2019 COST and OFFI Forum on U.S. State and Local Taxes for European Companies

U.S. Constitutional Limitations on State Taxation

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Agenda

- U.S. Federalism and Constitutional Limitations on State and Local Government
- Subnational vs. National Taxation in the U.S.
- Limitations on State Jurisdiction to Impose Sales Tax Collection Responsibilities
- Limitations on State Jurisdiction to Impose State Income Taxes
- Foreign Commerce Clause/Inbound Implications
- Other Restrictions

U.S. Federalism and Constitutional Limitations on State and Local Government

U.S. Federalism: Overview

- U.S. Constitution
  - States formed the federal (i.e., U.S.) government and crafted and adopted the Constitution
  - Assigns powers and duties to the various branches of the federal government
  - Places certain limits on federal and state governments, and
  - Defines individual rights of persons and citizens
- Federal government is accorded certain powers (defense, interstate commerce, general welfare)
  - Those powers not specifically granted to the federal government are "reserved" to the states
  - States may exercise the authority granted them as they see fit within the contours of the rest of the Constitution

U.S. Federalism: Overview

- U.S. Constitution prevails over both federal laws and treaties & state and local laws; federal laws prevail over state and local laws.
- Each state establishes its own tax policy except where prohibited by the Constitution or specifically preempted by a federal law
- Each state operates its own tax authority and administers its own taxes
- The tension between national and state fiscal and taxing authority dates back to the original Articles of Confederation and the U.S. Constitution

What does this mean practically

- Constitution (as interpreted by USSCT) sets framework, e.g., jurisdiction, discrimination
- Congress can preempt (when within its jurisdiction) but does not often do so
- States determine taxes they impose, significant control over base, establish rates, control administration
- Little interstate cooperation/simplification in administration

U.S. Federalism: Other notes

- States also have multiple types of local government jurisdictions
  - For the large part, local governments are limited to the powers and authority granted them by the state legislatures
  - Local governments are given wide authority to levy and administer ad valorem taxes on real and personal property, to "piggyback" on state sales/use taxes and (to a lesser degree) on state business and personal income taxes, and to adopt a variety of other excise and license taxes
  - Local governments administer their own property taxes, and in a handful of states, their own sales and income taxes

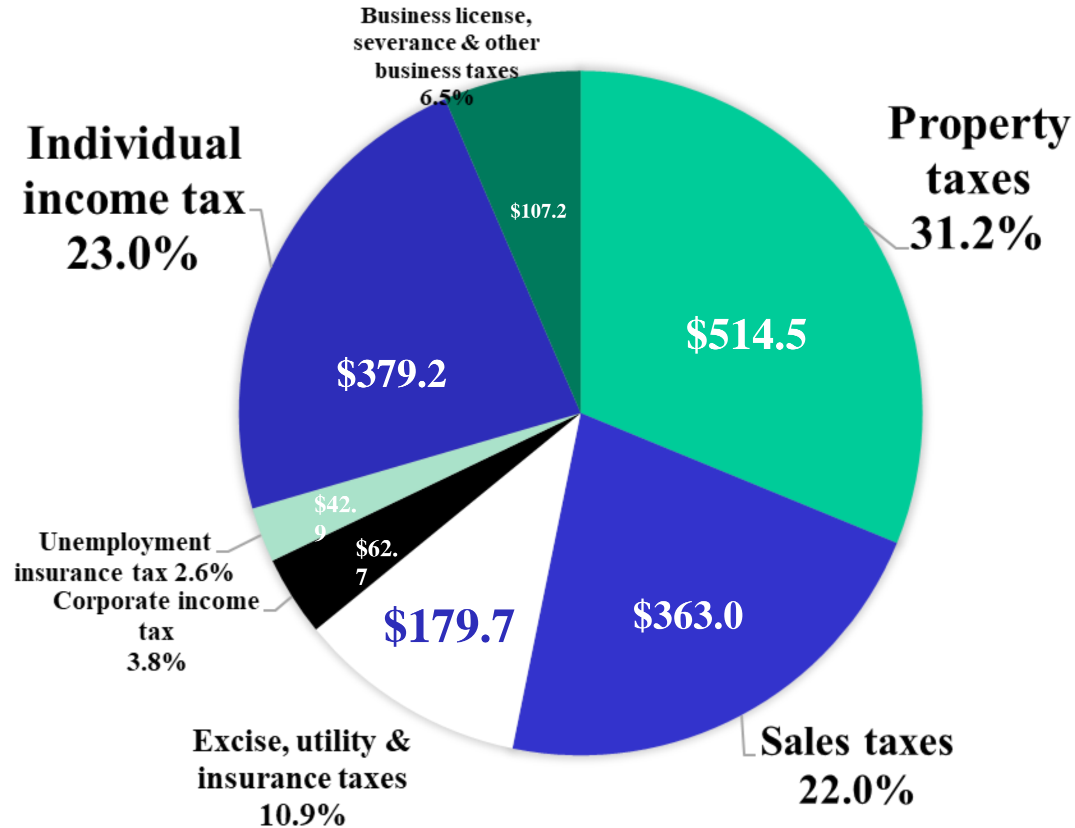
Key Constitutional Constraints on State Taxation

- The **Commerce Clause** provides that "Congress shall have the power to regulate Commerce with foreign Nations, and among the several states, and with the Indian tribes."

- The **Due Process Clause** (of the 14th amendment) provides that …"[N]or shall any State deprive any person of life, liberty, or property, without due process of law…"

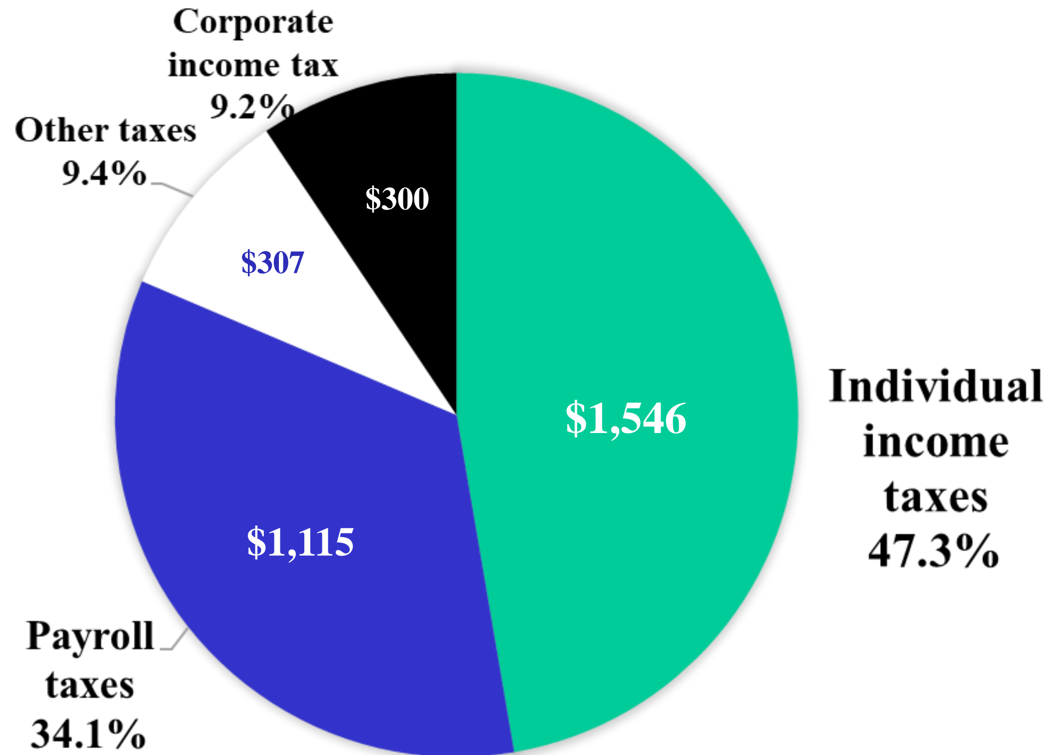
Subnational (State and Local) vs. National Taxation in the U.S.

Composition of Total State & Local Taxes on Businesses & Households, FY2016 ($1.648 trillion)



Source: STRI, COST & EY, *Total State & Local Business Taxes* (Aug. 2017)

Composition of Total Federal Taxes on Businesses & Households, FY2016 ($3.268 trillion)



Source: *An Update to the Budget and Economic Outlook: 2017 to 2027*, Congressional Budget Office, at 13 (Jun. 2017), https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/52801-june2017outlook.pdf.

Limitations on State Jurisdiction to Impose Sales Tax Collection Responsibilities

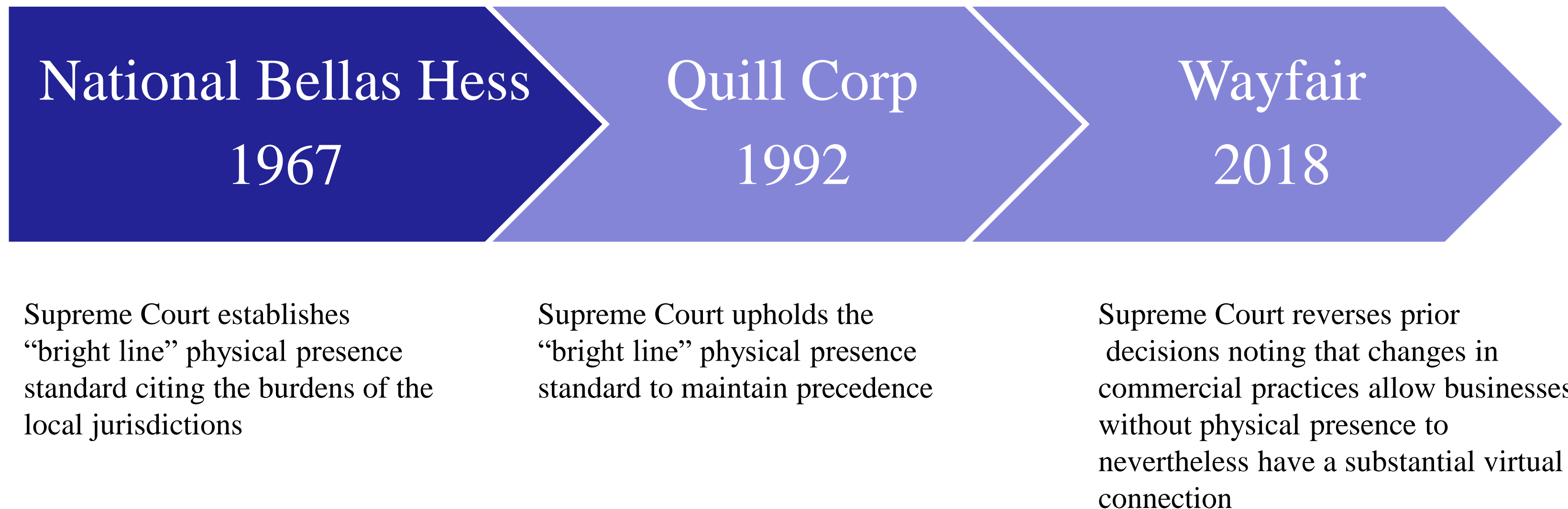
Subnational Jurisdiction to Tax (Generally)

- Jurisdiction to Tax is dependent on whether a taxpayer has "nexus" in the taxing state
  - From a constitutional perspective, a taxpayer must have a sufficient connection with the state and would not violate the U.S. Constitution
- Generally, 2 clauses are applicable to the analysis: Due Process Clause and Commerce Clause

Controlling Cases Jurisdiction to Tax

- *Complete Auto Transit Inc. v Brady*, 430 U.S. 274 was being addressed in the case
- 4 prong test outlined in Complete Auto provides permissible state taxing authority if:
  - the tax is applied to an activity with a substantial nexus with the taxing State
  - the tax is fairly apportioned
  - the tax does not discriminate against interstate commerce
  - the tax is fairly related to the services provided by the State

Development of Jurisdiction to Tax Sales/Use Tax



Note: cases relate to the requirement to collect tax from customers that owe it

Overview of Wayfair Decision

- Quill is flawed
  - Physical presence is an arbitrary distinction/artificial
  - Creates market distortions
  - "Substantial virtual connections" are meaningful in today's marketplace
- Stare decisis is not appropriate in this case
  - Quill safe harbor impairs a state's sovereign exercise of power
  - Revenue shortfalls of state
  - Rule is not easy to apply
- Application to South Dakota law
  - Court considered 3 aspects of South Dakota's law
  - Court noted that "other" aspects of Commerce Clause doctrine can protect against undue burden

Physical Presence vs. Permanent Establishment

- Economic nexus for sales and use tax collection purposes
  - Requires much less presence and permanence
  - Focuses on activities conducted to establish and maintain a market
  - Does not fall under the protection of tax treaties

Application of Wayfair to Inbound Retailers-Sales/Use Tax

- Nothing in *Wayfair* limits the holding to domestic US businesses
- *Japan Line Ltd. v. County of Los Angeles*, 441 US 434 (1979) may be instructive
  - Japanese shipping company was assessed property tax on cargo containers that were used exclusively in foreign commerce
  - Court first applied the four part test articulated in *Complete Auto Transit Inc. v. Brady* 430 US 274 (1977)

Application of Wayfair to Inbound Retailers-Sales/Use Tax

- Two additional factors must be considered regarding Foreign Commerce Clause
  - The tax may not create the risk of international multiple taxation
  - The tax must not prevent the US from speaking "with one voice" regarding foreign trade (citing *Michelin Tire Corp v. Wages*, 423 U.S. 276, 423 U.S. 285)

Application of Wayfair to Inbound Retailers-Sales/Use Tax

- In *Japan Line*, the Court found the ad valorem tax to be impermissible
  - International apportionment would not be enforceable (double tax concern)
  - Risk of retaliation by Japan would be felt by Nation as a whole
  - Sympathetic to revenue loss for services provided
- Tax collection requirement under Wayfair
  - Is there risk of double tax?
  - Is there risk of retaliation?

Limitations on State Jurisdiction to Impose Income Taxes

Nexus vs. Permanent Establishment

- Nexus
  - The "substantial nexus" standard is generally lower than the standard for establishing a permanent establishment.
- Permanent Establishment ("PE")
  - A PE is generally a fixed place of business through which the business of an enterprise is wholly or partly carried on.
  - A PE is necessary for the U.S. to levy federal income tax on foreign corporations in treaty jurisdictions.
  - States are not generally bound by federal tax treaties, so a foreign corporation can be subject to state income or business activity taxes without having a PE in the United States.

Is a Physical Presence Required for State Income Tax Purposes?

- The U.S. Supreme Court in *Quill* made clear it was not applying, and had not previously applied, a physical presence requirement to direct taxes.
- States used this opening to establish the concept of "economic nexus" for direct tax purposes.
  - Engaging in substantial economic activity in the state, regardless of physical presence.
  - Making a substantial amount of sales into the state.

Economic Nexus from Licensing Intangibles

Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993)

- **Facts**
  - Geoffrey was a DE-domiciled subsidiary of Toys R Us
  - Geoffrey had no offices, employees, or tangible property in SC
  - Geoffrey licensed trademarks and trade names to Toys 'R Us in exchange for royalties
  - Toys 'R Us deducted the royalty payments from its SC taxable income
- **Conclusion**
  - Quill does not apply to income taxes
  - Due Process: Geoffrey purposefully directed its activities toward SC by licensing its intangibles for use in the state
  - Commerce Clause: Geoffrey established substantial nexus with SC through intangible property in the state (including the receivables from the retailer attributable to sales in SC)
  - The U.S. Supreme Court denied cert. in this case.

Factor Presence Economic Nexus

- Most recently states have begun to pass laws stating that activities of any sort that generate receipts in excess of some threshold (e.g., $500,000) is sufficient to establish nexus for corporate income/franchise tax
- Some states have adopted the MTC Factor Presence standard:
  - Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

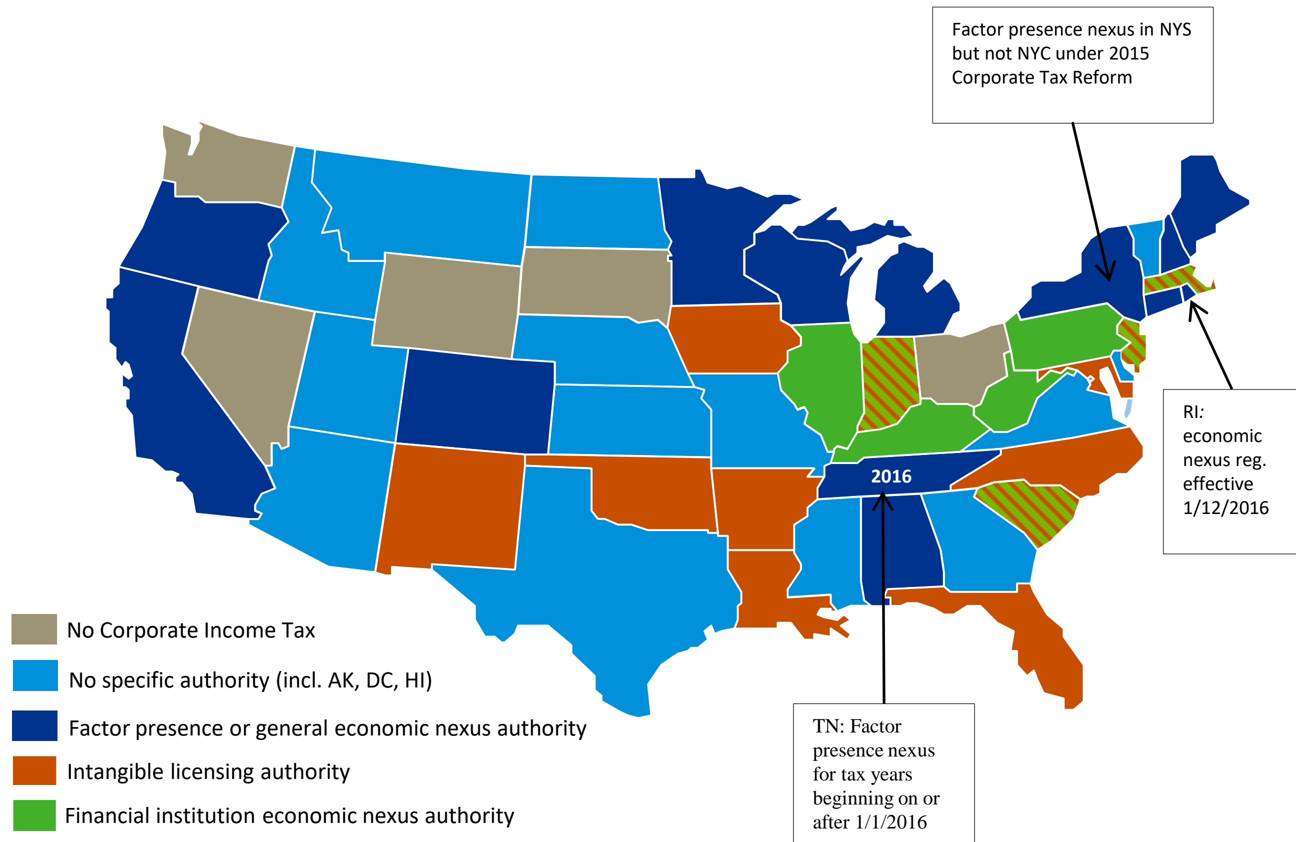
    (a) A dollar amount of $50,000 of property; or

    (b) A dollar amount of $50,000 of payroll; or

    (c) A dollar amount of $500,000 of sales; or

    (d) Twenty-five percent of total property, total payroll or total sales
  - Examples: AL, CA, CO, CT, MI ($350K), OH, TN, WA ($250K)
- New York’s factor presence test generally met if receipts are $1 million or more (note: NYC did not adopt factor presence nexus)

Economic Nexus for State Income Taxes



Public Law 86-272: Federal Preemption

- Even if a corporation is subject to tax under state law, federal law (P.L. 86-272) may prevent the state from imposing a net income tax on a business if:
  1. Sole in-state activity, excluding de minimis activity, is solicitation of orders for sales of tangible personal property
  2. Orders are sent out of state for approval
  3. Orders are filled from a warehouse or other place of business outside the state
- Is the in-state activity performed by an independent contractor?
  - Yes, then additional permitted activities include:
    - » Acceptance of orders shipped from outside the state
    - » Maintenance of in-state office
- Solicitation –"activities that serve no independent business function apart from their connection to solicitation of orders" (***Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.)***

Other Restrictions

Public Law 86-272: Applicable to Foreign Commerce?

- Public Law 86-272 applies to "interstate" commerce.

  - Several states have announced that they will apply Public Law 86-272 to transactions in foreign commerce (e.g., Alabama, Illinois).
  - Some states specifically do not apply Public Law 86-272 protections to foreign commerce.
    - California: applies only to U.S. states and Puerto Rico.

- MTC guidelines apply only to U.S. commerce, but contain guidance for purposes of applying Public Law 86-272 to foreign commerce.

Digital Services Taxes

- Corporate tax challenge
  - Taxation of profit should be in country in which values are created
  - Principle is being challenged by business models for which value creation is in part reliant
    on the engagement and participation of users
- Introduction of gross receipts tax that applies on key revenues
  - Aim is not to tax consumption, but revenues created from
    - Selling online advertising space,
    - Digital intermediary activities which allow users to interact with other users and
      which can facilitate the sale of goods and services between them, and/or
    - The sale of data generated from user-provided information
- Approach adopted or under consideration by several jurisdictions
  - Austria, Chile, the EU, France, India, Italy, New Zealand, Spain, the UK
- Similar considerations in US states – Washington B&O tax and PL 86-272 discussions

Unconstitutional Discrimination

- Commerce Clause prohibits taxes that favor local business over interstate commerce.
  - See *Boston Stock Exchange*, *Maryland v. Louisiana*, *Westinghouse Electric Corp.*, *Armco*, *Bacchus Imports*, *Tyler Pipe*, and *American Trucking Associations*.

Unconstitutional Discrimination (cont)

- A facially discriminatory state tax must be invalidated unless the state can show it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives or the tax is a compensatory tax.

(See *New Energy Co. of Indiana* and *Chemical Waste Management; Oregon Waste Systems, Associated Industries of Mo., Fulton Corp. v. Faulkner, General Motors, and Camps Newfound/Owatonna*).

Discrimination
Foreign Commerce

- A separate reporting state may not tax dividends from a controlled foreign corporation if it does not tax dividends from a controlled domestic corporation. (Iowa purported to do so by piggybacking on the federal regime, but without offering a credit for foreign taxes paid.)
- See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992)

Kraft precedence: Application to Federal Tax Reform

- **The 2017 Tax Cuts and Jobs Act** (federal tax reform added several provisions relating to the taxation of foreign commerce:
  - Global Intangible Low-Taxed Income; adopted by about one-half of the states
  - Transition tax on "deemed" repatriated dividends: adopted by one-third of the states
- **Separate Reporting**
  - It is important to recognize that the governing principle in the Kraft decision was not discrimination against *dividends per se*, but against *foreign commerce*.
  - Thus, under the *Kraft* precedent, the state taxation of GILTI would likely be prohibited in separate reporting states.

Kraft precedence: Application to Federal Tax Reform

- **Combined Reporting**: The fact pattern is different for taxing foreign subsidiaries dividends (or GILTI) in combined reporting states because these states include the income and apportionment factors of domestic subsidiaries in the calculation of taxable income.
- Nonetheless, the taxation of GILTI (or "deemed" repatriation) in combined reporting states likely violates Commerce Clause limitations unless foreign "factor representation" is allowed. Otherwise, the foreign income is discriminated against because its income-generating factors are not taken into account.
- See contra: E.I. du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82 (Maine 1996) and Appeal of Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993).

Unconstitutional Distortion

- The U.S. Constitution requires that an apportionment formula must not be unreasonable and arbitrary in its application.
- An apportionment formula will be held invalid whenever it results in taxation that is "out of all appropriate proportions" to the business activities conducted in the taxing state or that is "grossly distorted." (See *Hans Rees' Sons, Norfolk and Western Railway Co.*, and *Moorman Mtg. Co.*).