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A Federal Treaty and Approximately $2.00 Will Get You A Ride on the New York Subway…

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Tax directors of corporations that are formed outside the U.S. and have no permanent establishment in the U.S. are often surprised to learn that international tax treaties do not protect such corporations from state and local taxes. While federal treaties may exempt foreign corporations from federal U.S. tax altogether, or the federal income tax statues may permit separate accounting for the U.S. activities of non-U.S. corporations, state taxation frequently does not follow these rules. Sending employees or representatives into the U.S. may, as a result, have the unwelcome effect of subjecting a foreign corporation's worldwide income to state or local tax, on an apportioned basis. A recent New York State Tax Appeals Tribunal ("Tribunal") decision, *Matter of Infosys Technologies Limited*,[1] highlights some common concerns of multinational businesses relating to the state taxation of services.

Background

Infosys Technologies Limited ("Infosys") was incorporated and headquartered in Bangalore, India. It develops software and provides consulting services. During the years at issue, approximately 71% of Infosys' total revenue was attributable to clients in the U.S. Infosys did not maintain an office in New York, but the presence of its employees gave New York jurisdiction for tax purposes.

When engaged by a client, Infosys would send a team of "in-country" engineers to perform fact-finding to determine the client's needs. Then the information obtained would be sent to an off-shore development center. The in-country engineers coordinated and communicated with the client during the development phase. Infosys would add additional in-country engineers to assist with the installation and implementation of the software. Due to large differences in the cost of living in the U.S. as compared to India, the in-country team's wages were approximately ten times the wages of engineers in India working on the same client project.

[1] *Matter of Infosys Technologies Limited*, DTA No. 820669, N.Y. Div. of Tax App. (Feb. 21, 2008), aff'g DTA No. 820669, N.Y. Div. of Tax App, ALJ Unit (Feb. 15, 2007).

In determining its New York tax liability, Infosys calculated taxable income using separate accounting, rather than worldwide income as required under New York law. On audit, the New York State Department of Taxation and Finance ("Department") rejected this position. The Department also made adjustments to the payroll and receipts factors of the taxpayer's business allocation percentage.

Infosys, in a statement attached to its return, cited the Commissioner's discretionary adjustment authority and a New York State Court of Appeals decision that permitted separate accounting as support for its position.[2] Under New York law, taxpayers must take into account income from all sources, "which shall be presumably the same as the entire taxable income . . . which the taxpayer is required to report to the United States treasury department…"[3]. The statute goes on to provide, however, that "[e]ntire net income shall include income within and without the United states …."[4] The applicable regulation states that "in the case of a taxpayer organized outside the United States, all income from sources within and without the United States less all allowable deductions attributable thereto, which were not taken into account in computing Federal taxable income" must be added back to federal taxable income.[5]

At the hearing before the State Administrative Law Judge, Infosys introduced a report prepared by a Big Four accounting firm intended to demonstrate the appropriateness of the company's method of allocating income to its U.S. branch. The report advised Infosys to report its federal taxable income for the U.S. branch based on the U.S.-India income tax treaty, and applying Code § 482 transfer pricing standards. Under the accounting firm's interpretation of the treaty, the income of a U.S. permanent establishment ("PE") should be determined as if the PE were a separate entity transacting business at arm's-length terms with its foreign base of operations (*i.e.*, Bangalore, India). The report thus concluded that allocating the branch's income on an arm's-length, cost plus basis, pursuant to the regulations under I.R.C. § 482, was a sound method, and Infosys filed its federal return on that basis.

For New York purposes, however, and based upon the advice of a different accounting firm, Infosys filed using a separate accounting methodology. In applying this methodology, Infosys took into account only its U.S.-source income. It also made certain modifications to the statutory payroll and receipts factors. The Department, by contrast, asserted that Infosys' New York income should instead be determined by applying "the normal statutory formula to petitioner's worldwide income."

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[2] *See* N.Y.C.R.R., Tit. 20, § 4-6.1(c); *In the Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal of the State of New York, et al.*, New York Court of Appeals, 623 N.Y.S.2d 772, 647 N.E.2d 1280, 85 N.Y.2d 139 (Feb. 16, 1995).

[3] N.Y. Tax Law § 208.9.

[4] N.Y. Tax Law § 208.9(c).

[5] N.Y.C.R.R., Tit. 20, § 3-2.3(a)(9).

The Tribunal rejected Infosys' arguments in support of separate accounting based on the language in the U.S.-India tax treaty and an accompanying Treasury Department Technical Explanation. The U.S.-India tax treaty applies to "Federal income taxes imposed by the Internal Revenue Code . . . and excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations." The accompanying Treasury Department Technical Explanation states that "[s]tate and local taxes in the United States are not covered by the Convention." The Tribunal found the treaty to be irrelevant, and looked instead to the applicable New York State law and regulations to determine New York taxable income prior to apportionment.

Infosys' departure from the statutory payroll factor was approved by the Administrative Law Judge ("ALJ") below, and since the Department did not take exception to that conclusion, Infosys won that point. Specifically, Infosys successfully argued that the payroll factor should be adjusted downward because: (1) a large disparity in wages exists between employees in New York as compared to employees in India; (2) more India-based employees worked on its New York clients than employees performing services in New York; and (3) the offshore employees accounted for a larger number of man-hours performed for New York clients. The ALJ found these arguments persuasive and adjusted the payroll factor to reflect these facts.

As for the receipts factor, Infosys argued that the receipts factor should be based on a head-count ratio or a ratio of New York work days to total work days. This argument was inconsistent with the method utilized by Infosys on its return as filed. On its originally filed return, Infosys based its New York receipts on the amounts billed to clients for work performed in New York, a methodology the Department did not dispute. The ALJ did not permit the departure from the statutory formula Infosys argued for with respect to receipts. The Tribunal upheld the ALJ's decision regarding the receipts factor.

Finally, Infosys argued that New York's inclusion of worldwide income placed an unconstitutional burden on foreign commerce. According to the Tribunal, this argument rested on the "questionable premise" that New York's statute swept in only net income and not net losses. Based on the regulations, however, as well as the Department's assertion that losses are to be taken into account as well, the Tribunal rejected Infosys' constitutional challenge.

Points of Interest

Aliens Beware!

As more non-U.S. or "alien" corporations expand their business operations into the U.S. and New York, their tax directors may be surprised to discover that the state's taxing authority is not limited by federal principles or U.S. tax treaties. *Infosys* reiterates the previous ruling in *Reuters Limited*[6] and clarifies that a non-U.S. corporation must include its worldwide income in the New York taxable base, even if the income is not

[6] *Matter of Reuters Limited*, 603 N.Y.S.2d 795, 623 N.E.2d 1145, 82 N.Y.2d 112 (Oct. 12, 1993).

included in the alien corporation's federal taxable income. While corporations might challenge this rule under constitutional principles (*i.e.*, the Foreign Commerce Clause) or case law,[7] this result also can be avoided by separately incorporating the entity's New York or U.S. activities. Where New York activities are properly insulated from activities overseas, New York would not have a basis for reaching the alien entity's worldwide income.

In this regard, it is also worth noting that New York's combined reporting regime prohibits the combination of alien corporations.[8] Thus, by placing the U.S. activities in a separate corporation, the worldwide, non-U.S., income of any affiliated alien corporation becomes unreachable by New York. (Of course there can be circumstances in which the overseas activities could serve to reduce New York tax, and any planning should take that into consideration.)

Varying from the Statutory Formula

Contrary to the procedural rules in New York's statutes and regulations, Infosys deviated from New York's statutory allocation formula and calculated and paid tax based on an alternative formula, without receiving the prior consent of the Commissioner. The applicable regulation states, however:

> [a] taxpayer may not vary the statutory business allocation percentage or alternative business allocation percentage formulas . . . without the prior consent of the Commissioner. A taxpayer making a request for an adjustment of its business allocation percentage or alternative business allocation percentage must file its report and compute its tax in accordance with the statutory formulas. A request to vary the statutory formula must be attached to the report setting forth full information on which the request is based, together with a computation of the amount of tax which would be due under the proposed method.[9]

While both the ALJ and Tribunal decisions in *Infosys* refer to this rule, the ALJ permitted a departure from the statutory payroll formula even though the taxpayer did not follow the prescribed procedures; and the Department did not appeal that point. In the author's experience, taxpayers regularly deviate from the statutory formula without prior consent of the Commissioner and without paying tax as calculated under the statutory formula with the return as required. Query whether taxpayers adhering to the procedural requirements may be in a position of disadvantage, while others play the audit lottery, and occasionally win even that.

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[7] *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

[8] *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

[9] N.Y.C.R.R., TIT. 20, § 4-6.1(c).

Payroll Factor – Did the Taxpayer Win The Issue?

The Tribunal's decision notes that the ALJ reduced Infosys' payroll factor. As noted, neither the taxpayer nor the Department took exception to this issue on appeal. The ALJ, referencing one of Infosys' arguments in support of separate accounting (*i.e.*, that there was a significant disparity in wages between New York and India), found that an adjustment under the Commissioner's discretionary authority was warranted.

Instead of using wages to determine the payroll factor, the ALJ determined a revised payroll percentage based upon the number of days Infosys' employees worked for clients, referred to as "billable person days." The ALJ based the percentage on the ratio of billable person days in New York to total billable person days, reducing the payroll factor of the business allocation percentage from the originally filed return.[10] The ALJ reduced the payroll factor from 2.3365% in 2000 and 3.1418% in 2001, to 1.45% for both years.

New York State Regulation Section 4-5.1(d) states that for purposes of the payroll factor, "[e]mployees within New York State include all employees regularly connected with or working out of an office or place of business of the taxpayer within New York State, irrespective of where the services of such employees were performed." In other words, the wages of employees based in New York are sourced to New York; but wages of employees based outside New York (*e.g.*, Bangalore, India) are sourced outside of New York.

Infosys did not have an office in New York. During the audit period, its employees worked on at least 15 projects in New York, but in each case their New York work was actually done at the client's location, with the expectation that the employees would revert to their usual places of employment when their mission was accomplished. Thus, it is unclear why *any* wages were sourced to New York. The *Infosys* decision does not indicate whether Infosys argued that no wages should be considered New York wages. Perhaps the taxpayer's argument for tweaks to the formula was, therefore, simply too favorable for the Department to contest on appeal.■

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[10] The ALJ decision does not provide details regarding the methodology utilized by Infosys to calculate the payroll factor for the years under audit.