United States tax treaties may not provide protection from US state taxes

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A recent California appellate decision serves as a reminder that United States tax treaties do not necessarily protect foreign taxpayers from state and local taxation. In *Air China Limited v San Mateo County*, 93 Cal. Rptr. 3d 893 (Cal. Ct. App. 2009), an international airline discovered to its dismay that the transportation agreement between the People's Republic of China and the United States did not prevent San Mateo County, California, from imposing property taxes on its landing rights and leasehold improvements at San Francisco International Airport. Foreign persons conducting business activity within the United States and who rely upon the privileges and protections afforded by a US tax treaty are well advised to consider carefully the lessons of this case.

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To help observers fully appreciate these lessons, this article will first describe the US federal system of government and explain the role of the states within the overall US tax system. It will then make a few comments about the interaction between US tax treaties and state taxation, and then describe how states deal with these agreements. With this background in mind, the article will then analyse the *Air China* case and conclude by making several observations.

I. Primer on the US federal tax system

The United States has a federal system of government in which legislative power is shared among federal (i.e. national) and state (i.e. provincial) governments. In such a system, each state within the United States (and, with respect to certain taxes, each county or municipality within each state) enjoys its own tax regime. A state's taxing power is not unlimited, as the US Constitution restricts the ability of a state to tax out-of-

state persons. Under constitutional principles, there must be some minimum connection between a state and the person, property or transaction it seeks to tax, and state actions that unduly burden or otherwise inhibit interstate or foreign commerce are prohibited. The US Supreme Court has interpreted these requirements as prohibiting a state from taxing an out-of-state person unless that person has a "substantial nexus" with the forum state.

Unfortunately, "substantial nexus" does not require a US "permanent establishment," the touchstone for US income taxation for companies that are resident in a country with which the US has an income tax treaty. The exact requirements for establishing substantial nexus are somewhat unclear, but are generally viewed to be less demanding than the federal standard for taxation. For instance, several US states assert tax jurisdiction based on a volume of sales into the state, in some cases as low as $10,000 of sales per year.

II. Tax treaties and the states

Treaties are the supreme law in the land, second only to the US Constitution in legal significance. They are on equal footing with federal legislation, and will trump conflicting state and local law.

Tax treaties are treaties that address tax matters. They may be agreements concerned principally with matters of taxation, or they may be agreements that touch upon taxation as part of a broader set of issues.

Three points are worth noting when considering the interaction of US tax treaties and the states. First, treaties are within the exclusive province of the federal government. Although states are themselves sovereigns, they are constitutionally prohibited from concluding treaties. Thus, the individual states are not parties to US tax treaties.

Second, tax treaties are limited in scope. As contracts between nations, tax treaties cover only the matters addressed therein. United States income tax treaties, for instance, typically provide that the only US taxes that they address are the federal income taxes imposed by the US Internal Revenue Code and federal excise taxes imposed on certain tax-exempt organisations.

Third, US tax treaties seldom address state or local matters. Where a tax treaty takes the unusual step of addressing a state or local issue, the treaty usually will not claim to bind the states. While many constitutional scholars are of the view that US federalism imposes no subject matter limitations on the US treaty power, and that a treaty could bind a state even in those areas solely within a state's legislative authority, in practice the federal government treads very carefully where the issue of state rights is implicated by a treaty.

III. State approaches to tax treaties

The United States Supreme Court has stated that "the tax treaties into which the United States has entered do not generally cover the taxing activities of subnational governmental units such as the States. . . ." *Container Corp. v Franchise Tax Board*, 463 US 159, 196 (1983). With tax treaties usually restricted to federal tax matters, states are free to choose to follow or deviate from federal practice. Some states voluntarily forego their ability to tax foreign taxpayers by adopting the federal rules as the starting point for state income taxation. Others do not. And even among those that do, there are typically a host of state and local taxes not addressed in any treaty, including sales and use taxes, local property taxes, business license taxes, fuel taxes and so on.

In *Appeal of M.T. de Mey van Streefkerk*, 85-SBE-135 (Nov. 6, 1985), the California State Board of Equalization ruled that US tax treaties which expressly limit their application to federal income taxes do not prevent California from taxing persons otherwise covered by such agreements. As the State of California follows very few tax treaties, any inquiry into the US tax position of a foreign taxpayer conducting business activity within California must also consider state and local taxation. For example, a foreign taxpayer whose activities in California may not rise to the level of a permanent establishment under an applicable income treaty may nonetheless be deemed to have sufficient nexus with the state to warrant local income taxation. For many taxpayers not versed in the intricacies of US federalism, or who mistakenly believe a tax treaty covers all taxes, this can come as quite a surprise.

IV. Air China case

The recent *Air China* case provides a good opportunity to see these principles in practice. Air China Limited, a corporation organised under the laws of the People's Republic of China, operated aircraft out of, and leased space at, San Francisco International Airport for its air transportation operations. The airport is located in San Mateo County, and the county imposed property taxes (including possessory interest taxes) on Air China's landing rights at the airport and leasehold improvements to a leased facility. Possessory interest taxes are a type of property tax imposed on the possession of, claim to, or right to the possession of land or improvements.

Air China disputed the imposition of property taxes, arguing in part that the tax was precluded by the Agreement between the Government of the United States of America and the People's Republic of China with Respect to Mutual Exemptions from Taxation of Transportation Income of Shipping and Air Transport Enterprises (the "Treaty"). Air China paid the taxes under protest, and after pursuing administrative remedies filed suit for refund. The trial court granted the county's motion for summary judgment, and Air China appealed.

In affirming the trial court's judgment, the Court of Appeals concluded that nothing in the text of the Treaty or its legislative history reflected an intent to prevent imposition of local property taxes. To the contrary, all of the evidence indicated that the Treaty was intended solely as an agreement to exempt *income* taxes. Thus, Article I of the Treaty provided that, "[i]ncome and profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that Contracting State." The Senate Committee on Foreign Relations report on the Treaty also confirmed the narrow focus of the agreement in contemplating the possibility that state and local governments may

impose their own income taxes as well. Neither Article I nor the Senate report mentioned any other taxes.

Although the Treaty's scope seemed clearly limited, Air China pointed to a California Supreme Court decision to support a more expansive reading. *Scandinavian Airline Systems, Inc. v County of Los Angeles*, 56 Cal. 2d 11 (1961), addressed the issue of whether a county could impose property taxes on foreign owned airplanes flying exclusively in foreign commerce and using the Los Angeles airport infrequently as its sole United States terminal. The court held that the 1939 income tax treaty between the United States and Sweden (which has since been replaced) specifically prohibited income and property taxes on aircraft not registered in the taxing nation. The court's conclusion was based on its interpretation of a treaty article providing that "taxes on property . . . may be levied only in that contracting State which is entitled under the preceding Articles to tax the income from such property." The court read this provision in isolation, outside the guiding context of Article I (which identified only the federal income tax and federal capital stock tax as covered taxes) and despite the Senate Committee on Foreign Relations's statement during ratification hearings that "the United States makes no agreement respecting any of our State or local taxes." The court supported its conclusion by looking to the applicable Air Transportation Agreement. Although that agreement did not mention taxation at all, the court inferred that foreign negotiators perhaps unfamiliar with our federal-state system would have felt it unnecessary to address taxation if they had assumed the income tax treaty had sufficiently addressed matters of taxation.

The *Air China* court distinguished the *Scandinavian Airline* decision in two ways. First, without commenting on *Scandinavian Airline's* arguably unorthodox interpretation of the underlying income tax treaty, the *Air China* court ruled that the Treaty clearly did not encompass property taxes. Guided by the plain meaning of the Treaty, the court added that "had the parties wished to create an exemption from any and all types of taxation, they could have done so." Second, it held that the tax in *Air China* was not on aircraft, as it was in *Scandinavian Airline*, but rather on Air China's possessory interests. The court also chose not to follow a 2002 administrative ruling issued by the California State Board of Equalization which Air China argued supported its interpretation because the precise scope of the ruling was unclear, the decision was not entitled to judicial deference and, even if it were, would not be followed by the court because its conclusion was unsupported by either the Treaty or the cited case law.

V. Takeaways

While the outcome of the *Air China* case is perhaps unremarkable given the clear scope of the Treaty, the decision does serve the useful purpose of reminding foreign taxpayers of a few things.

First, anyone doing business in or investing in the United States should bear in mind that our federal system of government means that there can be multiple levels of taxation. Any tax planning or analysis of potential tax exposure should take into account national (i.e. federal), provincial (i.e. state) and local (i.e. county and municipal) taxation.

Second, the triggers for federal and state income taxation differ. At the federal level, in the absence of a treaty, taxation turns on whether a foreign person is engaged in a US trade or business and has income effectively connected with that business. Where an income tax treaty applies, taxation turns on whether the foreign enterprise has a permanent establishment in the US. At the state level, taxation turns on whether the foreign enterprise has sufficient contacts, or "nexus," with the forum state to warrant state taxation. In general, and in the absence of state legislation conforming to federal standards, the threshold for state taxation is lower than that for federal taxation as states have historically asserted that virtually any type of in-state business activity creates nexus for an out-of-state taxpayers.

Third, US income tax treaties may not encompass state income taxes. Unless states adopt federal standards for taxation, or use a foreign taxpayer's liability for federal income taxes as a starting point for its own computations, a foreign person may very well be protected (in whole or in part) from federal taxation but remain subject to state taxation. By the same token, as the *Scandinavian Airline* case shows, loose or ambiguous treaty language may provide taxpayers with opportunities to dispute state or local assessments.

Fourth, there are a multitude of treaties – including but not limited to income tax treaties, transportation agreements, diplomatic or consular agreements and treaties of friendship, commerce and navigation – addressing many kinds of taxes. Foreign persons should consider carefully whether the treaty upon which they are relying addresses the tax in question, and if so whether a state or local government follows the federal practice in the case of state and local taxes.

Fifth, foreign persons who are nationals or companies of a country with which the US has a treaty of friendship, commerce and navigation should explore whether the state and local tax which they seek to avoid is possibly addressed (whether in general or specific terms) in another country's treaty with the United States. If it is, the foreign person may be able to demand similarly favourable treatment under the "most favoured nation" provisions of the applicable treaty of friendship, commerce and navigation. In general terms, such provisions entitle a treaty partner's nationals and companies to rights and privileges no less favourable than those extended to nationals and companies of any third country operating within the territories of the United States.

Sixth and finally, even treaties that may offer protection against certain state and local taxes may not apply for the simple reason that the requirements for eligibility are not met. A recent New York district court decision, *City of New York v Permanent Mission of India to the United Nations et al.*, 533 F. Supp. 2d 457 (2008), illustrates this point. In that case, several foreign governments used their United Nations mission and consulate properties in ways seemingly not contemplated by various diplomatic and consular treaties exempting them from "regional or municipal dues and taxes" – as residences for non-qualifying personnel, a restaurant, a bank and an airline office. In holding the countries liable for most of the New York

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state property tax assessments, the court's conclusion was straightforward: although the foreign governments may have been exempt from New York state property tax under the treaties had they used their properties for eligible mission or consulate purposes, the use of their premises in a manner not contemplated by the agreements meant they were not entitled to treaty protection with respect to the non-qualifying portions.

In short, foreign taxpayers should be aware of the various subnational taxes that may apply when conducting business in the US, and not assume that tax treaties offer meaningful protection from all taxes. Working with tax counsel fluent in matters of state and local taxation should be an important part of any foreign business's US tax strategy.

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The views set forth in this article are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.