Foreign Entities Doing Business in The U.S. Should Become Familiar with the State Tax Environment

Nearly all of the individual states within the U.S. and some localities impose some form of tax on business income, including the income of foreign businesses that have a certain connection with the state, generally referred to as “nexus.” Nexus is also constitutionally required before a state can impose any other tax compliance responsibilities, such as sales, wage withholding, business activity, franchise or gross receipts taxes on a foreign corporation. The tax revenues raised by the states are principally used to fund education and health care in addition to a variety of other services. The 50 states and the District of Columbia spent over $1 trillion for such services in fiscal year 2010. At the same time, the recession that started in 2007 caused the largest collapse in state revenues on record. The budget gaps that states have had to close for fiscal year 2012 total $55 billion in 31 states. How does this affect foreign entities conducting business in the U.S.? It raises the likelihood of being pulled into a state tax audit as revenue hungry states have become increasingly smart, efficient and aggressive in the pursuit of additional state revenues.

Although the Germany/U.S. Tax Treaty specifies a number of U.S. activities that will not create a “permanent establishment” in the U.S. that would trigger U.S. federal income taxes, these same activities may cause particular states to impose their taxes because they are not bound by the provisions of U.S. tax treaties. Under the Germany/U.S. Tax Treaty, for example, the following connections should not result in a German business being subject to U.S. income tax on its earnings: (1) using facilities solely for storing, displaying or delivering inventory belonging to the taxpayer, (2) maintaining inventory belonging to the taxpayer for the purpose of storage, display or delivery or processing by another enterprise; and/or (3) maintaining a fixed place of business for the purpose of purchasing goods or collecting information for the taxpayer. Significantly, any of these activities is likely to create nexus for state tax purposes. Owning property in a public warehouse, for instance, is sufficient physical presence to constitute nexus in almost every state that has an income tax.

Moreover, a business need not have a physical presence in a state to be subject to its taxing jurisdiction. Earlier this year, the New Mexico Court of Appeals held that an out-of-state limited liability company operating as an online bookseller and selling merchandise through the internet to customers located in New Mexico had sufficient contact in the state to establish nexus for purposes of the gross receipts tax because of the in-state use of trademarks. An affiliate of the online bookseller
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Licensed the same trademarks from the mutual parent company which the affiliate used in its retail bookstores located in New Mexico. The use of the trademarks in New Mexico by the affiliate was held to strengthen the goodwill and trademarks of the online bookseller which in turn helped it to establish and maintain a market in New Mexico. This was held to create a substantial nexus between the online bookseller and New Mexico.

The best way to protect against unforeseen tax nexus is to be aware of the basic activities that create nexus by conducting a thorough evaluation of how you conduct business in every jurisdiction you do business. This evaluation should include the following information:

- All business locations, including warehouses and leased property at customer locations.
- Temporary places of business, such as trade show booths, sales meetings, off-site training, and movable equipment at job sites.
- Permanent and temporary locations of any employees and agents, including sales representatives and customer service personnel.
- States in which business contracts are executed.
- Locations where installation or training occurs.
- Manner in which products are shipped into another state.
- Corporate structure.

The risk in ignoring potential requirements around nexus can be significant. The exposure may not materialize for years and the company is responsible for any penalties and interest that the jurisdiction imposes. If, after assessing your operations, you find that your business has established state tax nexus and there may be back taxes, many states offer voluntary disclosure or amnesty programs that can be utilized to resolve tax liabilities without fear of civil or criminal penalties or excessive look-back periods. By implementing a comprehensive state tax compliance plan on a going forward basis, you can keep your focus on business objectives rather than on battles with state and local tax departments.