stock of goods in New Jersey and makes deliveries to its customers from such stock, shall be deemed to be doing business in New Jersey." Accordingly, the corporation is subject to New Jersey income tax.[2] Further, merely holding or storing property in New Jersey also causes a corporation to be subject to the corporate income tax.[3]

The result could be different if ITCO decided to maintain its inventory across the Hudson River.

If ITCO maintained the inventory in New York, it would generally be subject to the New York franchise tax. New York imposes its franchise tax on every corporation that employs capital in New York or owns or leases property in New York.[4] The regulations provide that a corporation that maintains "stockpiles of . . . inventories" in New York is subject to the franchise tax.[5]

However, New York does provide an exemption from its franchise tax for income derived from so-called fulfillment services.[6] Under that exemption, ITCO may store inventory in New York without incurring franchise tax if it performs no services in New York and only the following limited services are performed by an unrelated entity on its behalf:[7]

- acceptance of orders by mail or electronic medium;

[2]N.J. Admin. Code 18:7-1.11.

[3]*Id.*, at example 1.

[4]N.Y. Tax Law section 209(1).

[5]20 N.Y. Comp. Codes R. & Regs. section 1-3.2(c)(1).

[6]*Id.*, at section 209(2)(f).

[7]N.Y. Tax Law section 208(19).

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- responses to customer correspondence or inquiries by mail or electronic medium;
- billing and collections; and
- shipment of inventory products offered for sale by ITCO.

If ITCO maintained its inventory in Florida, it would create nexus for the Florida income tax. However, due to Florida's definition of taxable income, ITCO would not incur a Florida income tax liability. For Florida income tax, federal taxable income is the starting point in determining Florida net income. When a non-U.S. corporation is tax exempt by treaty for federal income tax purposes, Florida does not impose an income tax.[8]

The states' varying definitions of taxable income are not only relevant for determining whether ITCO is or is not subject to state income tax liability, but also whether ITCO is subject to state income tax on a portion of its worldwide income.

For example, in New Jersey[9] and New York,[10] for apportioning taxable income of a foreign corporation that has established nexus therein, the taxable income to be allocated and apportioned is its worldwide income. Obviously, the foreign corporation needs to compute its worldwide income under U.S. tax accounting principles and in U.S. currency. Further, New Jersey and New York have the right to audit the foreign entity's worldwide books and records.

Unfortunately, incorporating a wholly owned U.S. subsidiary to run the U.S. business operations does not always avoid state taxation of a portion of the worldwide income of the foreign investor. Unitary taxation (or worldwide combined reporting) is a method that several U.S. states (such as Alaska, Idaho, Montana, New Hampshire, North Dakota, Utah, and, most notably, California) use to determine how much of a corporate group's income they will tax. Generally, states tax corporations only on income attributable to their activities and properties within the state as determined by apportioning the corporation's income from all sources based on the corporation's overall payroll, property, and gross receipts that are within the state.

Unitary states follow essentially the same procedure, except that, when corporations belonging to a corporate group function as a "unitary" enterprise, the state apportions not just the income of the corporation doing business within the state, but the income of the entire corporate group, even outside the United States. In other words, the unitary method uses worldwide combined reporting and apportionment to ensure that affiliated corporations cannot shift income to avoid tax.

> ***Companies may approach a large number of states anonymously to propose settlement of potential state tax liabilities.***

Responding to pressure from foreign corporations and the U.S. business community about worldwide unitary taxation, the federal government appealed to the states to prohibit, through state law, the use of worldwide unitary taxation. As a consequence, most states — including California[11] — permit a corporation to make a water's-edge election under which some foreign corporations or activities are excluded from the unitary group for state tax purposes.

In general, under a water's-edge election, affiliated foreign corporations are excluded from the combined report. The statute allowing the election to file on a water's-edge basis does not supersede the concept of unity; however, it limits the unitary entities included in the combined report.

State Taxes and Treaty Provisions

Although states operate their tax systems independently from the federal government and this independence results in a variety of taxes with little uniformity between jurisdictions, there is one instance when the Italy-U.S. treaty applies to state taxes. Article 24 (nondiscrimination) applies to "taxes of every kind and description imposed by a Contracting State or a political or administrative subdivision or local authority thereof."[12]

States and localities may benefit from the information exchange provisions under article 26, but only when the information is relevant to the assessment of taxes covered by the treaty.[13]

This limitation of the use of the information exchange provisions was eliminated in the pending treaty and protocol with Italy signed on August 25, 1999, to replace the existing treaty, which was

[8]Florida Administrative Code sections 12C-1012(1); 12C-1011(l); 12C- 1.022(3)(d)(2). Florida Department of Revenue, Technical Assistance Advisements No. 86(C)1-005 and No. 86(C)1-006.

[9]N.J. Admin. Code 18:7-5.2(a)(1)(xiv).

[10]N.Y. Tax Law section 208(9)(c). *See also Reuters Limited v. Tax Appeals Tribunal*, 82 N.Y.2d 112 (1993), *cert. denied*, 512 U.S. 1235 (1994).

[11]Cal. Rev. & Tax. Code section 25110.

[12]*See* article 24(5).

[13]*See* article 1(16) of the 1984 treaty protocol.

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signed in 1984.[14] While it is unclear where the authorities stand with the 1999 treaty ratification process and whether this impasse will be resolved anytime soon (for discussion, see *Tax Notes Int'l*, Aug. 29, 2005, p. 791), the extension of the application of article 26 to taxes imposed at the level of states, counties, cities, and other political subdivisions or local authorities reflects U.S. policy on this matter.

The IRS now routinely exchanges taxpayer information with states and conducts audits jointly with state auditors; this would help identify areas of "noncompliance" in corporate filings, especially regarding increased use of flow-through entities.

> ***It may be argued that Italy should not even bother to be bullied into a treaty with the United States.***

Treaty provisions may affect tax revenues of states and localities indirectly, too. As discussed above, in determining taxable income for state tax purposes, the starting point often is federal adjusted gross income. If U.S. business profits are not subject to federal tax because they are not attributable to a U.S. PE, business profits might not appear in the income tax base used for calculating the state franchise tax. Thus, unless a state law specifically provides for an adjustment to addback income exempt for federal income tax purposes, the state may indirectly adopt the Italy-U.S. treaty.[15]

But that is the extent of the Italy-U.S. treaty's impact on state taxes. The basic purpose of this treaty is to facilitate international trade and investment by preventing the erection of tax barriers to the free exchange of goods and services, and to facilitate the free movement of capital and persons between Italy and the United States. The Italy-U.S. tax treaty is also supposed to make more predictable the tax exposure of Italian companies operating in the United States.

That is hardly the case, as state and local tax systems burden Italian, as well as other foreign-based, corporations and may result in international double taxation. However, arguments against state tax laws frustrating the U.S. federal government's ability to speak with one voice when regulating commercial relations with foreign governments have been put to rest by the U.S. Supreme Court in *Barclays Bank*, which upheld the Californian worldwide combined reporting methodology.[16] So, the United States has no sympathy for complaints about state taxation.

Things are not likely to change. State taxing powers are a sensitive issue. Almost all of the U.S. constitutional litigation involving taxes has had to do with state taxing powers and their consistency with principles of federalism. In addition, all treaties, including tax treaties, must be ratified by the U.S. Senate before they come into force. Each state is represented in the Senate with two votes, regardless of its size. A two-thirds vote is required to ratify a treaty. Thus, no treaty affecting state taxation can be ratified without the approval of the states.

The independence of the states from the federal government is so well established that the United States has refused to extend a treaty's scope to cover state and local taxes even when treaty partners do so. Switzerland, for example, agreed to extend the coverage of its income tax treaty with the United States to taxes imposed by its own cantons and communes under the cantonal income tax acts.[17] But Switzerland is unique. It adopted a constitution that established a confederation of Swiss cantons with very limited federal government. The cantons administer most federal laws.

Considering the exclusion of state and local taxes, and that even the taxes covered by article 2 of the Italy-U.S. treaty may be adversely affected by U.S. unilateral treaty overrides resulting from the infamous "later in time" rule, it may be argued that Italy should not even bother to be bullied into a treaty with the United States.

But having one seems to be a status symbol. Italian investors will have to get along with that. And, in the process, they may discover that significant state tax savings can be achieved through careful planning. ◆

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[14] *See* article 1(20) of the 1999 treaty protocol.

[15] Several states, including New York, New Jersey, Oregon, and California, specifically require that income exempted by a tax treaty be added back in computing state taxable income. *See* N.Y. Tax Law section 208.9(b)(1) and N.Y. Comp. Codes R. & Regs. 20, section 3-2.3(a)(9); N.J. Rev. Stat. section 54:10A-4(k)(2)(A); Or. Admin. R. 150-317.010 (10)-(B).

[16] *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1995).

[17] *See* article 2 (taxes covered) of the Switzerland-U.S. income tax treaty.

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