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I. Introduction

The outstanding characteristic of state corporate net income taxes is their broad conformity to the federal corporate income tax.1 Today, every state with a corporate income tax employs federal taxable corporate income (or some variation thereon) as the computational starting point for determining state taxable corporate income.2 In principle, the rules that provide for conformity of the state corporate income tax base to the federal corporate income tax base apply equally to domestic corporations (hereafter “U.S. corporations”) and to foreign corporations (hereafter “non-U.S. corporations”).3 However, because the U.S. regime for taxing non-U.S. corporations differs in some important respects from the U.S. regime for taxing U.S. corporations, the conformity is not as complete for non-U.S. corporations, and conformity issues may arise that do not arise for U.S. corporations.

The fundamental differences between the U.S. regime for taxing U.S. corporations and the U.S. regime for taxing non-U.S. corporations arise both from differences in scope of the United States’ power to tax the income of the respective corporations (“substantive jurisdiction”) and from differences in the United States’ power to enforce the tax in the two contexts (“enforcement jurisdiction”).4 Regarding substantive jurisdiction, the United States generally taxes U.S. corporations on all of their income,5 but it generally taxes non-U.S. corporations only on income derived from sources within the United States.6 This reflects well-established and widely recognized principles for jurisdiction to tax income, namely, residence and source.7 Furthermore, because many non-U.S. corporations operating entirely outside the United States earn U.S.-source income from activities not connected with a trade or business, the

non-U.S. corporations differs in some important respects from the U.S. regime for taxing U.S. corporations, the conformity is not as complete for non-U.S. corporations, and conformity issues may arise that do not arise for U.S. corporations.

1Jerome R. Hellerstein, Walter Hellerstein, and John Swain, State Taxation, para. 7.02 (3d ed. 2014 rev.) [hereinafter cited as Hellerstein]. This article reflects the revision to State Taxation, para. 7.05, which will appear in 2014 Supplement No. 3 to the treatise.

2See RIA, All States Tax Guide at para. 221 (Chart) (Federal-State Conformity).

3See 1 Hellerstein, supra note 1, para. 7.02. We use the terms “U.S. corporation” and “non-U.S. corporation” in this article to differentiate our terminology from the terminology employed in the Internal Revenue Code (“domestic corporation” and “foreign corporation”) in order to avoid confusion with the terminology.

(Footnote continued in next column.)
United States has adopted a special regime for taxing such income by requiring withholding of taxes by those over whom the United States has enforcement jurisdiction.8

II. Overview

A. Income Not Effectively Connected

Under the Internal Revenue Code, non-U.S. corporations are subject to a tax of 30 percent of specified items of gross income from sources within the United States when the income is not “effectively connected with the conduct of a trade or business within the United States.”11 Such income includes interest, dividends, rents, and “other fixed or determinable annual or periodical gains, profits, or income”10 (so-called FDAP income). The tax on FDAP income is enforced through a withholding mechanism, under which those persons making payments of items of FDAP income to non-U.S. corporations generally must “deduct and withhold from such items a tax equal to 30 percent thereof.”11

Although the states do not conform to the federal withholding tax regime associated with FDAP income earned by non-U.S. corporations, California and several other states have adopted that type of regime for withholding of tax on FDAP income earned by individual nonresidents from sources within the state.12 Moreover, the U.S. Supreme Court has sustained the constitutionality of a similar withholding regime.13 The explanation for the states’ failure to require conformity to the federal withholding regime for corporate FDAP income probably lies in the relative insignificance of such income to individual states along with the additional administrative complexity that adoption of that type of regime would entail, rather than any carefully considered decision not to conform to this aspect of the federal corporate tax regime. In this respect, it may simply reflect Justice Oliver Wendell Holmes’s wise observation that “a page of history is worth a volume of logic.”14

Accordingly, non-U.S. corporations deriving U.S.-source FDAP income that is not effectively connected with a U.S. trade or business generally pay no state tax on such income. Although such income is taxable at the federal level, it is not reported on the federal return, and if any, filed by non-U.S. corporations as “taxable income,”15 which is typically the starting point for state taxable income.16 Because the states have not independently adopted a withholding regime for non-U.S. corporations that mirrors the federal withholding regime (as applied to in-state income), such FDAP income therefore “falls between the cracks” of the framework of federal-state corporate income tax conformity.

B. Income Effectively Connected

Non-U.S. corporations are subject to a tax equivalent to the tax imposed on U.S. corporations on taxable income that is effectively connected with the conduct of a trade or business in the United States.17 Under international tax treaties, the United States and its treaty partners typically agree not to impose any tax on business profits earned by an enterprise of the other treaty partner unless the enterprise has a “permanent establishment” in the country.18 However, those treaties generally are not binding on the states.19 In some circumstances, therefore, a non-U.S. corporation may have federal income tax liability under the IRC and, in principle, under a conforming state’s tax law whose nexus rules are less demanding than the PE requirements, but have no federal income tax liability under a bilateral tax treaty. In such cases, some states have indicated that they will respect the immunity from source-based taxation provided by the PE threshold to

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8See IRC sections 881, 1441, 1442.
9IRC section 881.
10Id.
11IRC sections 1441, 1442. See 1 Hellerstein, supra note 1, at para. 6.04[2]. Under the extensive network of bilateral tax treaties that the United States has with more than 60 countries, the withholding rate on the principal categories of FDAP income (dividends, interest, and royalties) is substantially reduced or eliminated altogether. See United States Model Income Tax Convention of November 15, 2006, arts. 10, 11, 12.
12See Cal. Rev. & Tax. Code section 18662; Cal. Admin. Code tit. 18, section 18662-1, 18662-2 (adopting withholding regime for “interest, dividends, rent, prizes and winnings, premiums, annuities, emoluments, compensation for personal services, and other fixed or determinable annual or periodical gains, profits and income” paid to nonresidents). Other states have similar statutes either authorizing such withholding or requiring the filing of information returns regarding such income earned by nonresidents. See, e.g., Ark. Code Ann. section 26-51-811, 26-51-812; Miss. Code Ann. section 27-7-39; RIA, supra note 2, at para. 227-A (Chart) (Norwegian Information Returns).
13International Harvester Co. v. Wisconsin Dept of Taxation, 322 U.S. 435 (1944), discussed in 1 Hellerstein, supra note 1, at para. 6.04[2][a].
15Only those non-U.S. corporations that earn income effectively connected with a U.S. trade or business would normally be required to file a U.S. tax return. Even if a non-U.S. corporation does file a U.S. tax return (Form 1120-F), the corporation would report its FDAP income on a section of the return (Section I) that is separate from the section (Section II) for determining its taxable income that is analogous to the similar schedule on Form 1120, filed by U.S. corporations.
16See supra Section I.
17IRC section 882.
19See 2 Hellerstein, supra note 1, at para. 20.10[4].
III. Sourcing Conundrum and Schlumberger

A. Conformity Provisions and OSG Bulk Ships

The Alaska corporate income tax statute provides that “Sections 26 U.S.C. 1-1399 and 6001-7872 (Internal Revenue Code), as amended, are adopted by reference as part of this chapter ... unless excepted to or modified by other provisions of this chapter.”24 Despite this broad conformity to the IRC, the Alaska Supreme Court held in Alaska Department of Revenue v. OSG Bulk Ships Inc.25 that Alaska had not conformed to section 883, which exempts certain international shipping income earned by non-U.S. corporations from taxation. The court found that section 883 was implicitly “excepted to or modified by” other provisions of Alaska’s corporate income tax, namely, those provisions dealing with allocation and apportionment of income. In substance, the court concluded that section 883 was more in the nature of a sourcing provision than a substantive exemption provision and that it was “inconsistent” with Alaska’s “comprehensive methodology for the allocation and apportionment” of income “to exempt an entire class of foreign-earned income” from the taxpayer’s apportionable tax base.26 The Alaska State Legislature effectively nullified that decision by amending the state’s income tax to provide that nothing in the statute, or in the Multistate Tax Compact, which Alaska had adopted, could be construed as an exception to section 883.27

B. Schlumberger

Notwithstanding the Legislature’s response to OSG Bulk Ships, which restored Alaska’s conformity to the federal income tax base for non-U.S. corporations, the Alaska Supreme Court later held that another aspect of Alaska’s conformity to the U.S. federal income tax base for non-U.S. corporations was “trumped” by the state’s income attribution provisions. In Schlumberger Technology Corp. and Subsidiaries v. Alaska Department of Revenue,28 Schlumberger Technology Corp. (Technology), a U.S. corporation doing business in Alaska, filed a “water’s-edge” combined tax return29 that included its parent, a non-U.S. corporation (Schlumberger Limited (Limited)), with which Technology was conducting a unitary business. Limited was essentially a holding

income as defined for federal income tax purposes in their “entire net income,” thus conforming New York’s approach to the approach taken by most other states. N.Y. Tax Law section 208.9(iv) (effective 2015).24

25961 P.2d 399 (Alaska 1998).26

Id. at 404.27

Alaska Stat. section 43.20.021(h).28

28331 P.3d 334 (Alaska 2014).29

See 1 Hellerstein, supra note 1, at para. 8.18, for a discussion of worldwide combined reporting and water’s-edge combined tax returns.

Footnote continued in next column.)

20See, e.g., Fla. Technical Assistance Advisement No. 84(C)-002, Aug. 29, 1984 (acknowledging that Florida will not impose its income tax on a foreign corporation determined to be tax exempt under applicable U.S. treaty); Mass. TIR No. 10-16, Apr. 4, 2011 (excluding from Massachusetts income tax computation the income of a foreign corporation not a member of a combined group exempt from federal tax under U.S. treaty); S.C. Code Ann. section 12-6-200 (excluding from South Carolina taxable income amounts excluded from federal taxable income via U.S. treaty); Va. Admin. Code section 10-120-100(B)(4) (stating that for “Virginia purpuses the federal taxable income of such foreign corporations is ... the taxable income under the terms of any applicable treaty”).


22Before 2015, New York’s corporate franchise tax, which is measured by “entire net income” rather than federal “taxable income,” required non-U.S. corporations to add back all income derived from sources within and without the United States that was not in their federal “taxable income.” N.Y. Tax Law section 208.9(c) (pre-2015 law); N.Y. Comp. Codes R. & Regs. tit. 20, section 3-2.3(a)(9). As a result, it was possible that a non-U.S. corporation deriving New York-source income that was not effectively connected with a U.S. trade or business under federal law would nevertheless have income that is taxable in New York, despite the fact that it has no federal “taxable income.” Cf. Reuters Ltd. v. Tax Appeals Tribunal, 623 N.E.2d 1145 (N.Y. 1993), cert. denied, 512 U.S. 1235 (1994) (taxpayer had taxable New York income even though it reported no U.S. “taxable income” because its New York branch incurred losses under federal sourcing rules), discussed in 1 Hellerstein, supra note 1, at para. 8.18[4], Accord Infosys Techs. Ltd., No. 820669, 2008 WL 557564 (N.Y. Tax App. Trib. 2008). Beginning in 2015, non-U.S. corporations will include only their U.S. effectively connected trade or business income as defined for federal income tax purposes in their “entire net income,” thus conforming New York’s approach to the approach taken by most other states. N.Y. Tax Law section 208.9(iv) (effective 2015).

23See 1 Hellerstein, supra note 1, at para. 7.05[1].

24Alaska Stat. section 43.20.021(a).
company that managed the Schlumberger group’s non-U.S. subsidiaries, and it received substantial dividends from those subsidiaries.

For federal corporate income tax purposes, Limited would be taxable on dividends received from non-U.S. subsidiaries only if those dividends were effectively connected with the conduct of a U.S. trade or business. Because Limited’s foreign dividends were not effectively connected with the conduct of a U.S. trade or business, they were in principle excludable from the Alaska tax base under Alaska’s conformity provisions, as the taxpayers argued. However, under Alaska’s water’s-edge combined reporting method, only 80 percent of dividends received by water’s-edge group members from non-U.S. corporations are excluded from the apportionable tax base, leaving 20 percent of those dividends as taxable income subject to apportionment. Moreover, under the water’s-edge combined reporting method, no distinction is drawn between U.S. and non-U.S. group members, so that 20 percent of the dividends that a non-U.S. group member receives from non-U.S. subsidiaries are included in the water’s-edge apportionable tax base. The conflict between the federal conformity provisions and Alaska’s water’s-edge apportionment method is therefore apparent.

In Schlumberger, the Alaska Supreme Court concluded that resolution of the conflict was controlled by its decision in OSG Bulk Ships:

In . . . OSG Bulk Ships, Inc., we considered a similar conflict — whether Internal Revenue Code section 883, the provision which excluded foreign shipping income from federal taxable income, had been “excepted to or modified by” other provisions of [the Alaska Net Income Tax Act]. We concluded that it would be inconsistent with the Multistate Tax Compact to exclude “an entire class of foreign-earned income.” This conclusion remains true despite the developments we describe below: the sourcing provisions of the Internal Revenue Code continue to be fundamentally inconsistent with the formula apportionment required by the Multistate Tax Compact.

In this case, the Internal Revenue Code sourcing provisions exclude most dividends related to foreign operations, and exclude all foreign dividends received by a foreign corporation. [The Alaska water’s-edge combined reporting provision] excludes 80 percent of foreign dividends, but makes no distinction for foreign dividends received by a foreign corporation. These two formulas are simply inconsistent. We thus conclude that the formula provided by [the Alaska’s water’s-edge combined reporting provision] is an exception to the Internal Revenue Code provisions that would otherwise be incorporated by reference.

The “developments” to which the court alluded were the adoption of Alaska’s water’s-edge regime and the legislative response to OSG Bulk Ships. The court rejected the taxpayers’ suggestion that adoption of the water’s-edge regime changed the type of income that should (or should not) be includable in the apportionable tax base, because it was directed only at the types of corporations that must be in the group. As for the legislative response to OSG Bulk Ships, the court dismissed it as a provision directed to “narrow categories of income derived from specific sources.” The court further opined that the legislative overruling of OSG Bulk Ships could not be read to override the court’s broad conclusion in the case, which the court reaffirmed in Schlumberger, namely, that “the federal sourcing rules are generally inconsistent with the apportionment formula required by the [Alaska Net Income Tax Act].”

As a theoretical matter, there is much to be said for the Alaska Supreme Court’s decisions in OSG Bulk Ships and Schlumberger. The provisions at issue in the cases — addressed to taxation of specified items of income earned by non-U.S. corporations — were at bottom “sourcing” provisions. That should hardly come as a surprise because subchapter N of the IRC, which contains the controlling provisions addressed to federal income taxation of non-U.S. corporations, is entitled “Tax Based on Income From Sources Within or Without the United States.” Further, the sourcing principles in the IRC are plainly different from (or, if you will, inconsistent with) the method used by the states for determining the source of corporate income. It therefore makes sense, as a matter of principle, for Alaska to apply its sourcing rules (namely, apportionment and allocation of the tax base) rather than the federal sourcing rules for determining the income of non-U.S. corporations attributable to Alaska.

The problem with that interpretation of the Alaska tax regime is that it is flatly inconsistent with the Alaska statute, which provides that “Sections 26 U.S.C. 1-1399 . . . are adopted by reference as part of this chapter . . . unless excepted to or modified by other provisions of this chapter.” Sections 1-1399 include precisely the federal sourcing provisions at issue in both cases, and it is indisputable that these provisions

IRC section 882. There could be no issue regarding FDAP income, see IRC section 881; see also Section II.A supra, because the United States taxes FDAP income only when it is from U.S. sources, and dividends received from non-U.S. corporations are foreign-source income for federal income tax purposes. See IRC sections 861(a)(2), 862(a)(2).

Alaska Stat. section 43.20.145(b)(1).

Schlumberger, 331 P.3d at 339.

Id. at 340.

Id. at 341.

IRC subchapter N (emphasis supplied).

Alaska Stat. section 43.20.021(a).
were not “excepted by other provisions of this chapter.” Only by ignoring the plain language of its own statutes could the Alaska Supreme Court reach its conclusion. Moreover, the court’s suggestion that the legislative reversal of its decision in OSG Bulk Ships should be “confined to its facts” and not viewed as repudiation of the court’s bald attempt to rewrite the statutory rules on conformity insofar as they bear on sourcing provisions is nothing short of judicial chutzpah. The court should have viewed the legislative response for what it was, namely, an explicit declaration that the Legislature meant what it said when it conformed to the IRC, and nothing in the statute, or in the Multistate Tax Compact, could be construed as an exception to the federal sourcing rule that the court had attempted to read out of the conformity statute. After reading the court’s opinion in Schlumberger, one could be forgiven for wondering whether Sarah Palin was the only one looking at Russia from Alaska.

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37 Alaska Stat. section 43.20.021(h).