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Multistate Foreign Corporation State Income Taxation – Factor Presence Nexus

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Is it possible that a foreign corporation that has no physical presence in a state could be required to pay state income taxes resulting from business/sales within that state? The answer is yes. This surprises many foreign corporations, who find that additional state income taxes may result by them simply making sales in a particular state.

Factor Presence Nexus and Thresholds

State income tax nexus generally requires a physical presence within that state. The term "nexus" means "a connection" in general terms. From a state tax perspective, the term nexus is used to describe a situation where a business is subject to state income tax and sales tax for sales within that state, due to having nexus or physical presence in the state.

In 2002, the Multistate Tax Commission ("MTC") adopted the Factor Presence Nexus Standard ("FPNS") for business activity taxes. Since then, some states have adopted this approach. Under the FPNS, a foreign corporation is subject to state income tax during the tax period, if the corporation has property, payroll or sales in that state exceeding specified thresholds as follows:

- USD $50,000 of property in the state;
- USD $50,000 of payroll in the state;
- USD $500,000 of sales in the state; or
- 25% of the foreign corporation's total property, payroll or total sales are in the state.

If one of the PFNS tests is met, the corporation is treated as having state nexus and as a result, state income tax filing obligations, even though the corporation has little or no physical presence in that state.

States Adopting Factor Presence Nexus

As of 2016, the following 10 states have adopted factor presence nexus standards:

- Alabama
- California
- Colorado
- Connecticut
- Michigan
- New York
- Ohio
- Tennessee
- Virginia
- Washington

However, the criteria and thresholds vary by state. If a foreign corporation exceeds the state-defined factor thresholds, nexus is established based on the specific factor and the corporation is subject to state income tax without physical presence.

How to avoid Factor Presence Nexus

Congress enacted Public Law 86-272 to provide multistate corporations that have limited state activity with some potential relief from the imposition of state taxes. Public Law 86-272

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prohibits a state from taxing the income of a multistate foreign corporation, if the corporation's only in-state business activity is the solicitation of sales of tangible personal property, and the sales orders are approved and shipped outside of that state.

As a result, a foreign corporation merely soliciting the sale of tangible personal property is protected under Public Law 86-272 and may avoid factor presence nexus and state income tax obligation with respect to the sale of tangible personal property within that state.

However, Public Law 86-272 does not protect a foreign corporation with respect to the following:

- state sales and use taxes, gross receipts taxes, minimum taxes, franchise taxes or capital taxes;
- sale of non-tangible personal property, services performed;
- presence of salespersons who perform non-solicitation activities.

Each state must be examined individually. For example, for taxable years beginning on or after January 1, 2011, California has adopted FPNS with the thresholds of factor presence adjusted annually for inflation. Public Law 86-272 applies to the income taxes of a foreign corporation resulting from the sale of tangible personal property. However, a foreign corporation doing business in California is subject to a minimum/franchise tax which is not protected under Public Law 86-272. For 2016, once a foreign corporation's sales in California exceeds USD $547,711 or 25% of total sales, a foreign corporation is subject to California franchise tax and associated tax filings even though it may have no physical presence or permanent establishment in California.

Conclusion

It is possible for a foreign corporation with no physical presence in a state to have nexus for state tax purposes but not for federal income tax purposes. This is the case because some states adopt the FPNS and do not follow treaty provisions that might otherwise provide an exemption from state tax.

A foreign corporation doing business in the U.S. is advised to review the state-by-state activities regularly to determine whether it has any state tax filing obligations. If and when state tax filing obligations become a requirement, the corporation should make every effort to comply with the state tax laws and file voluntary disclosures, if required, to seek penalty relief.

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