Multistate Taxation of Passthrough Entities: Planning to Avoid Pitfalls

A CCH Seminar

Presented by

Kathleen K. Wright, CPA, J.D., LL.M. (Taxation), M.B.A. (Taxation)
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ABOUT THE SPEAKER

Kathleen K. Wright, J.D., CPA, LL.M., MBA

Kathleen Wright is a visiting professor at Golden Gate University School of Taxation (San Francisco). She has a BS (Accounting) from Florida State University, a JD from Fordham Law School (New York City), a MBA (Taxation) from New York University and a LLM (Taxation) from Golden Gate University School of Law in San Francisco. She is also a CPA licensed in California and New York and admitted to practice law in New York. She has a private tax practice focusing on personal and small business tax planning and consulting. She is a co-author of the State Taxation and Other Business Taxes (CCH Expert Treaties Series, 2014) and California’s Response to the Economic Recession, also published by Wolters Kluwer, CCH. She writes a column for State Tax Notes published by Tax Analysts (Washington DC) where she serves as the California correspondent. She publishes frequently on state and local issues with articles appearing in The Tax Adviser, The Tax Lawyer, The Journal of State Taxation and The Journal of Legal Tax Research. She has been elected to the Board of Trustees for the California CPA Education Foundation and the Executive Advisory Board for the Franchise Tax Board. She has also been appointed to the Technical Resource Panel for State and Local tax issues of the American Institute for Certified Public Accountants.

She speaks frequently on multistate topics and continues to present seminars for the California CPA Education Foundation on a wide variety of topics.
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PRESENTATION
Multistate Taxation of Passthrough Entities

Planning to Avoid Pitfalls

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Introduction

Doing Business
State taxation of the entity and other filing requirements.

Unitary (as applied to flow-through entities and their owners)

Collection
- Withholding
- Composite Returns
Doing Business

Flow-Through Entities

- Partnership (general or limited) or LLC taxed as partnership
  - States take position that based on aggregate theory of partnerships, ownership of a partnership interest is enough to create connection with the state so that state can require out of state entity to pay tax on income from the partnership
    - Which is doing business in the state
    - *CRIV Investments Inc. v. Dept. of Revenue* (4046 Ore. TC (1997))
  - Issue is whether ownership of the flow-through entity interest is enough to be deemed to be “doing business”

Doing Business

Illinois

- General Information Letter No. IT 12-0028
  - Nonresident individual receives guaranteed payments from a partnership doing business in Illinois
    - Argues that he never set foot in Illinois so cannot tax payment
  - Illinois responds that a guaranteed payment is the partner’s distributive share of the ordinary income of the partnership — and therefore must be sourced at the partnership level
### Out of state general partners will be deemed to be doing business in the state in all states except New Hampshire

- **New Hampshire**
  - Taxes the entity under their Business Profits Tax and Business Enterprise Tax
  - If income is taxed at the entity level (like a corporation) it is not taxed again at the partner level

### Nexus

#### General Partnership Interest

**Massachusetts**

- *Sahi USA Inc. v. Comm. Of Revenue* (2006) held that distributive share of capital gain and ordinary income realized by a Delaware corporate general partner was taxable by Massachusetts
  - Tiered structure
  - Lowest lever partnership owned and operated a hotel in Massachusetts
  - This partnership was owned by a mid tiered NY partnership which was owned by Sahi USA Inc. who had no other investment in Massachusetts
  - Partner is engaged in business of partnership
Doing Business

California


- Nonresident limited partners of a LP that was headquartered in California and engaged in the acquisition, holding, monitoring, and disposition of substantial blocks of stock and other securities were not subject to California income tax on their distributive shares of the income
- A nonresident’s income from intangible personal property generally is not California-source income, and is not subject to California income tax unless the intangible property has acquired a business situs in California
- Case was codified and now investment partnership exempted by statute

Doing Business

Ownership of a Limited Partnership Interest

California

- Could be doing business in state if meet statutory threshold
- Include TP pro rata share of income from CA entity to determine if doing business in state
  - Rev and TC 23101(d)
- Result is that out of state corporate limited partner could be doing business in state
  - If they had CA sourced income in excess of $500,000 from their investment in the partnership
Polling Question #1

- Corporation E is a limited partner in a CA partnership
- His share of the partnership CA sales is $70,000
- Corporation E has no property or payroll in CA, but does have sales of $450,000 sourced to CA
- Is Corporation E doing business in CA?
  - Yes, because it has total sales (including its share of flow through sales from the partnership) in excess of $500,000.
  - No, because it does not have sales in excess of $500,000. As a limited partner, does not have to count income from LP.

Nexus

California: Limited Partners

- Position of FTB seems to conflict with (or overrule) prior case (Appeal of Anman & Schmid Finanz AG (96-SBE-008)) which held that limited partner interest does not create nexus for out of state limited partner
Nexus
Flow-Through Entities

New Jersey

- In *BIS LP Inc. v. Director Division of Tax* 25 N.J. Tax 88 (2009) N.J. Tax Court holds that a limited partner was not subject to the corporate tax as it had no employees or agents in the state
  - Further, nexus was not created through a passive investment
- N.J.A.C. 18:7-1.9 states that foreign corporate limited partner is doing business if
  - Also a general partner
  - Takes control of partnership
  - Meets requirements for “doing business” in NJ
  - Business of partnership and limited partner are “integrally related”
  - TP did not meet this test
- Also see *Village Super Market of PA, Inc. v. Director*, Division of Tax
  - No. 021-002-2010 (2013)

Michigan

- MCL 206.623(1)
  - Corporation is doing business in the state if they have an ownership interest in an entity that is doing business in the state
    - RAB 2014-5 states that there is no minimum level of ownership
    - RAB 2014-5 also states that LP or LLC member does have nexus even if the activities of the partnership (or LLC) are protected by P.L. 86-272
**Nexus**

**Flow-Through Entities**

- **New York**
  - Tax Appeals Tribunal held that LLC members were taxable on the income of the LLC (partnership) that was doing business in NY
    - They looked at the service that the partnership was providing in NY
      - Rather than the contact with the state by the owners
    - *Shell Gas Gathering and Shell Gas Pipeline*, DTA Nos. 821569 and 821570, NYS Div of Tax Appeals (2010)
      - 20 N.Y.C.RR. 1-3.2(a)(6)(i) states that foreign corporation employs capital in the state if it owns a LP interest of 1% or more and the basis is more than $1,000,000

- **Pennsylvania**
    - Taxpayer owned a limited partnership interest in a Conn. based partnership
      - LP had nexus with Pennsylvania. In 2009, LP recognized COD income from foreclosure
    - PA successfully argues that taxpayer is doing business in Pennsylvania, because taxpayer specifically wanted an ownership interest in certain assets owned by the partnership (namely a large building located in Pittsburg)
      - He wanted to be a part of the investment opportunity offered by this LP and that was enough to create nexus with Pennsylvania
Nexus

Some states simply define nexus as ownership of an interest as a partner in a partnership that is doing business in the state.

Partial list of these states:
- Idaho
- Georgia
- Michigan

Flow-Through Entities

California

- LLCs
  - FTB aggressively pursues out of state LLCs and out of state members
    - R&TC 19135 extends the $2,000 penalty assessed against corporations doing business in the state that are suspended to both foreign and domestic LLCs
    - Liability for this penalty can accrue in different scenarios
      - Managing member of LLC lives in CA
      - Out of state LLC (or corporation) owns an interest in an LLC doing business in California
Nexus
Flow-Through Entities

- Legal Ruling 2014-01
  - “Doing business” if actively engaging in activity in the state for profit (Rev & TC 23101)
  - If an LLC “doing business” in the state, then so are members
  - Members have the right to manage the LLC
    - Doing business whether they actually are or not.
    - Can be non-member managed and still would qualify as doing business
    - But see next slide ...

Doing Business
Limited Liability Companies

California
- Swart Enterprises v. FTB (filed in Fresno Superior Court)
  - Doing business in Iowa
  - Has $50,000 investment in an LLC that is organized in CA to acquire, lease and dispose of capital equipment
  - Swart is a passive investor with a .02% interest
  - FTB claims that Swart is doing business in CA
    - Prior case (Appeal of Anman & Schmid Finanz AG (96-SBE-008) holds that limited partner interest does not create nexus for out of state limited partner
    - FTB maintains that LLC statute gives all members the right to manage LLC whether they do so or not
    - Ignores the fact that LLC statute also allows the members to be manager managed — not member managed
Swart Enterprises v. FTB (Nov. 20, 2014, No. 13CECG02171)

- Superior Court finds in favor of taxpayer
  - LLC interest was an investment
  - Swart had no ability to manage the affairs of LLC
  - Ownership interest was not comparable to that of a general partnership
    - Court found that Appeal of Anman & Schmid Finanz AG (96-SBE-008) applied
      - The involvement of Swart was much more similar to that of a limited partner
      - No statutory authority to view Swart as a general partner
  - FTB will probably appeal
    - But if not could limit application of case to investment in a fund

Nexus

Flow-Through Entities

California

- Legal Ruling 2014-01
  - LLC only registered to do Business in CA
    - LLC must file and pay at a minimum $800
    - Nonresident corporate members do not have to file. LLC not engaged in transactions for profit
  - LLC only organized in CA
    - LLC must file and pay at a minimum $800
    - Nonresident corporate members do not have to file
      - LLC not engaged in transactions for profit
**Nexus**

*Flow-Through Entities*

- **Member doing business in CA**
  - Sammy is the only member of a SMLLC that owns an apartment building in Montana
  - Sammy hires a manager in Montana but the operating agreement does state that Sammy is responsible for managing the LLC and the LLC used a CA address, had a CA CPA and a CA bank account used for most bill payment
  - Out of state LLC doing business and owes $800
    - *Appeal of Mockingbird Partners* (SBE, May 17, 2006)
  - Might also owe penalty

- **LLC “doing business” in CA**
  - Legends LLC organized and doing business in CA, owns a hotel in the state
  - The LLC is owned by ABC Corporation
    - Organized and doing business in Texas
  - ABC has never filed and paid tax in CA as Legends has always operated at a loss
    - And ABC thought that there was nothing to report
  - If ABC is a managing member of the LLC, then FTB will argue that ABC is doing business in the state and must file and pay the minimum tax of $800
Nexus

Example

California

- Individual (CA resident) owns a SMLLC (organized outside the state) which owns a tenant in common (TIC) interest in property located outside the state
- Is SMLLC doing business in CA?
  - Yes, because the TIC interest gives the owner the right to make a number of decisions regarding the property in CA
    - That is enough to create nexus with the state and the SMLLC must report and pay the $800 franchise tax and the LLC fee based on gross receipts

Polling Question #2

- An Illinois LLC (Number 1) owns an interest in a CA rental property
- One of the members of LLC #1 is LLC #2 (SMLLC) which is owned by a resident of Illinois
- Is the resident of Illinois doing business in CA?
  - Yes, LLC#2 is doing business in CA as the general partner of LLC#1. This means that owner of LLC#2 is doing business in CA as they are making decisions regarding the management of the CA property.
  - No, because they have no taxable presence in CA.
### Nexus Example

- LLC #1 holds a limited partnership interest in a limited partnership which owns property in CA
- Is LLC#1 (which has nothing else in the state and does not file in the state) have a filing requirement in CA?
  - No, as long as LLC #1’s distributive share of the income from CA does not exceed the statutory threshold of $500,000 of gross receipts sourced to the state

### Nexus

#### Penalties for Failure to File (for LLCs and Corporations)
- 5% per month up to 25% of amount due for failure to file
  - If amount due is $800 then penalty is $200 (R&TC 19131)
- $2,000 penalty for doing business in the state without filing and registering as doing business in the state
  - Penalty is per taxable year and can be assessed within 60 days after notice and demand to taxpayer (R&TC 19135)
- Interest
- $18 per member penalty for failing to file Schedule K-1
- Penalty assessed monthly up to a maximum of 12 months (Rev and TC 19172)
Nexus Taxpayer Options

When faced with assessment on LLC

- File the LLC tax returns for delinquent years, pay the tax ($800), fee on gross receipts if applicable and penalty assessed as $18 per member
  - If file and pay, then $2,000 penalty is not assessed if pay within 60 days
- File and pay (as above) and then file a refund claim and challenge the “doing business” determination
- Don’t pay and protest the assessment

Nexus California Legal Ruling 2011-01 (1/11/2011)

- Disregarded entity will be deemed to be activity of owners
  - Y owns B which is doing business in CA
    - Y is an out of state company that does not do business in CA — but owns B as a SMLLC
    - Y is deemed to be doing business in CA through activities of B which are part of Y (treated like a division)
- All assets, liabilities, income, deduction, and credits of a QSSS are treated as activities of the S Corporation (Rev and TC 23800.5)
  - Example
    - Out of state S Corporation owns a qualified subchapter S subsidiary doing business in CA
    - Even if they are not unitary, out of state S Corporation now deemed to be doing business in CA
Nexus

Out of state LLC member doing business in the state because of activities of in state entity.

- **Alabama**
  - Requires in state entity to file a composite return on behalf of out of state members
  - In *Tsitalia LLC v. Ala. Dept. of Rev* (2013) administrative law division held irrelevant that out of state member might not be “doing business” in the state

Out of state LLC member doing business in the state because of activities of in state member

- **California**
  - Any activity in the state by LLC members can create nexus for the entity in the state
  - Example is *Appeal of Mockingbird Partners* (SBE, May 17, 2006)
  - In state member responsible for financial administration including
    - Bill payment
    - Bookkeeping
    - Financial statement preparation, and
    - Tax returns
    - Had bank account in the state and wrote checks for operating expenses on account
    - Creates nexus for entity regardless of statutory standard
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Recognition of Entity

- Recognition of S Corp. status
  - These states tax the S Corporation the same as a C Corporation
    - New Hampshire
    - Louisiana
    - Tennessee
Recognition of Entity

These states require filing of a separate state election

- If no election filed, then taxed as a C Corporation for state purposes
  - Arkansas
  - New Jersey
  - New York
  - Pennsylvania
    - Only requires separate election if S Corp wants to be a PA C Corporation

Taxation of the Entity

Varies Dramatically by State

Alabama

- S Corps, LLCs, LLPs, and partnerships are subject to business privilege tax
  - Imposed on Alabama net worth (taken from balance sheet) and multiplied by AL Apportionment factor
  - Progressive rate structure, but maximum rate is $1.75 per $1,000 of Alabama net worth if taxable income is at least $2.5 million
Taxation of the Entity

Arkansas

- S Corporations and Partnerships are not subject to an entity-level tax
  - LLCs must pay the minimum franchise tax which is 0.3% of outstanding capital stock apportioned to Arkansas
    - Using property factor

Taxation of the Entity

California

- Limited Partnerships
  - Pays the $800 minimum franchise tax
- General Partnerships
  - Do not pay anything
- LLCs
  - Pay a fee based on gross receipts sourced to CA
- S Corporations
  - Pays the franchise tax on net income taxable in CA
    - Rate is greater of 1.5% or $800
**Flow-Through Entities**

*California*

**LLC Fee**

- Fee is now set by statute and (if changed) has to be changed by statute (Rev and TC 17943)
- Fee assessed on gross receipts sourced to CA
  - $250,000 - $500,000  $900
  - $500,000 - $1,000,000  $2,500
  - $1,000,000 - $5,000,000  $6,000
  - $5,000,000 or more  $11,790

**Rev and TC 17942**

- Amended to provide that fee is based only on receipts sourced to CA
  - New law effective 1/01/2007
- Sourcing Rules Reg 17942
  - Gross receipts is gross income plus cost of goods sold
  - Gross receipts does not include receipts that are subject to the fee assessed under Rev and TC 17942 (See example)
  - Gross receipts does include receipts from a partnership (not organized as an LLC) that are sourced to CA
  - Assign receipts using the same method as used to assign sales for apportionment purposes
    - Note that the LLC apportions its net income for purposes of the K-1s it gives to nonresidents
Flow-Through Entities

**California**

- Income from the passive holding of intangible personal property is assigned to the location from which the intangible property is managed by the LLC.
- Income is sourced based on apportionment methodology which the LLC elects for 2011 and 2012 (single sales or three-factor formula)
  - SSF for 2013
- If LLC receives income from a partnership, then LLC will source income using the sourcing rules applied by the partnership.

**Flow-Through Entities**

**California: Example**

Assume A, a limited liability company organized in California that is taxed as a partnership, has total income attributable to this state in the amount of $400,000.

A also owns an interest in B, a limited liability company organized in Ohio that is also taxed as a partnership.

- B has total income from all sources attributable to California in the amount of $200,000
- A’s distributive share of B’s total income attributable to California is $150,000
- How much will A report as gross receipts subject to the fee?
Flow-Through Entities
California: Answer

- In calculating its total income attributable to California, A will not include its $150,000 distributive share of income from B, even though B did not actually pay any limited liability company fee itself (B’s total income is below the $250,000 minimum threshold for the imposition of the fee), because the $200,000 earned by B was “subject to” the fee.

- As a result, A will pay a fee based on its total income from all sources derived from or attributable to this state of $400,000.

Flow-Through Entities

- Is the LLC fee deductible on the state return?
  - Appears so based on recent article in Tax News
  - Initially characterized as a fee and therefore deductible on the state return
    - Note that Rev and TC 17220 denies a deduction of all federal and state and local taxes on the California return
  - Even though characterized as a “tax” under Northwest, no deductions are allowed, and therefore not characterized as a tax for other purposes.
Flow-Through Entities

**Connecticut**
- Business entity tax of $250 assessed on S Corporations, LLCs, SMLLCs, LLPs and LPs
  - But not on General Partnerships

**Delaware**
- Franchise tax computed based on shares outstanding assessed on S Corporation
- Annual tax of $300 imposed on partnerships and LLCs
  - DE Code Ann. tit. 6, sec. 15-1208(a)

**Georgia**
- S Corporations subject to a net worth tax starting at $10 up to a maximum of $5,000
- Partnerships and LLCs do not pay an income tax or the net worth tax

**Idaho**
- Assesses a $20 minimum tax plus $10 on S Corporations if all of the income is not distributed
  - Amount is $10 for partnerships, LLPs and LLCs unless entity distributes income
  - If have undistributed income, then pays tax at rate of 7.6% (corporate rate)
    - Idaho Code 63-3006B
Flow-Through Entities

Idaho
- Idaho limits to $250,000 amount of guaranteed payments paid by partnership doing business in Idaho that may be attributed to state where partner performed services
- Amount paid in excess of $250,000 is apportioned using entity apportionment percentage

Illinois
- S Corps, partnerships and LLCs all pay the personal property replacement income tax

Kansas
- S Corporations and LLCs are subject to the Kansas Franchise Tax
  - $2 for each $1000 of shareholders equity attributable to Kansas with a maximum of $5,000

Kentucky
- No tax on general partnerships
- Limited partnerships, S corps and LLCs pay greater of limited liability entity tax or $175 for every entity with over $3 million in gross receipts or gross profits (Ky. Rev. Stat. Ann. 141.010(24)(b))

Louisiana
- Does not recognize S Corporation status. So pay tax like corporations
  - Can deduct “S Corp exclusion” which is a percentage of income distributed to shareholders
  - S Corp must also pay the annual franchise tax
Flow-Through Entities

Massachusetts
- S Corporations pay the greater of $2.60 per $1,000 on taxable tangible property or net worth, plus 1.97% on gross receipts of $6 million or more, or 2.95% on gross receipts of $9 million or more, or a fixed dollar minimum tax of $456.
- Partnerships and LLCs do not pay an entity-level tax.

Minnesota
- Graduated minimum fee imposed on $930,000 or more of in-state property, payroll and sales or receipts (Minn. Stat. 290.31(1)).
- Maximum fee is $9,500.

Mississippi
- Imposes the franchise tax on S Corporations — but not on partnerships and LLCs.
- Rate is $2.50 for every $1,000 of net worth in the state.
Flow-Through Entities

**Missouri**
- No entity-level tax on partnerships or LLCs
- S Corps pay the franchise tax
  - Franchise tax phases out by 2016
  - In 2015 is 1/150 of 1%

**Nebraska**
- No entity-level tax on partnerships or LLCs
- S Corps pay the franchise tax
  - Assessed every other year (in even years) and is measured by “property and credits” in the state

**New Hampshire**
- Business profits tax based on gross income

**New Jersey**
- No entity-level tax on partnerships or LLCs
- S Corp pays a fixed dollar minimum tax based on NJ receipts
New Mexico

- No entity-level tax on partnerships or LLCs
- S Corporations pay the franchise tax which is $50 per year

New York

- S Corp and LLCs pay fixed dollar minimum tax based on NY gross receipts
  - $100,000 or less: $25
  - $100,001 - $250,000: $50
  - $250,001 - $500,000: $175
  - $500,001 - $1,000,000: $300
  - $1,000,001 - $5,000,000: $1,000
  - $5,000,001 - $25,000,000: $3,000
  - Over $25,000,000: $4,500

- Partnerships pay graduated fee based on gross receipts
  - $1,000,000 or over: $500
  - $1,000,001 to $5,000,000: $1,500
  - $5,000,001 to $25,000,000: $3,000
  - $25,000,001 or more: $4,500
Flow-Through Entities

North Carolina

- No entity tax on partnerships or LLCs
- S Corporation pay the franchise tax
  - Tax is based on the higher of capital stock and surplus, 55% of appraised value of tangible property in NC; or actual investment in tangible property in the state

Ohio

- Subject to the commercial activity tax on gross receipts (Ohio Rev Code Ann. 5733.04(O))
- S Corps are also subject to the Ohio franchise tax

Oklahoma

- No entity tax on partnerships or LLCs
- S Corps pay the franchise tax computed on capital stock invested in the state
Flow-Through Entities

Oregon
- No entity tax on partnerships or LLCs
- S Corps pay the $150 minimum

Pennsylvania
- No entity tax on partnerships or LLCs
- S Corps are subject to the franchise tax

Rhode Island
- LLCs and LPs pay $500 minimum tax
  - S Corps pay the greater of the franchise tax of $2.50 per $10,000 of capital or the $500 minimum tax

South Carolina
- No entity tax on partnerships or LLCs
- S Corps are subject to the franchise tax

Tennessee
- S Corporations and LLCs pay the 6.5% excise tax
- All entities pay the “Hall income tax” on interest and dividend income that exceeds $1,250 (Tenn. Code Ann. 67-2-102)

Texas
- Margin tax imposed if total revenues exceed $1,080,000 for 2014 and 2015 (Tex. Tax Code Ann. 171.001(a))

West Virginia
- Business franchise tax imposed on value of apportioned and adjusted capital for all flow-through entities (W. Va. Code 11-23-3(b))
Flow-Through Entities

Wisconsin

- S Corporation pay the franchise tax and the “economic development surcharge”

States which do not tax flow-through entities


Flow-Through Entities

Unitary Method and Corporate Partners

Three different approaches used by states

- Corporate partner includes share of apportioned income/loss from entity (using pass-through entity apportionment) with its own post apportionment income/loss to the state
  - Arkansas and Louisiana
Flow-Through Entities
Unitary Method and Corporate Partners

- Corporate partner includes only its share of the income/loss of passthrough entity as apportioned by the entity, but does not include its share of property, payroll and sales
  - *Homart Development Co. v. Norbert* (1987) Delaware corporation with significant partnership income (all sourced to other states)
    - Taxpayer owned shopping mall in RI, which was only RI activity
    - Including partnership income (but not apportionment factors) put all of the partnership income in RI
    - Methodology struck down by Court as inequitable (and unconstitutional)

Flow-Through Entities
Unitary Method and Corporate Partners

- Corporate partner combines its share of income/loss and apportionment factors if corporation and corporate partner are unitary
  - California and Illinois
  - New York required combination even in not unitary
    - Struck down as unconstitutional in *In Movie Service Functions, Inc.* (1988)
    - Illinois corporation held a 90% interest in NY metal trading business, but got most of its income from making movies outside NY
      - Movie production and metal trading were not unitary and combination of apportionment factors was distortive
Flow-Through Entities

Corporate Partner

Classifying Pass Through Receipts

- Does characterization of receipts of the partnership flow through to the partners?
  - Michigan
    - RAB 2015-5 states that receipts that flow through from the partnership that are not “taxed” at the entity level (because they are protected by P. L. 86-272) are not protected at the corporate partner level
    - Flow through receipts are from an investment, and not from the sale of tangible property

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Flow-Through Entities

Corporate Partner

- Does characterization of receipts of the partnership flow through to the partners?
  - New York
    - TSB-A-13(11)C(2013) held that the owner of a partnership that owned SMLLCs could use the special sourcing rules applied to registered securities or commodities brokers
    - TP was not a registered broker, but the SMLLCs did qualify

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Flow-Through Entities

Apportionment

California

- Pass thru entities must apportion using single sales factor and market based sourcing (for service income and income from intangibles) in 2013 and thereafter
- Generally the entity will compute the apportionment factor and pass through the percentage to partners, members and shareholders
  - Nonresident partners, members and shareholders will apportion flow through income to CA using that percentage
  - Resident partners, members and shareholders will report 100% of their share of the flow through income to CA
    - They may get a credit for tax paid to other states, if they have to file and pay elsewhere
**Flow-Through Entities**

**California**

- **Corporate Partner**
  - Deemed to be doing business in state and unitary with partnership if general partner
    - Owes $800 at a minimum if partnership loses money
    - No consideration given to ownership in partnership with respect to unitary determination
    - Unitary status unlikely if corporation is a limited partner
    - % of apportionment factors will flow through and be combined with factors of corporation

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**Flow-Through Entities**

**California: Example**

- X Corp owns 10% of the stock of A Corp
  - X Corp is the 30% general partner of P partnership which owns 60% of A Corp
  - X Corp has the power to vote all of the stock of A Corp owned by Partnership
  - Therefore, X Corp will be deemed to own the 60% owned by Partnership and the 10% owned directly

- If X and A are in the same business they could be unitary as the more than 50% ownership test is met
Flow-Through Entities

**California: Unitary Concept**

- No longer just a big corporate concept
- Applies at individual and corporate level. Reg. 17951-4
- Owners of single members LLCs of a corporation and QSSS (subsidiary of an S Corp) are probably unitary (because they fold into parent) (Legal Ruling 2011-01)
- Result – Return filing requirement on parent because unitary with single member LLC in California

Flow-Through Entities

**California**

- Individual partners and members
  - If unitary will combine flow through income/loss at individual level
  - Can apply if own more than 20% of flow-through entity and otherwise unitary
  - Combine Schedule K income/loss of all entities
  - Flow through and combine percentage share of property, payroll and sales of the entity
  - Compute apportionment factor and multiply times business income
Nonunitary income from a partnership

- If corporation receives income from a partnership that is not unitary, then separately apportion (as a separate trade or business) using apportionment factors of the partnership.

**Flow-Through Entities**  
*California*

- **Malpass v. Dept. of Treasury** (2013)
  - Multistate business income may be reported by individuals through either the unitary or separate-entity method.
  - Prior case law had held that sole shareholder of S Corp could not combine apportionment factors of unitary S corporations.
Flow-Through Entities

New York

New law effective Jan. 1, 2015

- Corporate partners required to use aggregate method (combine partnership activity) unless another method allowed in regs.
  - Prior law did allow corporate partner to elect to file combined or separate return
    - Appears that choice is still available
  - However, now NY requires a combined report (not the case under prior law)
- Corporate partner must combine NY receipts from partnership with their own NY receipts to determine if meet $1 million gross receipts nexus threshold

Flow-Through Entities

Composite Returns

Owners of large multistate flow-through entities may be subject to filing requirements in several states

- Answer may be the composite return

Composite return filed by entity on behalf of all of the nonresident owners
Flow-Through Entities

**Composite Returns**

- California (Rev and TC 18535)
  - Partnership/S Corp/LLC can undertake to file nonresident return for all nonresident partners
  - To qualify to file in a nonresident return the partners must meet the following requirements
    - Income from partnership is only CA income
    - Partnership must agree to pay deficiencies
    - Taxes are paid at the highest CA marginal rate (now 12.3%)
      - TP subject to increased rate on millionaires must pay tax at the higher rate
    - Partnership must ensure that estimated tax payments are made by partners
    - Partnership liable to pay any deficiencies if partners do not pay
    - Can now make election for just a single partner

Flow-Through Entities

- States which require a composite return

- States which do not authorize filing a composite return
  - Alaska, Illinois (effective 2014), Nebraska, New Hampshire (taxed like C Corporations); New Mexico; Utah.

- States which do not have an individual income tax
  - District of Columbia (nonresidents not subject to income tax); Florida; Nevada; South Dakota; Tennessee; Washington; Wyoming (does not tax passthrough income)
**Flow-Through Entities**

**Developments**

- **Illinois**
  - Eliminated composite income tax returns and replacement tax returns for shareholders of passthrough entities
  - Enacted in 2013

- **Oklahoma**
  - Now allows nonresident partners that are C Corporations, S Corporations or partnerships to be included in a composite return
  - Trend is towards loosening requirements on the filing of a composite return — facilitates collection

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**Withholding**

**Flow-Through Entities**

- Traditional method of collection of state tax from nonresident partners, members and shareholders is through withholding by entity level income tax withholding

- Easier to collect from the in-state entity
  - Rather than the out of state owner
Penalties and Interest

- *United Wisconsin Grain Producers LLC v. Wis. Dept of Revenue* (2011) held that the Department could assess interest on the LLC for failure to withhold, even though the member had ultimately filed and paid the tax.

What is withholding?

- Prepayment of state income or franchise tax (similar to wage withholding)
- The withholding agent is the person making payment
  - The payee is the person or entity that receives payment
- Withholding is required in CA on payments/distributions of CA source income made to a nonresident, unless there is a waiver
  - Withholding begins when the payments exceed $1,500
### Withholding

#### California

- Rate is 7% on distributions of CA source income to domestic nonresident S Corp. shareholders and partners.

- Rate is 12.3% on distributions to foreign (non-U.S.) non-corporate partners
  - Foreign corporate partners — 8.84%

### Withholding

#### California: Exceptions to Withholding

- California residents and corporations with a permanent place of business in CA
- Total payments less than $1,500
  - Once go over $1,500 then start to withhold
- Payment is for goods
- Payment is for services which were not performed in CA
- Payments are for interest and dividends
  - Unless property has acquired a business situs in the state
- Payments are to nonresident corporate director
- Distribution is of exempt income
- Partners certifies that income was previously reported on partner’s CA tax return
Withholding Exception

Distributions from Investment Partnerships

- States which source income from investment partnerships to state of residence include
  - Alabama, Arkansas, California, Georgia, Idaho, Illinois, Kentucky, Maryland, New Jersey, New York, North Carolina, Ohio and Texas.
  - Connecticut, Minnesota and New Mexico do not exempt nonresident partners, but do have rules that allocate income to state of domicile of nonresident partner.
  - Virginia states that if investment partnership has no property or payroll in state, then not doing business in state and no VA source income.

Withholding Waivers

Reduced Withholding

- Waiver can be obtained if 7% rate results in significant over-withholding.
  - FTB Form 589 Nonresident Reduced Withholding Request

Can waive withholding if payee has tax returns on file for the most recent two years, and is current on tax obligations.

- Waiver is for one year and only available for domestic nonresident partners.
Flow-Through Entities
Withholding

California

- LLCs
  - LLC required to withhold on distributions to nonresident domestic members if the income paid to the nonresident exceeds $1,500 during the year (Rev & TC 18662)
  - If LLC fails to file a nonresident member agreement to file a CA return, the LLC must pay an amount equal to the highest marginal tax rate (12.3%) times the member’s distributive share of the LLC income and reduced by any withholding previously paid

Withholding
California: Example

A nonresident domestic member had a $1,000 distributive share of income allocable to CA, and only $900 was actually distributed

The non-consenting non-resident withholding applies to distributions which do not exceed $1,500

Therefore, if the LLC does not get the nonresident agreement, then the LLC will be required to pay $1,000 x 12.3% or $123 minus whatever they may have withheld on the $900 distributed
Flow-Through Entities

**Withholding**

**California**

- **Partnerships**
  - (FTB Pub 1017)
  - CA withholds on distributions to nonresident partners at rate of 7%
  - Only withhold if income of partnership has not been previously reported
  - Only withhold on distributions of $1,500 or more
  - If partner does not owe any CA tax, then can request a waiver

- **S Corporation**
  - Required to withhold on distributions of current or prior year income to nonresident shareholders (Rev and TC 18662)
  - Withholding rate is 7%
    - Can request a waiver for S Corporation shareholder if consistently files returns and makes timely estimated payments
  - S corporation can file a composite return on behalf of nonresident members
### Flow-Through Entities

#### New Jersey

- Imposes withholding at rate of 6.37% on nonresident, non-corporate partners allocable share of entire net income (not distribution)
- Imposes rate of 9% on nonresident corporate partners

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### Georgia (GA Code Ann. 48-7-129)

- For 2012 and later, Georgia requires withholding at the rate of 4% on net income sourced to GA
  - Not on distributions — note difference with CA
- No withholding required if GA source income less than $1,000

- Idaho (ID Code 63-3022L(4))
  - If entity fails to comply with withholding requirements and fails to file a composite return for nonresident taxpayer, then tax will be assessed against entity doing business in the state at the corporate rate
Flow-Through Entities

Withholding

New York

- No withholding but can require entity (Corporation, S Corporation, LLC, or partnership) to pay the tax on behalf of the nonresident
- The estimated tax is based on the NY sourced distributive share (defined as pro rata share) of the income times the highest tax rate

Flow-Through Entities

Withholding

Indiana

- Requires withholding on distributive shares of income paid to nonresident partners, shareholders
- Statute amended (Indiana Code Sec. 6-3-2-2) to clarify that income earned by the entity doing business in Indiana is sourced to Indiana even if it flows through to another passthrough entity (not doing business in Indiana) to a partner, shareholder who is a nonresident
Flow-Through Entities
Withholding

New Mexico

- Pass through entities are now required to make quarterly withholding tax payments on net income distributed to nonresident owners
  - Rate is at highest personal income tax rate or 4.9%
    - Effective 2011
  - Prior law had required passsthrough entity to make the payment if nonresident owner had not filed a consent

Flow-Through Entities
Summary of Withholding

Require withholding if nonresident consents not filed
- Arkansas, Colorado, Kansas, Louisiana, Nebraska, North Carolina, Oklahoma, and West Virginia

Require withholding unless a composite return is filed
- Georgia, Idaho, Illinois, Maine, Minnesota, North Dakota, Oregon, and Rhode Island

Require withholding unless a composite return is filed or nonresident consents
- Massachusetts, Missouri, Montana, Ohio, and South Carolina
Flow-Through Entities

Withholding

Opt-out of withholding

- North Carolina
  - Opt out provisions do not apply to individuals
- New Jersey and New York
  - Require that the affidavit that the nonresident must file (agreeing to withholding) must be filed with the passthrough entity
- North Carolina, Wisconsin
  - Require that passthrough entity file the affidavit with the state

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CONCLUSION
Thank you for attending today’s program
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II. “Doing Business” in the State.

In many, but not all, states, corporations that have an interest in a pass-through entity must aggregate its apportionment factors with its distributive share of the pass-through entity's factors. This is not, however, a hard-and-fast rule. Some states require apportionment at the entity level. In other states the taxpayer may aggregate the apportionment factors, only for a pass-through entity with which a taxpayer has a unitary relationship.

States generally take the position that an ownership interest in a partnership, or limited liability company (LLC) classified as a partnership, doing business in the state is sufficient to create constitutional nexus for a nondomiciliary corporation. In asserting nexus, the states rely primarily on the aggregate theory of partnership, which holds that a partnership is the aggregation of its owners rather than an entity that is separate from its owners. Under this theory, the partners are viewed as direct owners of the partnership’s assets. Based on the aggregate theory, most states take the position that the mere ownership of a partnership interest is sufficient to create constitutional nexus for a nondomiciliary corporation, regardless of whether the corporation is a general or limited partner.

Extending jurisdiction to collect the income tax to a nonresident who owns an interest in a pass-through entity is an issue that has been discussed by the Courts and in the literature for many years. It is fairly well settled that in most states that a corporate partner in a partnership doing business in the State is subject to the State’s corporate income or franchise tax on its distributive share of the partnership income, even if the corporate partner is only a limited partner and has no other ties to the state. The activities of a limited partner may not rise to the level of “doing business” in the state, however its investment in a partnership doing business (and earning income in the state) is sufficient to create a connection to assess the tax through no more than a passive investment. (see CRIV Investments Inc. v. Department of Revenue (4046 Ore. TC (1997)) Now the states are going well beyond this result and asserting that the out of state corporate limited partner itself, is in fact “doing business” in the state.

A. General Partnership Interest.

The only state where a general partner interest or an LLC interest does not create nexus is New Hampshire.

1. New Hampshire.

New Hampshire imposes a business profits tax and a business enterprise tax. The business profits tax is imposed on any enterprise, whether corporation, partnership, limited liability company, proprietorship, association, business trust, real estate trust, or other form of organization organized for gain or profit and carrying on any business in New Hampshire. Businesses with gross receipts under a certain amount are not required to file a business profits tax return. The business enterprise tax is imposed on the compensation, interest, and dividends paid by taxpayers engaged in business activities in New Hampshire. Enterprises with gross
receipts from all their activities over a certain amount, or an enterprise value tax base more than a certain amount are required to file a business enterprise tax return.

Any business organization whose income or expenses are reportable by the underlying owners for federal income tax purposes (that is, a pass-through entity) must include all of its items of income and expense in its BPT return rather than passing through those items for reflection on the return of the underlying shareholder, partner, member, or other owner. Any element of income or expense that must be reported at the entity level for BPT purposes, rather than by the underlying owner, must be removed from the owner’s BPT return. In short, no pass-through of income items is permitted for state tax purposes, contrary to what is permitted for federal income tax purposes. (N.H. Code Admin R. Ann. 304.01).

2. Alabama

In *Department of Revenue v. Seneca GP, Inc* (Administrative Law Division, Docket Nos. 94-285 94-286 94-28, June 20, 1995) the taxpayer, a foreign corporation, was not liable for any Alabama corporate income tax, despite the fact that it was “doing business” in Alabama, because the income in question constituted “business income” and the taxpayer had a zero apportionment factor in Alabama. The taxpayer was incorporated for the sole purpose of serving as a general partner in two Delaware limited partnerships and maintaining a sufficient equity to satisfy the net worth requirements imposed by the Internal Revenue Code. The basis for the income tax assessment was interest income earned by the taxpayer on a promissory note contributed by the taxpayer's sole shareholder. The taxpayer did not employ any employees, own any real property, or have any gross sales in Alabama during the years in issue and, therefore, had a zero apportionment factor in Alabama. In order for a taxpayer to be considered as “doing business” within Alabama, the taxpayer must be “engaged in the transaction of business, or any part of the business, for which it was organized or created.” In this case, the taxpayer was engaging in activities that furthered its corporate purpose and, therefore, was subject to Alabama corporate income tax. However, because the interest income derived from the note constituted “business income” and the taxpayer had a zero apportionment factor in Alabama, the taxpayer was not liable for any Alabama corporate income tax for the years in question.

3. Massachusetts

In *Sahi USA Inc. v. Commissioner of Revenue* (Appellate Tax Board (Massachusetts), No. C262668, October 27, 2006) the distributive share of the capital gain and ordinary income realized by a Delaware corporate general and limited partner (“the taxpayer”) from the sale of a lower-tiered New York partnership’s interest in the lowest-tiered Massachusetts-based partnership, which owned and operated a Boston hotel, was taxable by Massachusetts, for state corporation excise tax purposes. Because both the mid-tiered partnership and the lowest-tiered partnership were doing business in Massachusetts, their income-producing activities were proportionately imputed and attributable to the taxpayer through the tiered-partnership arrangement. Furthermore, the taxpayer, through the tiered-partnership arrangement, had sufficient nexus with Massachusetts for purposes of imposing the state’s corporation excise tax. The taxpayer had argued that it had no nexus with Massachusetts insofar as the sale of the hotel...
was concerned and owed, at most, the minimum corporation excise tax applicable to an out-of-state corporation.

For purposes of the Massachusetts personal income tax, a nonresident individual partner is taxable under G.L. c. 62, §§17 and 5A on his distributive share of income from any partnership that is either engaged in Massachusetts business or owns or leases real property in Massachusetts. Several Board decisions have applied the aggregate theory in ruling that individual partners, whether general or limited, were subject to Massachusetts’s income taxation because the activities of the partnership were imputed to its partners. See, e.g., Neese v. Commissioner of Revenue, ATB Findings of Fact and Reports 1987-477, 488 (finding that a limited partner was engaged in the business of the partnership and, therefore, entitled to claim his distributive share of partnership losses as a deduction on his nonresident income tax return); Katz v. Commissioner of Revenue, ATB Findings of Fact and Reports 1998-537, 542-43, aff’d, 48 Mass. App. Ct. 1117 (2000) (finding a nonresident limited partner taxable on his distributive share of partnership income earned from the partnership’s sale of real estate located in the commonwealth “to the same extent as if the gain were received directly by the Appellant and his wife”).

More recently, the Board applied the principle that a partner is engaged in the business of the partnership and ruled that an out-of-state corporate partner had nexus with Massachusetts. Utelcom, Inc. v. Commissioner of Revenue, ATB Findings of Fact and Reports 2005-09. The Board in Utelcom ruled that in G.L. c. 63, §39, the statute addressing the commonwealth’s power to assess a tax on a corporation, the definition of “doing business” is “broad enough to include earning income from a limited partnership interest” when those earnings are derived from the entity’s activities within the state. Id. at 17 (citing International Harvester v. Wisconsin Dept of Tax’n, 322 U.S. 435, 441-42 (1944) and Borden Chemicals and Plastics and L.P. v. Zehnder, 726 N.E.2d 73, 79 (Ill. App. Ct. 2000)).

In addition, the Commissioner has promulgated a regulation at 830 CMR 63.39.1(8)(a), which provides that a foreign corporation which is a general or limited partner in a partnership “does business in Massachusetts” if the partnership’s activities, “if conducted directly by a foreign corporation, would subject that corporation to the corporate excise under the provisions of M.G.L. c. 63, §39.” Accordingly, a partnership’s activities are imputed to the corporate partner to determine whether the necessary nexus exists to subject the corporate partner to the Massachusetts corporate excise.

The regulation further provides that “[i]n the case of a tiered partnership, as defined in 830 CMR 63.39.1(8)(b)(3), the activities of the partnership(s) occupying the lower tier(s) of a tiered partnership arrangement are imputed, proportionally, to all partners holding interests in partnership(s) occupying higher tier(s).” A “tiered partnership arrangement” is defined as “one in which some or all of the interests in one partnership (lower tier partnership) are held by a second partnership (upper tier partnership). A tiered partnership arrangement may have two or more tiers.” 830 CMR 63.39.1(8)(b)3.

The partnership arrangement under which SAHI owned a general and limited partnership interest in MBG, which in turn owned a partnership interest in OSA, is a “tiered partnership
arrangement” as defined by 830 CMR 63.39.1(8)(b)(3). Pursuant to that regulation, OSA's activities of operating the Meridien Hotel in Boston, which undeniably qualified as “doing business” in the commonwealth, were imputed to SAHI by virtue of SAHI's interests in MBG, thereby providing nexus to the commonwealth for taxation of SAHI's distributive share of income from MBG.

B. Limited Partnership interest and Members in LLCs.

Some states provide different nexus standards for corporate limited partners, reflecting the view that a limited partnership interest is a passive investment. Other states provide special exemptions for corporate partners of investment partnerships and/or partnerships engaged in trading activities.

1. California.

Cal Rev and Tax Code 23101(d) (which defines the factor presence nexus standard) provides that sales, property and payroll include the taxpayer’s pro rata share of pass through entities. This is true regardless of whether the partner is unitary with the partnership. FTB Guidelines analyze this provision by looking at a number of different relationships that could create nexus with the state.

An out of state partner or member of an LLC (taxed as a partnership) will be deemed to be doing business in the state if they own an interest in a flow through entity that is doing business in the state and their share of the activity exceeds the factor presence thresholds.

Example:

Corporation E, an out-of-state corporation, has no property or payroll but has $450,000 of sales to customers located in California. Corporation E also has a 30 percent limited partnership interest in Limited Partnership X that is doing business in California. For tax year 2011, Partnership X has $30,000, $50,000 and $250,000 in property, payroll and sales in California, respectively. Corporation E is considered to have the following distributive shares of property, payroll and sales from Partnership X:

Flow - through Partnership Property = $9,000 ($30,000 x 30%)
Flow - through Partnership Payroll = $15,000 ($50,000 x 30%)
Flow - through Partnership Sales = $75,000 ($250,000 x 30%)

Corporation E is doing business in California because it has a total of $525,000 sales in the state ($450,000 of its own sales + $75,000 of Partnership X’s sales.)

Corporation E would be deemed to be doing business in California even if the $525,000 of California sales flowed through entirely from the limited partnership interest. Prior to the enactment of the factor presence nexus standard, an out of state corporate limited partner was not doing business in the state solely through ownership of a limited partnership interest in a partnership that was doing business in the state. In Appeal of Amman & Schmid Finanz AG, the
SBE held that foreign corporations are not subject to the corporate franchise tax because they are limited partners in one or more limited partnerships doing business in California. (Appeal of Amman & Schmid Finanz AG, et al., SBE, April 11, 1996). In that case, the taxpayers did not meet the active participation requirement for “doing business” in the state. Under the bright line nexus standard, the active participation standard no longer applies.

a) Investment Partnerships.

California (along with several other states) does recognize an exception for investment partnerships. Partners in a qualified investment partnership may exclude their distributive share of income from qualified investment securities regardless of the partnership’s presence in California. Investment of partners’ capital for long-term appreciation, as opposed to buying and selling securities to profit from short-term price changes is not the conduct of a business in California and does not produce California-source income, even if the partnership has offices and employees in California to facilitate those investments.

Cal. Rev and TC sec. 17955 provides that a nonresident will not be taxed on dividends, interest, or gains and losses from qualifying investment securities if their only contact with the state is through a broker, dealer or investment advisers located in the state. This same exemption is applied to a partner in an investment partnership, a beneficiary in a qualifying estate or trust, and a unit holder in a regulated investment company.

In order to qualify, the qualifying partnership or estate or trust must have no less than 90% of its total assets in qualifying investment securities, deposits at banks and office space and equipment necessary to carry out its activities. In addition no less than 90% of its gross income must consist of interest, dividends and gains from the sale or exchange of qualifying investment securities.

b) LLCs: Out of state Corporate Members.

In the January 2014 edition of Tax News (the monthly newsletter of the FTB) the FTB Chief Counsel discusses return filing requirements for members of LLCs with multiple members. The article states that if the LLC is treated as a partnership and its members are treated as partners, then the term “partnership” refers to a traditional partnership known as a “general partnership.” In a general partnership, all of the partners are “general partners”, who have the right to manage and conduct partnership business”. The Chief Counsel concludes that the “doing business” analysis flows from this form of entity decision, meaning that if the members have the right to manage the business, then they are characterized as “general partners” whether they exercise that right or not. This is the basis for the FTB assertion that out of state passive corporate members in an LLC are doing business in the state.

The Chief Counsel goes on to recognize that in the Appeal of Anman & Schmid Finanz AG, et al. (1996)(96-SBE-008) the Board of Equalization (SBE) held that a limited partner in a
limited partnership was not “doing business” in California even though the limited partnership was doing business in the state. The SBE drew this distinction based on the conclusion that the general partner of a limited partnership has the rights, powers and restrictions of a partner in a general partnership, which include the right to manage and conduct partnership business, but limited partners do not have these rights. Acts of the general partner bind the partnership, but a limited partner is not bound by the obligations of the partnership unless that partner is also named as a general partner or has participated in the control of the limited partnership’s business. This analysis looks to management ability and control of the decision making process of the entity, not the question of limited liability of the member as the deciding factor.

The FTB therefore, concludes that since members of an LLC have statutory rights to participate in the affairs of the LLC that they cannot be viewed as limited partners and therefore, like general partners are deemed to be doing business in the state.

This view ignores the Appeal of Anman & Schmid Finanz AG, et al. wherein the SBE commented that in the record of the appeal only one of the limited partnership agreements of the limited partnership that was doing business in California was presented for review. This agreement did not conflict with the general provisions of the California limited partnership law. Therefore, the SBE states that they assumed that the limited partners’ rights and liabilities as generally recognized by California partnership law and “not as those rights and liabilities might be permissibly altered by partnership agreements” would be deemed to apply. However, if the SBE had been able to review the partnership agreements that had been permissibly modified by state law, then it is implied that the SBE would have considered that modification in its analysis.

California’s LLC statute has always provided the LLC with the option of determining how it will be managed. Effective January 1, 2014 SB 323 (Ch. 12-419) replaced the existing LLC statute (the “Old Act”) with the Revised Uniform Limited Liability Company Act (RULLCA). RULLCA continues to allow the LLC to determine if it wants to be manager-managed or member-managed, although RULLCA does modify the procedure to implement the distinction. The new law requires a written statement designating the LLC a manager-managed LLC in the LLC’s articles of organization and written operating agreement (which now must be in writing). This modification changes the relationship of the parties.

Under the RULLCA if the LLC is to be managed by one or more managers, then the members lose their right to approve business decisions or to bind the LLC vis-à-vis third parties. (Cal. Corp. Code sec.17703.01(b)(1)). Further, only managers may bind the LLC as to matters in the ordinary course of business and a document executed by two managers (or a single manager if called for in the Manager Statement) on behalf of the LLC with a third party is conclusively binding upon the LLC. (Cal. Corp. Code §17703.01(d)). If the test in California for “doing business” is based on who has control of the decision making process as evidenced by the LLC’s written operating agreement (now required) then arguably limited partnership status can be achieved by the LLC through inclusion in the operating agreement of provisions that delegate management authority to Managers. If possible, every LLC operating in the state with nonresident non-managing members should insure that they have revised their operating agreement to reflect manager-managed status. Stretching the concept of nexus to include passive corporate non-managing members means an annual tax return filing requirement plus payment at
a minimum of $800 (the statutory minimum tax under Cal Rev & TC §23153).

The FTB has also issued Legal Ruling 2014-01 that addresses when a business entity with a membership interest in a multiple-member limited liability company (hereafter "LLC") that is classified as a partnership for tax purposes, required to file a California return and pay any applicable taxes and fees. The results of the ruling and related examples are summarized here.

If an LLC is treated as a partnership for tax purposes, both the LLC and its members, are subject to the same legal principles applicable to any partnership. Thus, if an LLC classified as a partnership for tax purposes is "doing business" in California under Section 23101, the members of the LLC are themselves "doing business" in California. This is true even in the case of "manager-managed" LLCs. Members of LLCs generally have the right to participate in the management of the business. Part of that power necessarily includes the right to delegate the power to manage the business in favor of a manager, and the power to revoke that delegation at any time. This analysis is not affected by whether or not members participate in the management of an LLC or appoint a manager to do so because the members' rights to participate in the management of the business arise out of the statutory relationship between an LLC and its members. Partners are considered co-owners of the partnership enterprise and the partnership acts as a conduit through which the enterprise is operated. "The courts have recognized that the execution of an agreement relinquishing control is itself an exercise of the requisite right of control over the conduct of the partnership business." Thus, the distinction between "manager-managed" LLCs and "member-managed" LLCs is not relevant for purposes of determining whether a member of an LLC, which is "doing business" in California and is classified as a partnership for tax purposes, is "doing business" here within the meaning of Section 23101.

It is well established that partners of a partnership are "doing business" in California if the partnership is "doing business" in California. In a narrow exception, in the Appeals of Amman & Schmid Finanz AG, et al., 96-SBE-008, April 11, 1996 (hereafter "Amman & Schmid"), the State Board of Equalization (hereafter "the Board") held that out-of-state corporations whose only California contacts were as limited partners in limited partnerships were not "doing business" in California even if the limited partnerships were "doing business" in California. The Board drew this distinction based on the conclusion that the general partner of a limited partnership has the rights and powers of a partner in a general partnership, which include the right to manage and conduct partnership business. Conversely, limited partners of a limited partnership do not have the power to manage and conduct partnership business. Thus, the decision of the Board hinged on the right to manage or control the decision making process of the entity, not whether a partner enjoys limited liability. The default rules in California's LLC Act provides that members of LLCs have the right to manage and conduct the LLC's business. Therefore, following the Board's logic in the Amman & Schmid decision, if an LLC is classified as a partnership for tax purposes, the members, who are considered general partners for tax purposes, are "doing business" where the LLC, i.e., a general partnership for tax purposes, is "doing business," even though the members have limited liability protection.
Legal Ruling 2014-01 includes several examples, all of which hold that the out of state corporate member is doing business in the state with the exception of a member of an LLC which is registered or organized in the state, but has no activity or factor presence in the state. In these two cases, the out of state corporate member is not deemed to be doing business in the state, does not have a California return filing requirement and is not subject to the franchise tax as a result of its membership interest in the LLC. This is because the LLC act of registering to do business in California is not a transaction or activity for the purpose of financial or pecuniary gain or profit that is attributed to the out of state corporate member.

Example: LLC Commercially Domiciled in California

LLC "E" is an LLC with two or more members, and is classified as a partnership for tax purposes. During a taxable year beginning on or after January 1, 2011, LLC E is commercially domiciled in California within the meaning of paragraph (1) of subdivision (b) of Section 23101.

Does LLC E have a California return filing requirement and obligation to pay all applicable taxes and fees?

Yes. In this situation, LLC E is "doing business" in California within the meaning of Section 23101 because it is commercially domiciled in California; therefore, it has a California return filing requirement and is subject to the LLC tax and fee.

Member F:

Member "F" is a corporation that is a member of LLC E holding a 15 percent interest in LLC E. During the same taxable year beginning on or after January 1, 2011, Member F is not incorporated, organized, or registered to do business in California and has no activities or factor presence in California other than through its membership in LLC E.

Does Member F have a California return filing requirement and obligation to pay all applicable taxes and fees as a result of its membership interest in LLC E?

Yes. The term "commercial domicile" refers to the principal place from which the trade or business of the taxpayer is directed or managed. Put another way, the location of a taxpayer's commercial domicile is based on activity; i.e., the location of the day-to-day management of the business. Therefore, because LLC E is commercially domiciled in California, one or more of its members are engaging in day-to-day management, which constitutes a transaction or activity in California for the purpose of financial or pecuniary gain or profit within the meaning of Section 23101. Because LLC E is classified as a partnership for tax purposes, this activity is attributed to each of LLC E's members under general principles of partnership law, and thus, the members are "doing business" in California within the meaning of Section 23101. The members have a California return-filing requirement and must pay all applicable taxes and fees.

In this situation, Member F is "doing business" in California within the meaning of...
Section 23101; therefore, it has a California return-filing requirement and is subject to the franchise tax.

Example: LLC "Doing Business" in California

LLC "G" is an LLC with two or more members, and is classified as a partnership for tax purposes. During a taxable year beginning on or after January 1, 2011, LLC G has activities or factor presence in California sufficient to constitute "doing business" within the meaning of subdivisions (a) or (b) of Section 23101.

Does LLC G have a California return-filing requirement and obligation to pay all applicable taxes and fees?

Yes. In this situation, LLC G is "doing business" in California within the meaning of Section 23101; therefore, it has a California return-filing requirement and is subject to the LLC tax and fee.28

Member H:

Member "H" is a corporation that is a member of LLC G holding a 15 percent interest in LLC G. During the same taxable year beginning on or after January 1, 2011, Member H is not incorporated, organized, or registered to do business in California and has no activities or factor presence in California other than through its membership in LLC G.

Does Member H have a California return filing requirement and obligation to pay all applicable taxes and fees as a result of its membership interest in LLC G?

Yes. Because LLC G is classified as a partnership for tax purposes and is "doing business" in California within the meaning of Section 23101, all of LLC G's members are "doing business" in California, and thus have California return filing requirements and are subject to all applicable taxes and fees, because the attribute of "doing business" by LLC G is attributed to its members under general principles of partnership law.

In this situation, Member H is "doing business" in California within the meaning of Section 23101; therefore, it has a California return-filing requirement and is subject to the franchise tax.

In all of the situations presented in Legal Ruling 2014-01, the LLCs in question have California return filing requirements and are subject to the LLC tax and fee. In the first two situations, the corporate members in question are not required to file California returns and are not subject to the franchise tax because the LLCs' acts of registering to do business in California and organizing in California are not attributed to their members. Conversely, in the remaining situations, the corporate members in question have California return filing obligations and are subject to the franchise tax, because the activities of the LLCs are attributed to their members under general principles of partnership law, and those activities
constitute "doing business" within the meaning of subdivisions (a) or (b) of Revenue and Taxation Code section 23101. Additionally, in Situation 6, Member L is also "doing business" in California because its distributive share of the California sales of LLC K exceed the sales threshold for doing business.

Swart Enterprises Inc. v. Franchise Tax Board (Superior Court, Fresno County (California), No. 13CECG02171, November 14, 2014) is a case filed in Fresno Superior Court regarding doing business issues and LLCs. Swart is a company whose principal place of business is in Iowa, although they also have business operations in Kansas and Nebraska. They do not do business in California, but in 2007 they did invest $50,000 in an LLC that was organized in California and acquired, leased and disposed of capital equipment. The LLC was manager-managed by a single manager, and Swart was a passive investor with a .02% interest. This case finds California joining other states in their quest to stretch nexus concepts to their constitutional limits.

In an order on motions for summary judgment, a California superior court ruled that an out-of-state corporation with no business activities or physical presence in California, whose sole connection with California was its ownership interest in a manager-managed California limited liability company (LLC), was not doing business in California and, therefore, was not subject to the $800 minimum franchise tax. The Franchise Tax Board (FTB) took the position that an entity owning an interest in an LLC operating in California is doing business in California per Rev. & Tax. Code Sec. 23101 (actively engaging in any transaction for the purpose of financial or pecuniary gain or profit) and, therefore, is subject to the minimum franchise tax, even if owning the interest in the LLC is the entity’s sole connection with California. However, "actively " requires active participation, and here the transaction in which the corporation invested in the LLC took place a couple years before the tax year at issue. Passively holding an investment in the LLC in the relevant tax year did not constitute actively engaging in a transaction for gain or profit.

The FTB asserted that under Reg. 23101, the purchase and sale of securities constitutes doing business in the state, and an interest in an LLC is a "security." However, Reg. sec. 23101 does not use the term "securities," but instead states that "doing business" includes the purchase and sale of stocks or bonds. While stocks and bonds may be securities, not every investment in any security falls within the meaning of "doing business."

The FTB also argued that because the LLC elected to be treated as a partnership for tax purposes, the corporation, as a partner, had the right to manage and conduct partnership business and was doing business in the state on that basis. However, the corporation had no interest in specific property of the LLC, was not personally liable for the LLC’s obligations, played no role in the LLC’s management and had no right to do so, and could not act as an agent for the LLC or bind it in any way. The FTB suggested that the corporation exercised control over the business by relinquishing control to the manager of the LLC. However, this ignored the fact that the corporation made its investment in the LLC 16 months after the LLC was formed (i.e., it was not a founding member). Also, its ownership interest (about 0.2%) was not large enough for it to influence any decision regarding the removal of a manager.

New York's tax regulation provides that a corporation will always be considered subject to tax in New York if it is a general partner in a partnership that does business in New York (N.Y. Comp. Codes R. & Regs. ' 1-3.2(a)(5)).

In Matter of Shell Gas Gathering Corp. No. 2 et al. (DTA Nos. 821569 and 821570, Sept. 23, 2010) the New York Tax Appeals Tribunal upheld the administrative law judge’s decision which held that two members of a limited liability company were taxable in New York based on the LLC’s earning income in the state, even though the members had no presence in New York. The case involved two corporate owners of an LLC named SUSGP that was treated as a partnership for federal and state income tax purposes. Shell Gas Gathering Corp. #2 (SGG) and Shell Gas Pipeline Corp. #2 (SGP) were holding companies and, under the SUSGP LLC agreement, did not manage or control SUSGP, did not possess the authority to act on behalf of SUSGP, and had no ownership interest in the property of SUSGP. Neither SGG nor SGP had any connection to New York other than their respective ownership interests in SUSGP. During the years in issue, other than own a membership interest in SUSGP, SGG and SGP did not:

(a) Conduct any business in New York,
(b) Employ anyone in New York, including independent contractors or agents,
(c) Own or lease any real property within the State,
(d) Own or lease any personal property within the State,
(e) Solicit or sell anything in New York,
(f) Enter into any contracts with any New York residents,
(g) Provide any services in the State,
(h) Maintain any bank accounts in the State,
(i) Have a listed telephone number in New York,
(j) Make any management decisions in New York,
(k) Utilize New York's court system to enforce or defend any rights or obligations.

SUSGP owned a series of LLC interests that ultimately resulted in a 99 percent limited partnership interest in Coral Energy Resources L.P. (CER). CER owned property and was engaged in business in New York. SUSGP filed partnership returns in New York. Neither SGG nor SGP paid New York corporate franchise tax, because their only connection to New York was the passive investment in SUSGP. On audit, the New York State Division of Taxation determined that both SGG and SGP were subject to New York corporate franchise tax based on the fact that they were members of SUSGP, which had an indirect interest in CER, which did business and earned income in New York.

Under New York Tax Law section 209(1), a corporation is subject to tax in the state if it does business in the state, employs capital in the state, owns or leases property in the state, or maintains an office in the state. Under the division's regulations, a corporate general partner of a partnership doing business in New York will be subject to tax based on its interest in the partnership. (20 N.Y.C.R.R. section 1-3.2(a)(5))
Regarding limited partners, 20 N.Y.C.R.R. section 1-3.2(a)(6)(i)(a) provides, in part:

“A foreign corporation is doing business, employing capital, owning or leasing property or maintaining an office in New York State if it is a limited partner of a partnership, other than a portfolio investment partnership, which is doing business, employing capital, owning or leasing property or maintaining an office in New York State and if it is engaged, directly or indirectly, in the participation in or the domination or control of all or any portion of the business activities or affairs of the partnership. A foreign corporation is engaged in such manner in the business activities or affairs of the partnership if . . . the foreign corporation has a one percent or more interest as a limited partner in a partnership and/or the basis of the foreign corporation's interest in the limited partnership, determined pursuant to section 705 of the Internal Revenue Code, is more than $1,000,000.”

In this opinion, the Court made clear that the issue at hand was not the activity of petitioners' holding companies, the recipients of the New York income that do not have any activities in New York. Rather, the issue involved the activities of CER, in which SUSGP has a substantial interest. The activities being taxed are the activities of CER. In summary, the law in New York states that the critical relationship is between the source of the income being taxed and the taxing jurisdiction, and not between the entity being taxed and the taxing jurisdiction.

3. Arizona.

A.R.S. §43-1412.17 requires that, in computing the taxable income of a partner, each partner must include its distributive share of the partnership's Arizona taxable income.

In Corporate Tax Ruling 94-2 the Department of Revenue explained that the underlying basis for requiring the corporate partner to report its income or loss from the partnership is that the partnership's business activity in Arizona requires the partner to either apportion or allocate its distributive share of the partnership's income or loss.

A corporation would be required to report its distributive share of the partnership's income or loss even if the only connection with Arizona is its interest in the Arizona partnership.

Examples:

1. Corporation A is domiciled in Los Angeles, California and holds a 25 percent interest in the profit, loss, and capital of Arizona Partnership B, which is formed and domiciled in Arizona. Corporation A's only connection with Arizona is being a partner in Partnership B. Since Partnership B is conducting business in Arizona, Corporation A must file an Arizona corporate income tax return reporting its distributive share of Partnership B's Arizona income or loss. Corporation A would apportion its distributive share of Partnership B's income or loss if its partnership interest is business or make an allocation if its partnership interest is nonbusiness.
2. Corporation A has business activity within and without Arizona in addition to holding a 25 percent interest in the profit, loss, and capital of Partnership B. Corporation A must file an Arizona corporate income tax return apportioning its income from business activities within and without Arizona. It must also report its income or loss from the partnership based on its distributive share of Partnership B's Arizona income or loss. Corporation A would apportion its distributive share of Partnership B's income or loss if its partnership interest is business or make an allocation if its partnership interest is nonbusiness.


The Kentucky Court of Appeals has upheld a circuit court decision that a corporation and its affiliates with no physical presence in Kentucky, but with a 99% limited partnerships ownership interest in a Delaware limited partnership doing business in Kentucky, had taxable nexus with Kentucky and, therefore, were required to pay corporation income tax on its distributive share of partnership income. (Revenue Cabinet v. Asworth Corporation, Kentucky Court of Appeals, Nos. 2007-CA-002549-MR, 2008- CA-000023-MR, (November 20, 2009)). However, the circuit court was reversed insofar as it concluded that the Kentucky statutory three-factor apportionment formula provided the correct method for calculating the taxes because it reasoned that prohibiting taxpayers from using the three-factor formula would subject the formula to possible constitutional problems.

The taxpayers argued that the circuit court erred in finding the corporations subject to Kentucky taxation because the parties stipulated that the corporations did not own property, lease property, or have individuals receiving compensation in Kentucky. The taxpayers principally relied on Quill Corp. v. North Dakota, (504 U.S. 298 (1992)) in arguing that the substantial nexus requirement under the Commerce Clause of the U.S. Constitution can only be satisfied through a physical presence with the taxing state, which they claimed the corporations did not have with Kentucky. The Kentucky Court of Appeals admitted that application of Quill's physical presence requirement to income tax cases is unclear. However, the court noted that a 99% ownership interest in a partnership doing business in Kentucky and distributions of income from such a partnership gives rise to a substantial nexus with, and/or a physical presence within, Kentucky that satisfies the Commerce Clause requirement. According to the court, such a partnership unquestionably has received protection and benefits from Kentucky, thereby enabling the distribution of income to the corporations. Likewise, the corporations' ownership interest in, and receipt of income from, a partnership doing business in Kentucky provided the requisite minimum contacts link for taxation required by the Due Process Clause of the U.S. Constitution.

5. Pennsylvania

In Houssels v. Pennsylvania, Docket No. 14-638, petition for cert. filed 11/26/14, ruling below as Wirth v. Commonwealth, 95 A3d 822 , 2014 WL 2743554 (Pa. 2014), the Pennsylvania Supreme Court, with one dissent, affirmed a Commonwealth Court decision that nonresident
limited partners, who invested in a Connecticut limited partnership that owned and operated a Pennsylvania skyscraper, realized gains from the foreclosure of the skyscraper that were properly subject to Pennsylvania income tax. The petition for cert. has been denied.

The petitioners, John Houssels and Robert Marshall (the "Petitioners"), are two out of 735 individual investors (e.g., limited partners) in 600 Grant Street Associates Limited Partnership (the "Partnership"), a Connecticut limited partnership organized for the purpose of owning and operating the U.S. Steel Tower in Pittsburgh, Pennsylvania (the "Tower"). The Partnership owned the Tower and leased space to commercial tenants. The Partnership, however, was not financially successful.

As explained by the Pennsylvania Supreme Court, the Partnership secured a nonrecourse Purchase Money Mortgage Note (PMM Note) as part of its transaction to acquire the Tower. Interest on the PMM Note was payable on a monthly basis, but the PMM Note provided that if the monthly interest amount exceeded the Partnership's net operating income from the Tower, the Partnership did not have to pay the excess interest. Instead, the interest could be deferred and compounded on an annual basis.

Since the Partnership incurred net operating losses in every year of its existence (1984-2004), it did not pay the interest per the terms of the PMM Note. And, the nonresident limited partners of the Partnership (710 out of 735 limited partners), including the Petitioners, did not have to file Pennsylvania Personal Income Tax ("PIT") returns related to their investment in the partnership because they had no Pennsylvania source income (only Pennsylvania source losses). By 2005, the compounded accrued interest on the PMM Note totaled more than $2.3 billion. Given this amount of debt, the Partnership was unable to sell the Tower, and the lender foreclosed on the property. As noted by the Pennsylvania court, the sole reason for the Partnership's existence was to own and operate the Tower. Thus, shortly after the foreclosure, the Partnership liquidated, and each of the partners, including the Petitioners, lost their entire investments in the Partnership.

The court noted that none of the limited partners, including the Petitioners, received any proceeds from the property's foreclosure or the Partnership's liquidation. Each of the investors, including the Petitioners, paid a combination of cash and executed promissory notes, which were satisfied prior to the Partnership's liquidation, for their interests in the Partnership. In the time between the foreclosure and the liquidation, however, the Partnership reported a gain on its federal and state tax filings that consisted of the unpaid balance of the PMM Note's principal and accrued interest (approximately $2.6 billion). The Partnership allocated the gain to each individual partner in an amount proportionate with the partner's ownership interest in the partnership.

As summarized by the lower court, the Pennsylvania Department of Revenue (the "Department") "therefore, and despite their individual investment losses . . . assessed PIT against the [Petitioners and other limited partners], plus interest and penalties, related to the foreclosure on the [Tower] for tax year 2005. The PIT equaled each limited partner's distributive share of the gain associated with the foreclosure, multiplied by the Pennsylvania PIT rate of 3.07%." The Petitioners now challenge Pennsylvania's right to tax this income.
The Department relying on the so-called "Tufts Rule," announced in the U.S. Supreme Court's decision in Commissioner v. Tufts, 461 US 300, 75 L Ed 2d 863, 83-1 USTC ¶9328, 1983-1 CB 120 (1983), assessed PIT on the Petitioners following the foreclosure of the Tower, even though the Petitioners did not receive any cash or other property upon foreclosure. Under the Tufts Rule, foreclosures on nonrecourse mortgage notes constitute the disposition of property and therefore result in the realization of income or gain for federal tax purposes equal to the amount of the discharged debt.

The Department argued in the case below that the Tufts Rule was consistent with section 7303(a)(3) of the Pennsylvania statutes (discussed above), which provides that the Department may tax the net gain associated with the disposition of real property. The Pennsylvania Supreme Court agreed. According to the court, the "Tufts [R]ule is encompassed within the plain meaning of 'disposition of real property,' as contemplated by Section 7303(a)(3) and Regulation 103.13, and the [Department's] assessment of PIT was proper."

In their petition for certiorari, the Petitioners argue that they do not have constitutional nexus with Pennsylvania and that, under Pennsylvania's taxing laws, the state has impermissibly discriminated against the Petitioners based on their status as nonresidents.

Before the Pennsylvania courts, the Petitioners argued that both the Commerce and Due Process Clauses of the federal Constitution prohibited the Department from assessing PIT. According to the Pennsylvania Supreme Court, however, the Petitioners waived their Commerce Clause arguments as a result of their "underdevelopment" of the argument before the lower court and, therefore, the court did not address the merits of the Petitioners' Commerce Clause claim. According to the court, "the entirety of the [Petitioners'] Commerce Clause argument . . . was as follows: 'A state's ability to tax is limited by the Commerce and Due Process Clauses of the United States Constitution.' The remainder of the constitutional argument focuses exclusively upon the notion of minimum contacts, which . . . relates solely to an alleged violation of the Due Process Clause." The Pennsylvania Supreme Court therefore focused its analysis on the Petitioners' Due Process claims.

The Department determined that the Petitioners could not use their investment losses in the Partnership to offset the gain realized at the time of foreclosure. The Pennsylvania Supreme Court agreed.

As summarized by the court, "unlike the federal IRC, which defines income in an all-encompassing manner, the [Pennsylvania] Code enumerates eight specific categories of income . . . of which net profits from business operations . . . and net profits from the disposition of property . . . are two distinct classifications." And under Pennsylvania law, "a person shall not be allowed to offset a gain in one class of income with a loss in another class of income." (61 Pa. Code § 121.13(a)).

Although the Department conceded that both the disposition of the Tower and the Petitioners' investment losses constituted "the disposition of property"-and that therefore both transactions related to the same category of income-the Department nevertheless denied the
Petitioners any offsetting reduction to their PIT liabilities. According to the Department, the Petitioners' investment loss was the disposition of an intangible asset, which is "localized at the owner's domicile for purposes of taxation." Accordingly, the Department argued that gains and losses from the disposition of intangible personal property couldn't be taxed or deducted within Pennsylvania by a nonresident.

As stated above, the Pennsylvania Supreme Court agreed with the position of the Department. The court agreed that the Petitioners' interests in the Partnership constituted "intangible personal property, separate and apart from the real property interest associated with the [Tower]." And the court agreed that the Petitioners' "shares in the Partnership", and therefore their responsibility to the assets and debts of it, are at the situs of the partnership interest (i.e., the source), which is intangible personal property, and therefore at the domicile of each individual [Petitioner]." Therefore, the Petitioners could not use their investment loss to reduce their Pennsylvania PIT liability in contrast to resident Pennsylvania investors.

Although the Pennsylvania Supreme Court found "the question presented close," it ultimately agreed with the Department that "the inability of [Petitioners] to deduct the investment loss does not violate the Privileges and Immunities Clause (or, for that matter, the Equal Protection or Commerce Clauses)." The court distinguished Lunding by noting that Lunding involved "a specific type of New York taxable income-alimony-and therefore all of the related taxation of income and deduction of payments stemmed from the same economic event: a judicial decree regarding the payment of alimony. In the instant appeal, while under Pennsylvania law the disposition of the [Tower] via foreclosure and the loss related to the investment in the Partnership both fall under the Section 7303(a)(3) class of income, the inability of Appellants to deduct the investment loss from the foreclosure gain because of the situs of the investment loss does not foreclose their ability to deduct from the foreclosure gain by some other Pennsylvania-sourced loss that falls under Section 7303(a)(3)."

Additionally, the court noted that Pennsylvania, as a purely jurisdictional matter, could not have received tax on income from any gain on the Petitioners investment in the Partnership.

6. Alabama.

In Tsitalia LLC v. Alabama Department of Revenue, (Ala. Dept. Of Revenue Admin. Law Div. Dkt. No. BIT 12-492, 2/01/2013) an Alabama limited liability company (LLC) that failed to report and pay Alabama income tax on its nonresident member’s distributive share of Alabama sourced income was assessed for the tax and interest due on the income tax owed by a nonresident who resided abroad. The ruling stated that it was irrelevant whether the state had jurisdiction over the nonresident member, who lived in Greece, because the statutory composite filing/payment requirement was imposed on the LLC, which clearly had a sufficient nexus with Alabama to permit the state to enforce collection of the tax through the composite filing. The Judge stated, "I agree with the Taxpayer's representative that Alabama's composite return and payment provisions were enacted ... to avoid the jurisdictional problems involved in taxing a nonresident partner or member. But such provisions are clearly constitutional, and while the tax is measured by the nonresident's distributive share of the entity's income, it is levied on the in-
state entity."

In Vogt v. Alabama Dept of Revenue (Administrative Law Division, No. INC. 11-660, January 3, 2013,) a nonresident member of a limited liability company who received Alabama sourced income in 2008 could not be personally assessed for the tax due. Note that beginning with tax year 2009, a pass-through entity is required to file a composite return on behalf of its nonresident members and report and pay Alabama income tax on the nonresident members’ distributive shares of the income of the entity apportioned and allocated to Alabama at the entity level.

7. New Jersey

In BIS LP, Inc. v. Director, Division of Taxation (N.J. Super. Ct. App. Div., No. A-1172-09T2, Aug. 23, 2011) the New Jersey Superior Court, Appellate Division, affirmed a foreign corporation’s business tax refund because the corporation lacked sufficient nexus to make it subject to taxation. In BIS, the parent company, BISYS, and its wholly owned subsidiary, BIS LP, formed Solutions as a New Jersey limited partnership. BISYS contributed ninety-nine percent of its banking information assets to BIS and one percent of its banking information assets to Solutions. BIS subsequently contributed all of the assets it received from BISYS to Solutions. Following those transfers to Solutions, BISYS became a general partner with a one percent interest in Solutions and BIS became a limited partner with a ninety-nine percent interest in Solutions. Once the restructure was complete, BIS was no longer involved in the banking information business.

The limited partnership interest in Solutions was BIS’s most substantial asset, and it produced most of BIS’s income. However, BIS was not in the same line of business as Solutions. Nor was there a “substantial” overlapping of officers or sharing of offices, operational facilities, technology, or know-how.

The New Jersey regulations state that a foreign corporate limited partner of a limited partnership doing business in New Jersey is considered to be doing business if:

- the limited partner is also a general partner in the partnership;
- the limited partner takes control of the partnership;
- the limited partner meets the requirement for “doing business” in New Jersey as set forth in N.J.A.C. 18:7-1.9 and 1.6; or
- the business of the partnership and the limited partner are “integrally related.”

N.J.A.C. 18:7-7.6(c).

The tax court focused on the third and fourth tests. In analyzing the third test, the court determined that because BIS did not have a place of business in New Jersey, did not have employees or agents in New Jersey, and did not have control of the business, it did not meet the requirements for doing business in New Jersey set out in N.J.A.C. 18:7-1.9 and 1.6. The Court then turned to whether the businesses of BIS and Solutions were integrally related. In making that determination, the court looked to whether BIS and Solutions could be found to be engaged in a unitary business.
The Court concluded that BIS, an investment company, and BISYS, a banking information data business, did not have a unitary relationship as a result of the different business operations. The court also determined that the partnership interest was BIS's only asset and that there was not a substantial overlapping of officers or operations with BISYS. Because BIS did not have an operating location in New Jersey and was not actively managing BISYS, the court held that BIS was not doing business within the state.

In a more recent decision, the New Jersey Tax Court held that an out-of-state limited partner in a New Jersey limited partnership had nexus in New Jersey for corporation business tax purposes because the partnerships were in the same line of business, were parties to the same New Jersey-governed cash management agreement, and had common agents and directors and shared a principal place of business in New Jersey. (Village Super Market of PA, Inc. v. Director, Division of Taxation (No. 021-002-2010, Oct. 23, 2013).

The result in these cases and under the New Jersey regulation appears to support the conclusion that passive investment alone by an out of state corporation in a New Jersey limited partnership would not meet the “doing business” or the “integrally related” tests necessary to subject the corporate limited partner to income taxation by the state.

8. Wisconsin

Wisconsin Department of Revenue recently released Publication 119 Limited Liability Corporations (02/2014). Publication 119 addresses the tax treatment of out-of-state corporations who are members in an LLC that is doing business in the state. If a corporation that has not been engaged in business in Wisconsin acquires an interest in an LLC that is engaged in business in Wisconsin, the corporation is subject to Wisconsin franchise or income taxation. The corporate member is engaged in business in Wisconsin as a result of holding an interest in the LLC.

The corporation’s share of the LLC’s net income or loss is includable in its apportionable income. (Wis. Stats. §§71.22(1r) and 71.25(5)(a)14) The corporation must combine its share of the LLC’s apportionment data with its own apportionment data to determine the income apportionable to Wisconsin. (Wis. Stats. §§71.25(9)(e)8, 71.25(15), and 71.45(6)).

Publication 119 does recognize however, that income from an LLC may be nontaxable under the principles of the U.S. Supreme Court decision in Allied-Signal v. Director, Div. of Taxation, 504 U.S. 768 (1992), if the investment is passive and does not serve an operational function. In this case, the corporation would not include its share of the LLC’s apportionment factors in the numerator and denominator of its apportionment factors.

9. Michigan

The new Michigan corporate income tax (CIT) applies to a corporation with business activity in Michigan or an ownership interest or beneficial interest in a flow-through entity that has business activity in Michigan. (MCL 206.623(1). A “flow-through entity” is defined in the
CIT as a subchapter S Corporation, a general partnership, a limited partnership, a trust, a limited liability partnership, or a limited liability company that for the tax year is not taxed as a corporation for federal income tax purposes. Michigan recently released Revenue Administrative Bulletin 2014-5 (January 29, 2014) that explains how the corporate income tax applies to flow through entities.

RAB 2014-5 takes an aggressive position regarding ownership interest in flow through entities. A taxpayer has nexus with Michigan “if the taxpayer has an ownership interest or a beneficial interest in a flow-through entity, directly, or indirectly through 1 or more other flow-through entities, that has substantial nexus in this state.” (MCL 206.621(1)). Flow through entity includes a limited partnership or a limited liability company.

RAB 2014-5 goes on to clarify that there is no minimum ownership percentage or degree of control threshold that a taxpayer owner of a flow-through entity must have in order for nexus with Michigan to exist.

RAB 2014-5 also addresses the issue of whether nexus exists for the limited partner or LLC member where the activities of the entity are protected under P.L. 86-272. The distributive share of income of a corporation that has nexus with Michigan that is attributable to its ownership in a flow-through entity whose activities are otherwise protected by PL 86-272 is not itself protected by PL 86-272 and is not excluded from the corporation’s corporate income tax base. The application of PL 86-272 is not triggered by the receipt of income from interstate commerce, but by the absence of certain contact by the taxpayer with the taxing state. In other words, PL 86-272 does not exempt from the corporate income tax the distributive income from a flow-through entity protected by PL 86-272 to its corporate owners; it only prevents a state from exercising its taxing jurisdiction over the business entity engaged in the protected activities, i.e., the flow-through entity. The distributive share income of a corporate owner that is itself not protected by PL 86-272 is not exempt from the corporate income tax merely because it flows from an entity otherwise protected by PL 86-272.

10. Georgia

Georgia accomplishes taxation of the nonresident corporate limited partner or LLC member directly by Regulation. Ga. Comp. R. and Regs. 560-7-7-.03 states:

“A corporation will be considered to be owning property in this state, doing business in this state, or deriving income from sources within this state whenever the corporation is a partner, whether limited or general, in a partnership which owns property in this state, does business in this state, or derives income from sources within this state. A corporation will be considered to be owning property in this state, doing business in this state, or deriving income from sources within this state whenever the corporation is a member of a limited liability company or similar nontaxable entity, not treated as a corporation for federal income tax purposes, which owns property in this state, does business in this state, or derives income from sources within this state.”
11. **Idaho**

Idaho also accomplishes the taxation of a nonresident corporate limited partner or LLC member directly by Regulation. Idaho Administrative Rule 35.01.01(620)(02) states:

A corporation is transacting business in Idaho if it is a partner in a partnership that is transacting business in Idaho even though the corporation has no other contact with Idaho. In this case, both the partnership and the corporation have an Idaho filing requirement.

12. **Illinois**

In General Information Letter No. IT 12-0028-GIL (Ill. Dept. of Rev. Sept. 27, 2012) the Illinois Department of Revenue ruled that a nonresident individual taxpayer who received guaranteed payments from a partnership operating in Illinois, had sufficient connections with the state to be subject to the Illinois income tax. The ruling pointed out that a partner in a partnership doing business in Illinois has sufficient nexus with Illinois to be subject to Illinois income taxation. (Citing *Borden Chemicals & Plastics, L.P. v. Zehnder*, 312 Ill. App. 3d 35 (2000). Admitting that the matter has never been raised before an Illinois court, the ruling states that courts in other states have held that guaranteed payments received by a nonresident partner from a partnership doing business in the state are subject to the state's income tax, even when the partner has no other connection with the state. (Citing *Matter of Heffron v. Chu*, 144 A.D.2d 729, 535 N.Y.S.2d 14 (1988) and *Matter of Heller v New York State Tax Commn.*, 116 A.D.2d 901, 498 N.Y.S.2d 211 (1986). Therefore, the nonresidents receipt of guaranteed payments related to Illinois-source business income was taxable by Illinois.

C. **Out of State LLC doing business in the State: Activities of LLC Member in the State.**

1. **California.**

Partnerships and LLCs are considered doing business in California if they have general partners or members in the state. Although general partners are charged with the responsibility of managing the affairs of the partnership under state law, this is not the case with members of an LLC. The FTB takes the position that any activity, including solicitation for sales by a California resident member that is a for profit transaction on behalf of the foreign LLC results in the foreign LLC engaging in business in California. The FTB arrives at this conclusion by virtue of the fact that members of LLCs have the right to act on behalf of and manage an LLC. The fact that the California resident member is not the managing member of the foreign LLC does not mean that the member’s presence in California would not cause the foreign LLC to be doing business here. This concept has almost been elevated to a presumption that a California resident member’s California activities will constitute doing business by the out of state LLC unless the taxpayer is able to present evidence to show that the California resident member’s activities did not cause the foreign LLC to be doing business in California.
The FTB has won several cases in this area such as the *Appeal of Mockingbird Partners, LLC* (SBE May 17, 2006). In this case the SBE upheld the imposition of the minimum tax imposed on a limited liability company with out of state investment property whose member agents engaged in business activities on behalf of the LLC in California. The LLC owned, operated and managed residential rental property located in Montana. The rental property was managed on a daily basis by a firm located in Montana. The LLC had two members who lived in California. The operating agreement stated that one of the members was responsible for general and financial administration, including bill payment, bookkeeping, financial statement preparation and tax returns. The operating agreement authorized the members to open a bank account in San Francisco and both members had the right to sign checks on the account. According to the SBE, since the LLC members were California residents and since every LLC member is an agent of the LLC for conducting business of the LLC (unless the articles of organization or operating agreement restrict the scope of the agent’s authority) the LLC was doing business in California. This result is not impacted by the factor presence nexus standard and is a restatement of existing law.

a) **Disregarded Entities.**

The FTB issued Legal Ruling 2011-01 on January 11, 2011, regarding the activities of a disregarded entity. For federal income tax purposes, disregarded entities are treated as a sole proprietor if the sole owner is an individual, or as a branch or division of the owner if the sole owner is any entity other than an individual. (Reg. 1.7701-2(a)). California recognizes the disregarded entity status and has now addressed the question regarding whether the sole owner of a disregarded entity is doing business in California if the owner has no other activities in the State other than the disregarded entity. (Legal Ruling 2011-01, January 11, 2011).

The FTB’s legal ruling takes the position that the activities will be attributed from the disregarded entity to the owner so that the owner — who otherwise might not be doing business in California — is now considered to be doing business here. The ruling addresses the Qualified Subchapter S Subsidiary (Qsub) and the Single Member Limited Liability Company (SMLLC).

The FTB ruling analyzes several situations. In each situation, the sole owner is a corporation incorporated in a state other than California and that — except for the activities of the disregarded entity — would otherwise not be doing business in California. The disregarded entity is also formed in another state but has activities within California that constitute doing business.

III. **State Recognition and Taxation of the Flow Through Entity.**

State and local taxation of pass-through entities (also called flow-through entities) has become increasingly complex as the states depart significantly from federal law. Certain states have their own filing requirement in order to elect flow through entity treatment, and several states now tax the entity. The entity level tax is often not in the form of a net income tax, but rather an assessment on gross income or gross receipts. In other cases the assessment is on capital rather than income. These issues, coupled with varied sourcing rules that apply to the
income that flows through to the shareholders, result in planning opportunities as well as tax traps.

This section discusses the separate election requirement in certain states and the entity level taxes/fees for all types of flow-through entities including partnerships, limited partnerships, LLCs and S Corporations.

A. Recognition of the Flow Through Entity.

1. S Corporations.

Most states recognize the federal S Corporation election, but not all. Arkansas, New York, and New Jersey are a few of the states that require a separate state S election to be filed; otherwise, the entity will be considered an S corporation for federal income tax purposes but a C corporation for state income tax purposes—a trap for the unwary.

Ohio requires that an S corporation file a notice of the federal S election with the Ohio Tax Commissioner between the first day of January and the last day of March of every year for which the election is in effect.

In Georgia, a federal S election is valid for state income tax purposes only if all the shareholders are subject to Georgia income tax on their shares of the S corporation’s income. Also, all nonresident shareholders must pay Georgia income tax on their shares of the S corporation’s income. The S corporation must file a consent form for each nonresident shareholder; failure to do so negates Georgia’s recognition of the federal S election.

The states that require compliance with additional filing requirements and conditions are discussed here.

a) Arkansas.

Arkansas requires a corporation that desires to be an S corporation for state purposes to file a separate corporate election and shareholder consents with the Department of Finance and Administration. The state election and consents are filed at the same time and in the same manner as is required for the federal election and related consents. In Arkansas, a taxpayer can elect to be treated as an S corporation for federal tax purposes but not for state tax purposes and in that case, the taxpayer would be an Arkansas C Corporation.

b) Louisiana

Louisiana law does not recognize S corporation status and the S corporation is required to file in the same manner as a C Corporation in that state. However it, in certain instances, the corporations income may be excluded from the Louisiana tax through an “S corporation exclusion” which is the percentage of income on which Louisiana tax has been paid directly either shareholders. In addition to the income tax, every domestic and foreign corporation
including S corporations, that are qualified to do business in Louisiana or in fact are doing business in Louisiana must pay the annual franchise tax at the rate of $1.50 for each $1000 or major fraction thereof on the first $300,000 of taxable capital and at the rate of $3.00 for each $1,000 that exceeds $300,000 of taxable capital.

c) New Hampshire

S corporation status is not recognized in New Hampshire. A corporation that qualifies for an elects S corporation status for federal purposes is treated as a regular C Corporation for state purposes. That means it is subject to the business profits and business enterprise tax imposed on corporations. Pass-through treatment is inapplicable for state tax purposes.

d) New Jersey

New Jersey has not incorporated S corporation provisions. Therefore a New Jersey S corporation election must be made in order to be treated by New Jersey as an S corporation. A corporation that qualifies as an S corporation for federal purposes but does not elect S corporation status for state purposes must file a return and pay tax as though they were a C Corporation. In other words, the federal S Corporation election is not recognized.

e) New York

New York requires an S corporation make a separate New York S election to be taxed as a New York S corporation. If the separate election is not made, then the corporation is taxed as a C Corporation for New York purposes, not an S corporation. A corporation can only elect to be a New York S corporation if it is already a federal S Corporation, qualifies as an eligible Corporation, and all of the Corporation’s shareholders agreed to make the New York S election.

f) Pennsylvania

Pennsylvania no longer requires a separate state election unless the S Corporation does not want to be a Pennsylvania S Corporation. In that case a separate Pennsylvania election must be filed which requires the consent of 100% of the S Corporation shareholders.

g) Tennessee

Tennessee does not recognize S Corporations that are taxed the same as C Corporation. That means that they are subject to the 6.5% excise tax and the franchise tax described below.

h) Texas
Texas recognizes the S Corporation election, but taxes the entity the same way as other corporations. This means that the S Corporation is subject to the revised Texas margin tax (just like regular C Corporations).

2. **LLCs**

All states recognize LLCs, but several states have opted to tax the entity as described below. Several states now assess a gross receipts, gross income, or net income tax on the flow-through entity. This reduces the issues associated with trying to collect the tax imposed on the entity's owners, which is difficult if the owner does not live in the state. Each state has its own unique requirements, which are cumbersome and difficult to comply with.

**B. Taxation of the Entity.**

Several states now assess a gross receipts, gross income, or net income tax on the flow-through entity. In addition, several states assess their business privilege tax (or minimum franchise tax) on the entity which is assessed for the privilege of doing business in the state. A few states do not tax the entity, although these are generally the states that do not impose an income tax on taxpayers. Each state has its own unique requirements, which are cumbersome and difficult to comply with.

1. **States which do not tax the entity.**

   Some states do not tax the entity. These states include Alaska, Arizona, Colorado, Florida, Hawaii, Indiana, Iowa, Louisiana, Maine, Maryland, Michigan, Montana, Nevada, North Dakota, South Dakota, Utah, Virginia, Washington and Wyoming.

2. **States which do not tax Partnerships or LLCs.**

   Several states do not tax partnerships or LLCs but do subject the S Corporation to taxation, albeit the tax imposed is the states “business privilege tax” or the tax assessed on the entity for the privilege of doing business in the state (not on the net income of the entity). States which take this approach include Georgia, Kansas, Massachusetts, Mississippi, Missouri, Nebraska, New Jersey, New Mexico, North Carolina, Oregon, Pennsylvania, South Carolina and Wisconsin.

3. **States which assess all flow through entities under Franchise Tax.**

   Some states assess all flow through entities under their “doing business” tax structure. This type of tax can include assessments calculated on net worth that is sourced to the state or simply be assessed as a flat dollar minimum. These states include: Alabama, Arkansas, Connecticut, Kansas, Vermont and West Virginia.
4. **States which assess Income Tax/Franchise Tax against all flow through entities.**

   **California**

   (1) **Limited Partnerships**

   Limited partnerships actively engaged in any transaction for gain or profits are subject to the minimum franchise tax of $800 for the privilege of doing business in California. California does not allow a deduction either to the partners for this payment (Cal. Rev. & Tax. Code 17220) or from the income of the limited partnership when computing the partnership's distributive shares. This requirement only applies to limited partnerships, defined as **any partnership formed by two or more persons under the laws of this state or any other jurisdiction and having one or more limited partners.**” (Cal. Rev. & Tax. Code 17220) The tax is due and payable with the partnership return. (Cal. Rev. & Tax. Code 17935(c)). This tax can become burdensome if the operating form of the partnership is a multi-tiered limited partnership structure with several entities. Each entity will be required to pay the $800 fee.

   (2) **General Partnerships**

   California does not impose an income or franchise tax on general partnerships. This is the case even if the general partnership has opted to register with the Secretary of State's office. Although registration is not required, a general partnership may elect to register in order to provide a public record of the names of those partners who can legally bind the partnership. Every partnership that is doing business in California or that has California-source income must file an annual California partnership tax return (Form 565). (Cal. Rev. & Tax. Code 18633(a); FTB Form 565 Instructions).

   (3) **Limited Liability Companies**

   The Limited Liability Company (LLC) is required to pay the minimum franchise tax and a tax based on gross receipts. The tax based on gross receipts has been the subject of recent litigation regarding the method used to determine the total receipts attributable to the state. The original assessment methodology was struck down as unconstitutional, and was revised in 2007 so that from January 1, 2007, and going forward only gross receipts sourced to California are subject to the tax. The entity level assessment is a big downside to electing to organize as an LLC because the business will be required to pay the assessment even if it operates at a loss.

   (a) **The Franchise Tax**

   The California LLC is required to pay the $800 minimum franchise tax. (Cal. Rev. & Tax. Code 17941). Similar to limited partnerships, the tax is required to be paid each year until the LLC formally dissolves. The tax is due and payable no later than the fifteenth day of the fourth month of the taxable year. (Cal. Rev. & Tax. Code 17941(c)). The minimum tax is submitted with FTB 3522, LLC Tax Voucher and should not be paid with the filing of the Form 568 (LLC Tax Return). The $800 minimum franchise tax is also imposed on foreign LLCs doing
business in the state. Note the difference in the procedure governing payment of the minimum franchise tax by the limited partnership and the limited liability company. The minimum franchise tax payment is due and payable with the tax return for the limited partnership, while the same payment is due and payable on the 15th day of the fourth month of the taxable year for the LLC.

The $800 is a tax and is therefore not allowed as a deduction on the California income tax return filed by either the LLC or its members. (Cal. Rev. & Tax. Code 17220). The minimum franchise tax is deductible on the federal return as a state income tax.

(b) The Entity Level Fee

California imposes a fee based on gross receipts plus the minimum franchise tax (currently $800) on every LLC doing business in California. Since 2001, the fee is set by statute (it had previously been determined by an annual study conducted by the Franchise Tax Board (FTB)). (Cal. Rev. & Tax. Code 17942).

Prior to 2009, the entity level fee was paid with the Form 568, which was required to be filed by the 15th day of the fourth month after the close of the tax year. California Revenue and Taxation (Cal. Rev. & Tax.) Code Section 17942 now requires that the LLC fee be paid by the 15th day of the sixth month of the taxable year. This means that for the year 2009, the LLC was required to pay the fee that relates to the 2008 year on April 15, 2009, and the fee for the 2009 year on June 15, 2009. Failure to pay the amount owed on June 15, 2009, resulted in a penalty equal to 10% of the underpayment. The underpayment is equal to the difference between the total amount of the fee imposed for the year and amount paid on June 15, 2009. Cal. Rev. & Tax. Code Section 17942(d)(2) does provide that no penalty is imposed if the amount paid at least equals the total amount paid in the preceding year.

Example.

Final Foreclosure LLC had a big year in 2010. During that year it generated gross receipts of $7 million and paid a fee based on gross receipts of $11,790. In 2011, as the economy begins to recover, the owners anticipate that the gross receipts will total about $4,500,000 and that the LLC will pay a fee of $6,000. Although this assumption appears to be true, things changed dramatically in November 2011 when the price of oil shoots up to $200 per barrel and the Arab nations threaten another war. More foreclosures ensue, and Final Foreclosure is back up over $7 million of gross receipts for the year. Since it underpaid the assessment in June and did not pay at least what it paid in 2010, it would be subject to a penalty of 10% on the underpayment.

For tax years beginning on or after January 1, 2007, “total income” for purposes of the fee will be based on income derived from activity in California rather than worldwide income. (Cal. Rev. & Tax. Code ’17942(b)(1)(B))
If the LLC does business wholly within California, total gross receipts are assigned to California. If the LLC conducts business within and outside the state, the LLC must assign its total income, item by item, to California based on the rules for assigning sales to the numerator of the sales factor in the apportionment formula. (Cal. Rev. & Tax. Code 25135, 25136.)

The special industry rules used to source sales under Cal. Rev. & Tax. Code Section 25137 apply, with an exception for the provisions that exclude receipts from the sales factor. For example, Cal. Code Regs. tit. 18, Section 25137(c)(1)(A) excludes certain receipts from the sales factor if they are substantial, arise from an occasional sale, and are distortive. In addition, Cal. Code Regs. tit. 18, Section 25137(c)(1)(B) excludes certain receipts from the sales factor if they are insubstantial and arise from an incidental or occasional transaction. These exclusion rules do not apply for purposes of computing the LLC's gross receipts.

Other than the new sourcing rules, the fee's structure did not change. The fee is still computed pursuant to the following schedule: (Cal. Rev. & Tax. Code ' 17942(a).

<table>
<thead>
<tr>
<th>Total Receipts</th>
<th>LLC Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $250,000</td>
<td>0</td>
</tr>
<tr>
<td>$250,000 but less than $500,000</td>
<td>$900</td>
</tr>
<tr>
<td>$500,000 but less than $1,000,000</td>
<td>2,500</td>
</tr>
<tr>
<td>$1,000,000 but less than $5,000,000</td>
<td>6,000</td>
</tr>
<tr>
<td>$5,000,000 or more</td>
<td>$11,790</td>
</tr>
</tbody>
</table>

Small LLCs with total gross receipts of less than $250,000 pay no fee. In addition, if an LLC owns another LLC, the gross receipts of the lower-tiered LLC are not counted in computing the fee of the parent. (Cal. Rev. & Tax. Code ' 17942(b)(1)(A).

Cal. Rev. & Tax  17942 now refers to Sections 25135 and 25136 (and the related regulations) for purposes of determining the sourcing rules applied to gross receipts, which are summarized here. Note that these rules changed as of January 1, 2011, under legislation that adopts significantly different sourcing rules for service-based income, modifies the definition of throwback, and adopts a throw-out rule. (Cal. Rev. & Tax. Code 25136.) The rules changed again effective January 1, 2013 with the enactment of Proposition 39 that eliminates the election between single sales factor apportionment and the three-factor formula with double weighted sales. For the year 2013 and going forward, the single sales factor formula with market based sourcing (for income from services and intangibles) is the only allowable method.

The sourcing rules that apply in 2013 and later years are summarized as follows:

- Total income from sales of tangible personal property \((i.e.,\text{,}\text{ inventory})\) with a destination in California is attributable to California if the property is delivered or shipped to a purchaser within California regardless of the freight-on-board point or other conditions of sale.
- Total income from sales of tangible personal property shipped from California is assigned to California unless the seller is taxable in the destination state. Special rules
apply to sales to the U.S. government.
- Total income from sales, other than sales of tangible personal property, is attributable to California if the customer gets the benefit of the purchase in the state.
- Total income from the sale, rental, leasing, licensing, or other use of real property is attributable to California if the property is located within California.
- Total income from the rental, leasing, licensing, or other use of tangible personal property is attributable to California if the property is located within California.
- Sales from the sale, lease, rental, or licensing of real property are in the state if the real property is located in the state;
- Sales from the rental, lease, or licensing of tangible personal property are in the state if the property is located in the state.

The LLC does not apportion its total income, but rather simply sources each type of income using the sourcing rules for purposes of computing the numerator of the sales factor. Using this computation, the LLC determines its total income sourced to California, which in turn serves as the base for computing the fee it owes to the states. The LLC must determine an apportionment percentage to flow through the net business income to the nonresident members. The apportionment percentage will now be based on a single sales factor using market based sourcing for service income and income from intangibles.

Example:

Assume E, a limited liability company organized in California that is taxed as a partnership. The entity uses single-factor sales pursuant to Revenue and Taxation Code section 25128.5. For purposes of calculating the LLC fee, service income will be assigned to California based on the market-rules for sales contained in Revenue and Taxation Code section 25136, subdivision (b) or market based sourcing.

Many LLCs hold portfolio or investment assets (such as stocks and bonds) that are managed by members located in several states. In addition, many businesses operating as LLCs earn nonbusiness income that is not sourced under the sales factor rules. Sales for purposes of the sales factor means all gross receipts not allocated under Cal. Rev. & Tax. Code Sections 25123-25127. (Cal. Rev. & Tax. Code ' 25120(e)). In other words, only business income goes in the sales factor and is sourced under Cal. Rev. & Tax. Code Sections 25135 and 25136.

Nonbusiness income, such as interest and dividends (which comprise the bulk of the income for investment LLCs), is not addressed under these rules. Generally, nonbusiness interest and dividends for a multistate entity are allocated to the state of commercial domicile. (Cal. Rev. & Tax. Code ' 25126). Presumably this is the sourcing rule that best fits the LLC holding nonbusiness assets, but it raises another question regarding location of commercial domicile when there is no board of directors but, rather, a small group of managing members who may be located in several states. Cal. Rev. & Tax. Code Section 25120(b) defines commercial domicile as the principal place from which the trade or business of the taxpayer is directed or managed. The LLC managed by members may provide multiple commercial domiciles based on the location of its members.
Example.

XYZ LLC, organized in California, holds only investment securities through a brokerage firm located in Philadelphia. The investments are handled by managing members who live in multiple states (New York, California, Connecticut, and Florida). The income from the portfolio is $700,000. According to the Franchise Tax Board Limited Liability Company Tax Booklet, the managers' activities are personal services, and the total income from these services is split based on the time the managers spend performing their services for XYZ. Thus, if the manager in California contributes 35% of the total time spent on managing the portfolio, 35% of $700,000, or $245,000, would be includible for purposes of computing the fee. The location of the investment advisory firm is not taken into account because income-producing activity does not include activities performed on behalf of an LLC, such as those conducted by an independent contractor. In this case XYZ would not owe a fee to California because the total California-sourced gross receipts are less than $250,000.

Example.

ABC LLC owns an apartment complex in Nevada. The managing members are located in California and maintain a bank account in that state, which they use to deposit checks and pay bills for the apartment complex. They make decisions about major renovations and improvements from California and hire a local CPA to prepare the tax return. They employ a property management company in Nevada to take care of day-to-day maintenance and to manage the rental process of advertising available units and showing the property to prospective tenants. Although under recent administrative case law the level of activity conducted in California may have created nexus with the state, (In re Mockingbird Partners, SBE May 17, 2006) the rental income from the apartment building is sourced to Nevada and is not subject to the fee. Since the LLC may have nexus with California, the LLC owes the $800 minimum franchise tax.

The treatment of the interest on the California bank account is more uncertain because it relates to an income-producing activity located entirely outside California. Using that analysis, the interest on the bank account would be sourced outside California. However, the Franchise Tax Board could take the position that because the account and the managing member are state residents, the interest would be treated as California income and would be included in the base for purposes of computing the fee.

If the LLC conducts business within and outside California, the LLC must assign its total income, item by item, to California based on the rules described above. The LLC does not compute an apportionment percentage but rather sources each type of income and then determines the total California gross receipts. A Limited Liability Company Income Worksheet
Example.

ABC LLC is organized in California and sells computer software. ABC is located in San Jose, California, where it owns a building and has 50 employees. It has three managing members, two in California and one in Arizona. ABC sells various types of robots, which is generally sold with installation service and warranty contracts. This portion of the income is personal service income and will be sourced using market based sourcing. The robots are sold to customers located primarily on the West Coast.

ABC has nexus with California and Arizona and therefore sales to other states will throw back to California. The warranty contract covers any on-site maintenance that may be required for two years. The company also has an investment portfolio that is handled by the managing member in Arizona and generates interest and dividends that will be used in the trade or business. The investments are held in a brokerage account in Arizona. The broker is in Arizona and the trades are taken and placed in that state. In 2013, ABC sold its building in San Jose for a total sales price of $10 million (gain of $8 million). ABC's gross receipts sourced to California for purposes of computing the fee are calculated as follows:

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Total</th>
<th>California</th>
<th>Sourcing Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Robot Sales</td>
<td>$5,000,000</td>
<td>$1,000,000</td>
<td>Sourced based on where the customer is going to use the robot. Sale will be thrown back to California if the seller is not taxed in destination state.</td>
</tr>
<tr>
<td>Installation Fees</td>
<td>$200,000</td>
<td>$40,000</td>
<td>Sourced based on where the customer will be using the robot.</td>
</tr>
<tr>
<td>Warranty Service Fees</td>
<td>$400,000</td>
<td>$80,000</td>
<td>Sourced based on where the customer will get the benefit of the warranty service.</td>
</tr>
<tr>
<td>Interest and Dividends</td>
<td>$500,000</td>
<td>$0</td>
<td>Sourced based on where the managing member who manages the portfolio is located.</td>
</tr>
</tbody>
</table>
Gain on sale of Building

$8,000,000  $8,000,000  Sourced based on where the real property is located.

Total gross receipts subject to LLC fee:  $9,120,000

ABC's sales factor for purposes of the apportionment formula is 18% ($1,120,000 California receipts/$6,100,000 total receipts). The gain on the sale of the California building is omitted from the apportionment formula computation because it is distortive. This same income is included in the computation of gross receipts for purposes of computing the fee, and it is the net gain that is reportable. Total income subject to the fee based on gross receipts includes gross income as defined by Cal. Rev. & Tax. Code 24271, which in turn refers to Code 61. Cal. Code Regs. Section 1.61-6 states that gross income includes gain realized on the sale or exchange of property, which has been interpreted to mean that the net gain on sales is the amount included in the LLC fee computation.

(4)  Deductibility of Fee on the California Return

Until the litigation discussed above, the gross receipts fee was assessed as a fee (not a tax) under Cal. Rev. & Tax. Code Section 17942. Although Cal. Rev. & Tax. Code Section 17220 denies a deduction for all federal, state and local taxes on the California return, this fee was not a tax and therefore was deemed to be deductible on the California return as a trade or business expense. Since the fee has now been held to be an unconstitutional tax, it is entirely possible that the Franchise Tax Board will decide that the payment is no longer deductible on the California return. The Franchise Tax Board has not announced any change in policy on this matter.

For federal purposes, the payment (whether characterized as a tax or a fee) is deductible.

b)  S Corporations

An S election in California will not alleviate all corporate level taxes. California (and several other states) imposes a 1.5% tax on the S corporation's income (in addition to the tax imposed on the shareholders) whether or not the income is distributed. (Cal. Rev. & Tax. Code ' 23802(b). This compares to the franchise tax of 8.84% imposed on C corporations for years beginning on or after January 1, 1997. This aspect of California law compounds the complexity of electing S corporation status. Income must be computed under the corporate rules for purposes of assessing the 1.5% tax, and again under the rules as they pertain to individuals for purposes of computing the pass-through to the shareholders. California does not allow shareholders a deduction for this tax. (FTB Notice 89-129 (Mar. 22. 1989); Cal. Rev. & Tax. Code 17220.

Corporations doing business in California that elect California S corporation treatment are subject to the minimum franchise tax ($800). (Cal. Rev. & Tax. Code 23151.) Therefore, if the S corporation loses money it would still be required to pay the minimum $800 franchise tax to the state. This tax is nondeductible to the shareholders. Note that for years beginning on or after
January 1, 2000, the S corporation (along with the C corporation) will not be required to pay any minimum tax for its first year of operation if it operates at a loss. If the S corporation earns income, then it is required to pay 1.5% of the net income earned in California. (Cal. Rev. & Tax. Code 25153).

5. Delaware.

The franchise tax, which is computed based on the authorized number of shares outstanding or assumed capital value, is assessed on S Corporations. (Del. Code Ann. tit. 8 sec. 501). An annual franchise tax is imposed upon all corporations for the privilege of being incorporated in Delaware unless specifically exempted by law. (Del. Code Ann. tit. 8, Sec. 501) (Instructions, Form 1100, Delaware Corporate Income Tax Return). The rate of the Delaware franchise tax varies with the basis used to compute the tax.

**Authorized shares method.**—This table shows the Delaware franchise tax rate for effective for tax years as of January 1, 2014 computed using the authorized shares method. (Del. Code Ann. tit. 8, Sec. 503(a)(1))

<table>
<thead>
<tr>
<th>Authorized Number of Shares</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>5,000 shares or less</td>
<td>$175</td>
</tr>
<tr>
<td>5,001 - 10,000 shares</td>
<td>$250</td>
</tr>
<tr>
<td>10,000 or more shares</td>
<td>$250 plus $75 for each additional 10,000 shares or fractional shares</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assumed Capital Value</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$500,000 or less of assumed no-par capital</td>
<td>$175</td>
</tr>
<tr>
<td>$500,001 - $1,000,000 of assumed no-par capital</td>
<td>$250</td>
</tr>
<tr>
<td>$1,000,000 or more of assumed no-par capital</td>
<td>$250 plus $75 of each additional $1,000,000 or fraction of assumed no-par capital</td>
</tr>
</tbody>
</table>

The assumed no-par capital is determined by multiplying the number of authorized shares of capital stock without par value by $100. The tax multiplier is $350 on each $1,000,000, or fractional part, in excess of $1,000,000 of capital. If the assumed par value capital is less than $1,000,000, the tax is calculated by dividing the assumed par value capital by $1,000,000 then multiplying that result by $350. The tax liability of a corporation with both par value and no-par-value shares is the sum of each category.

Effective January 1, 2014, the minimum tax based on the authorized shares method of computing the tax is increased from $75 to $175. The minimum tax computed using the assumed capital value method remains at $350.
Partnerships and LLCs pay a $300 annual tax, but do not pay an entity level tax based on income or net worth or capital.

6. Idaho.

Idaho generally follows the federal income tax treatment of a pass-through entity and its owners for state tax purposes. Accordingly, a pass-through entity is generally treated as a reporting, but not a taxable, entity. Instead, the income of the entity is passed through to the underlying owners, and each individual owner is taxed on his or her distributive share. However, an income tax may be imposed at the entity level if certain conditions occur (i.e., a partnership's failure to fully distribute its income, an individual nonresident S corporation shareholder's failure to report his or her Idaho source income from the entity, etc.).

Idaho generally exempts an S corporation from state corporate income tax to the same extent that it is exempt under federal corporate income tax law (see IRC Sec. 1361—IRC Sec. 1379) because Idaho follows the provisions of the IRC. Idaho assesses a $20 minimum tax and a $10 additional tax unless all of the income is distributed and the S Corporation does not have any taxable income attributable to state sources. (Idaho Code Ann. '63-3025A.)

Partnerships, LLPs, and LLCs pay a $10 tax unless all income or loss is distributed or is otherwise reportable and the entity does not have any taxable income attributable to Idaho sources. If these entities have undistributed income, then it is taxed at the corporate tax rate of 7.6%. A single member LLC does not have to pay an entity level tax. (Idaho Code Ann. 63-3006B, 63-3083, 63-3006A.)

In completing its return, the partnership first computes its Idaho taxable income in much the same manner as an individual. It makes many of the same additions to, and subtractions from, federal adjusted gross income as do individuals, except for net operating losses, capital gains and losses, and any other modifications restricted to individuals (Idaho Admin. Rules 35.01.01.128(05); Form 65 Instructions.) The partnership also adds any Idaho compensation paid to nonresident partners but not reported by them. After determining its Idaho taxable income, the partnership then deducts the amounts that its partners reported on their individual returns. Any balance, which represents undistributed partnership income or unreported income of nonresident partners, is taxed at the 7.6% corporate income tax rate.

Effective retroactive to 1/1/13, Idaho legislation (H.B. 139, 3/15/13; L. 2013, ch. 83, amending Idaho Code §63-3026A(3)(a)(i)) limits to $250,000 in a calendar year the amount of guaranteed payments paid by a partnership doing business in Idaho that may be attributed to the state in which the partner performed the services. Amounts paid in excess of $250,000 per year are sourced to Idaho based upon the partnership’s Idaho apportionment factor. The $250,000 limit will be adjusted annually for inflation. This legislation also clarified that all guaranteed payments made to retired partners are sourced to the recipient partner’s state of domicile.

The personal property replacement income tax (which was enacted to replace the corporate personal property tax) is an additional income tax that is imposed on corporations, partnerships, S corporations, and limited liability companies (LLCs). The required additions and subtractions for replacement tax purposes are the same as the corporate income tax additions. (Ill. Admin. Code. Tit. 86, 100.9759; 805 Ill. Comp Stat. 215/0.01-215/1402, 206/100 – 206/1299, 805 Ill. Comp stat. 180/1-180/60-1.)

In General Information Letter No. IT 12-0032-GIL (Ill. Dept. of Revenue, 12/3/12), the Illinois Department of Revenue held that a taxpayer was not a qualified investment partnership because more than 10% of its income came from lottery winnings. The partnership was formed by a group of individuals to play the Illinois state lottery and to collect, invest, and distribute any lottery winnings and earnings on invested winnings. They paid income taxes on all winnings and investment income at the individual level.

The Illinois Income Tax Act provides that the term "partnership" does not include any group, joint venture, or other unincorporated organization "established for the sole purpose of playing the Illinois State Lottery." In addition, partnerships are not subject to regular Illinois income tax, but partnerships other than "investment partnerships" are subject to the so-called personal property tax replacement income tax. In this case, the Department said, since the entity does not merely collect and distribute Illinois lottery winnings, but invests those winnings, it is a partnership for purposes of the Illinois Income Tax Act. Further, the Department noted that since more than 10% of the partnership's income resulted not from qualifying investment securities but, rather, from lottery winnings, the partnership was not a qualified investment partnership. Since nothing in the Illinois Income Tax Act exempts from taxation lottery winnings or investment income received by a partnership, this partnership was subject to the Illinois personal property tax replacement income tax on all such income.

8. Kentucky

For tax years beginning after January 1, 2007, C corporations, S corporations, LLPs, LLCs, and other limited liability pass-through entities with over $3 million in Kentucky gross receipts pay a limited liability entity tax of $175.

If gross receipts or gross profits are $6 million or more, then the fee is the lesser of $.095 per $100 of gross receipts and $.75 per $100 gross profits. Taxpayers with gross receipts or gross profits over $3 million but less than $6 million may reduce the gross receipts or gross profits portion of the limited liability entity tax by an amount equal to $2,850, or $22,500 in the case of the gross profits computation, multiplied by a fraction, the numerator of which is $6 million minus the amount of gross receipts or gross profits for the taxable year, and the denominator of which is $3 million. (Ky. Rev. Stat. Ann. 141.010(24)(b), 141.010(26), 141.0401(2), 141.0401(2)(b)(1)(B), 141.0401(2)(b)(2)(b)).

General partnerships are not subject to this tax.
9. **Minnesota**

Corporations, S corporations, partnerships, and limited liability corporations must pay a minimum fee if the sum of Minnesota source property, payroll and sales or receipts is at least $930,000 ($500,000, prior to tax year 2013). C corporations must pay the fee in addition to the franchise tax and alternative minimum tax. Effective for tax years beginning after 2012, the Commissioner of Revenue must adjust the dollar amounts of both the tax and the property, payrolls, and sales or receipts thresholds for inflation. (Minn. Stats. 290.0922(1)(a)).

For tax year 2014, the minimum fee is imposed according to the following graduated schedule:

- Less than $950,000: $0
- $950,000 to $1,899,999: $190
- $1,900,000 to $9,499,999: $570
- $9,500,000 to $18,999,999: $1,900
- $19,000,000 to $37,989,999: $3,800
- $37,990,000 or more: $9,500

10. **New Hampshire**

New Hampshire does not recognize the federal income tax provisions relating to an S corporation (i.e., Code Sections 1361-1379), therefore a corporation that qualifies for and elects S corporation status for federal income tax purposes is treated the same for business profits and business enterprise tax purposes as a corporation that files as a regular C corporation for federal income tax purposes. Therefore, such a corporation is subject to the usual corporate-level taxes on the applicable taxable amounts. Pass-through treatment is inapplicable for state tax purposes. For state tax purposes, an S corporation must recompute its federal taxable income to show the amount that would have been shown on federal Form 1120 had the corporation been taxable at the entity level under federal law.

New Hampshire does not conform to the federal income tax provisions relating to a partnership (i.e., Code Sections 701-761). Although there is no entity-level tax on a partnership for federal income tax purposes, a partnership is subject to the entity-level taxes for business profits and business enterprise state tax purposes.


New Hampshire does not utilize the federal income tax provisions relating to partnerships, including limited partnerships and LLPs. Therefore, while limited partnerships and LLPs are not subject to a federal income tax at the entity level, they are subject to entity-level business taxes for state tax purposes. (N.H. Rev. Stat. Ann. "77-A:1(I), 301.14(b)(1)).

In New Hampshire, the tax classification of a limited liability company (LLC) as a corporation, partnership, or disregarded entity for business profits or business enterprise tax purposes follows the federal income tax classification. However, for state tax purposes, whether
an LLC is classified as either a corporation or a partnership, it remains subject to the usual business taxes at the entity level. For example, if an LLC files a partnership tax return for federal purposes, then the business profits tax would be applied as though the LLC were a partnership and its members were partners. (N. H. Rev. Stat. Ann. 77-A:1(XXIII)(a), Rev. 301.14(b)(1)).

Therefore, all business entities organized in New Hampshire pay the business profits tax and the business enterprise tax. The business profits tax rate is 8.5% of taxable business profits of business organizations, based on federal net income before net operating losses and special deductions, adjusted by state additions and deductions. A business organization with gross receipts of $50,000 or less is not required to file a business profits tax return.

For gross incomes over $150,000 or tax bases over $75,000, the business enterprise tax is imposed at the rate of 0.75% upon the taxable enterprise value tax base of every business enterprise subject to tax. The enterprise value tax base is defined as the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by the business enterprise, before consideration of adjustments required to be made to the value tax base. The tax is computed and reported on Form BET, Business Enterprise Tax Return for Corporations, Partnerships, Fiduciaries and Nonprofit Organizations. Businesses with business activity both inside and outside New Hampshire, must use Form BET-80, Business Enterprise Tax Apportionment, to compute the amount of compensation, interest, and dividends apportioned to New Hampshire for purposes of the business enterprise tax.

Chapter 77, N.H. Revised Statutes Annotated, also imposes a tax on the gross income from interest and dividends in excess of $2,400, of resident individuals, partnerships, limited liability companies, associations, and certain trusts and fiduciaries. The tax on incomes generally is referred to as the interest and dividends tax. Nonresident individuals are not taxed.

For taxable periods ending on or after December 31, 2010, however, as a member of a limited liability company with nontransferable shares, if the taxpayer receives distributions during those taxable periods, the taxpayer will not be required to file or pay the Interest and Dividends Tax with respect to those distributions. Under the new law, applicable to taxable periods ending on or after December 31, 2010, distributions from LLCs, partnerships, and associations will be subject to the interest and dividend tax only if they have transferable shares.

11. New York

An S corporation pays a fixed-dollar minimum tax based on New York receipts. Other than the fee based on gross receipts, there is no other entity level tax measured by income or net worth/capital imposed by New York on S Corporations. (N. Y. Tax Law 210(1)(g), TSB-M-03(5)(c).

New York receipts
not more than $100,000 $25
$100,001 to $250,000 $50
$250,001 to $500,000 $175
Partnerships pay a fee based on prior years' gross income attributable to state sources as follows: (N.Y. Tax Law "601(f), 658(c)(3).

New York Receipts

- $500,001 to $1,000,000: $300
- $1,000,01 to $5,000,000: $1,000
- $5,000,01 to $25,000,000: $3,000
- over $25,000,000: $4,500

LLCs and LLPs pay a fee based on prior years' gross income attributable to state sources as follows: (N.Y. Tax Law "601(f), 658 (c), Publication 16.)

New York Receipts

- $1,000,000: $500
- $1,000,01 to $5,000,000: $1,500
- $5,000,01 to $25,000,000: $3,000
- $25,000,01: $4,500

SMLLCs pay a $25 minimum fee for tax years beginning after 2007. (N.Y. Tax Law "601(f), 658 (c), Publication 16).

Ohio

Beginning with the tax period that commenced July 1, 2005, Ohio levies a commercial activity tax (CAT) on each person with taxable gross receipts for the privilege of doing business in the state. For purposes of this tax, “doing business” means engaging in any activity, whether legal or illegal, that is conducted for, or results in, gain, profit, or income, at any time during the calendar year.

The CAT applies to all types of businesses; therefore S corporations, LLCs, LLPs, partnerships, QSSS, and SMLLCs pay the commercial activity tax (CAT). (Ohio Rev. Code Ann. "5733.04(O), 5733.41, 5751.01(A), 5751.03(B)).
Ohio adopts the MTC bright line test to determine if a taxpayer is “doing business” in Ohio. A person has bright-line presence in Ohio for a reporting period and for the remaining portion of the calendar year if any of the following applies. The person (Ohio Rev. Code Ann. ’5751.01(I).

- has at any time during the calendar year property in Ohio with an aggregate value of at least $50,000;
- has during the calendar year payroll in Ohio of at least $50,000;
- has during the calendar year taxable gross receipts of at least $500,000;
- has at any time during the calendar year within Ohio at least 25% of the person's total property, total payroll, or total gross receipts; or
- is domiciled in Ohio as an individual or for corporate, commercial, or other business purposes.

The Commercial activity tax (CAT) on gross receipts is computed as follows. Gross receipts above $1 million are subject to the commercial activity tax (CAT) at a rate of 0.26%. (Ohio R. C. sec. 5751.03)

Applicable to tax periods beginning on or after January 1, 2014, the tax on the first $1 million in taxable gross receipts each calendar year is calculated as follows: (1) For taxpayers with annual taxable gross receipts of $1 million or less for the calendar year, the annual minimum tax is $150; (2) For taxpayers with annual taxable gross receipts greater than $1 million, but less than or equal to $2 million for the calendar year, the annual minimum tax is $800; (3) For taxpayers with annual taxable gross receipts greater than $2 million, but less than or equal to $4 million for the calendar year, the annual minimum tax is $2,100; (4) For taxpayers with annual taxable gross receipts greater than $4 million for the calendar year, the annual minimum tax is $2,600.

13. Rhode Island.

Rhode Island imposes a $500 minimum tax on LLCs and limited partnerships.

The S Corporation pays the greater of the franchise tax imposed at a rate of $2.50 per $10,000 of authorized capital or the $500 minimum tax.

14. Tennessee

S corporations are subject to the 6.5% excise tax imposed on net earnings (as well as the franchise tax, equal to the greater of 25¢ for each $100 of net worth or actual value of tangible property, but no less than $100) in the same manner as other corporations without regard to the special provisions of IRC Secs. 1361—1379. (Sec. 67-4-2004(27), T.C.A; Sec. 67-4-2007, T.C.A.; Sec. 67-4-2105, T.C.A; Sec. 67-4-2106, T.C.A; Sec. 67-4-2119, T.C.A.).

Unlike federal tax treatment, for an S corporation subject to the Tennessee excise tax, net operating losses (NOLs) are not passed through to shareholders. Instead, the entity itself may
take the NOL deduction. If a taxpayer does receive a loss passed through from an S corporation subject to the excise tax, the loss amount must be added back by the taxpayer.

LLCs, LLPs and SMLLCs are subject to the excise tax imposed at the rate of 6.5%. These entities are also subject to the franchise tax equal to $.025 for each $100 of net worth or actual value of tangible property whichever is greater, but no less than $100.

These entities and partnerships are also subject to the “Hall income tax,” which is a tax on interest and dividend income that exceeds $1,250, (Tenn. Code Ann. 67-4-2004(27), 67-4-2007, 67-4-2105, 67-4-2106, 67-4-2119; Tenn. Comp R. & Regs. 1320-6-1-.19(1). There is a credit allowed against the excise tax with respect to the amount of the Hall income tax paid. (Sec. 67-2-102, T.C.A) Under the Tennessee Hall income tax on dividend and interest income, with respect to investment income from LLCs, if an LLC is treated as a corporation for federal income tax purposes, any distribution received by, or accrued or credited to, an owner is taxable as a dividend.

15. Texas.

For tax returns due after 2007, Texas imposes a margin tax on all entities whose owners enjoy the privilege of limited liability. The margin tax is directly imposed not only on corporations (including S corporations), but also on LLCs, limited partnerships, limited liability partnerships, professional associations, and business trusts.

The exemption from the revised franchise tax increased from business with total revenues less than or equal to $300,000 to less than or equal to $1 million beginning with tax year 2010 and was set at $1,030,000 for the years 2012 through 2013, and $1,080,000 for reports due on or after January 1, 2014 and before January 1, 2016, as adjusted for inflation (as required by Tax Code Sec. 171.006(b).

IV. Unitary Method and Corporate Partners.

Corporate partners in a partnership face unique challenges in reporting their share of the pass-through entities taxable income on their state tax returns. Corporate partners must determine what portion of their business income that flows through from the partnership is reportable to the state. This is either done through separate accounting, which means that the apportionment is done at the entity level, or at the partner level. If done at the partner level, then the corporate partner aggregates the partnership income or loss with the corporation’s other business income or loss. States take different approaches in identifying the share of the pass-through entity income or loss that is picked up by the corporate partner and apportioned to the states.

A. Passthrough Approach.

The first approach requires that a corporate partner include their share of the apportioned income or loss from the pass-through entity (using the pass-through entities apportionment
formula) with its own post-apportionment income/loss to the state. Both Arkansas and Louisiana take this approach. (Ark. Corp. Inc. Tax Regs. section 1.26-51-802(b); La. Stat. Ann. section 47:287.93(A)(5)). In Arkansas, any taxpayer with an interest in a partnership, which has gross income from sources within Arkansas, must directly allocate the partnership's Arkansas income to Arkansas, rather than include partnership income and apportionment factors in the taxpayer’s apportionment formula.

Example:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership Total Income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Partnership Income Directly Allocated to Arkansas</td>
<td>$50,000</td>
</tr>
<tr>
<td>Corp. A’s Ownership</td>
<td>10%</td>
</tr>
<tr>
<td>Corp. B’s Ownership</td>
<td>90%</td>
</tr>
<tr>
<td>Corp. A ($50,000 x .10)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Corp. B ($50,000 x .90)</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

Under a second method, the corporate partner includes only its share of the income or loss of the pass-through entity as apportioned by the entity, but does not include its share of the property, payroll or sales of the pass-through entity in the computation of the apportionment percentage that applies to the combined income.

This approach has been challenged and struck down as unconstitutional by at least one court in *Homart Development Co. v. John H. Norberg* (529 A.2d 115, July 9, 1987) a decision of the Rhode Island Supreme Court. The case involved a Delaware corporation that included distributive share income from out-of-state partnerships in net income and also included a proportionate share of the payroll, property, and receipts of the partnerships in the apportionment formula calculation. The taxpayer's only activity in Rhode Island was the ownership and operation of part of a shopping mall in the state. The partnerships in which the taxpayer had an interest conducted all of their business activity outside Rhode Island. Since an application of the apportionment formula including distributive share income from the partnerships, but excluding their apportionment factors, would result in a “manifestly inherent distortion” of the taxpayer's business activity in Rhode Island, the statutory apportionment formula was challenged. The taxpayer argued that the State’s apportionment statute (General Laws 1956 (1970 Reenactment) §44-11-14, as amended by P.L. 1975, ch. 188, art. 1) may be properly interpreted to include the partner's proportionate interests in the partnerships' payroll, property, and receipt factors in the “taxpayer's” apportionment formula. This methodology is consistent with the “aggregate” theory of partnership taxation. In the alternative, the taxpayer argues that failure to include the partnership factors provides an unconstitutional result of inequitable apportionment (or taxing income earned entirely outside the state).

The third methodology requires a corporate partner to include its share of the income or loss and apportionment factors for each pass-through entity in which it invests with its own income or loss and apportionment factors to compute a combined income or loss that is apportioned using the combined apportionment factors. This is the methodology used by California and Illinois, but these states only require this approach if the taxpayers are unitary. (18 Cal. Code Regs. sec. 25137-1(f); 86 Ill. Admin. Code section 100.3380(d)).
Application of this methodology, where the corporate partner and the partnership are not unitary has been successfully challenged by taxpayers as unconstitutional as it results in an apportionment formula that does not represent the economic activities in the state. In Movie Service Functions, Inc, (New York Division of Tax Appeals, (File No. 801472, May 5, 1988) an Illinois-based corporation was entitled to an adjustment of its business allocation percentage because the apportionment percentage did not accurately reflect the taxpayer’s business activity in New York. The corporation held a 90% interest in a New York metal trading business, but primarily received income from motion pictures it had produced outside New York before acquiring the New York business. Because the motion picture production and metals trading operations did not constitute a unitary business, the statutory formula did not accurately reflect the taxpayer's business activity in New York. The Court held that the State Tax Commission's failure to adjust the corporation's business allocation percentage constituted an abuse of discretion.

B. Classifying Passthrough Receipts.

If the state requires the corporate partners to include their share of the net income of the partnership and apportionment factors, then the question arises regarding whether the gross receipts from the partnership are from the sale of tangible property or from an intangible (i.e., the partnership interest). A further question arises regarding any special characterization that applies at the partnership level. Does the special characterization flow through to the corporate partner from the partnership? The states do not reach the same conclusion in response to this question.

a) Michigan.

For example, Michigan recently addressed the issue of the application of Public Law 86-272 in the flow through entity context. (Revenue Administrative Bulletin 2014-5, Michigan Department of Treasury, January 29, 2014). RAB 2014-5 defines “doing business” in the state and discusses the application of Public Law 86-272 under the corporate net income tax. PL 86-272 restricts a state from imposing a net income tax on income derived within its borders from interstate commerce if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property, which orders are to be sent outside the state for acceptance or rejection, and, if accepted, are filled by shipment or delivery from a point outside the state. The distributive share income of a corporation that has nexus with Michigan that is attributable to (or derived from) its ownership in a flow-through entity whose activities are otherwise protected by PL 86-272 is not itself protected by PL 86-272 and is not excluded from the corporation's corporate income tax base. According to the state, the application of PL 86-272 is not triggered by the receipt of income from interstate commerce, but by the absence of certain contact by the taxpayer with the taxing state. In other words, PL 86-272 does not exempt from the corporate income tax the distributive income from a flow-through entity protected by PL 86-272 to its corporate owners; it only prevents a state from exercising its taxing jurisdiction over the business entity engaged in the protected activities, i.e., the flow-through entity. The distributive share income of a corporate owner that is itself not protected by PL 86-272 is not exempt from the corporate income tax merely because it flows from an entity otherwise protected by PL 86-272.
New York has taken a different view on the flow through of partnership attributes to the corporate partner. In New York Advisory Opinion TSB-A-13(11)C (2013), the New York Department of Taxation and Finance held that the owner of a single member LLC could use a special sourcing methodology called the production credit method of allocation found in Tax Law sec. 210.3(a)(9)(A)(iii). In order to use the production credit method of allocation for income from principal transactions, the taxpayer must be a “registered securities or commodities broker or dealer.” (Tax Law sec. 210.3(a)(9)(A)). A registered securities or commodities broker or dealer is a broker or dealer who is registered by the Securities and Exchange Commission or the Commodities Futures Trading Commission. In this case, the taxpayer itself is not registered with either of those commissions. However, several of the SMLLCs that are either owned directly or owned indirectly through a partnership are registered with the Securities and Exchange Commission. The opinion concludes that the taxpayer, either directly through its ownership interest in various single-member limited liability companies (SMLLCs) that were registered broker-dealers prior to January 2005, or through its partnership interest in a partnership that in turn owned SMLLCs that were registered broker-dealers after December 31, 2004, is viewed as a principal in the transactions for purposes of Tax Law sec. 210.3(a)(9)(A)(iii). Therefore, the advisory opinion held that the taxpayer would be deemed to be a registered broker-dealer and may use the production credit method to source gross income from principal transactions when the gross income is passed to it directly as the single member of the SMLLCs in question or indirectly from the SMLLCs owned by the partnership in which the taxpayer is a partner.

California has adopted regulations that describe how the unitary corporate partner and the partnership compute their California taxable income. (18 CCR sec. 25137-1). The FTB’s position is that a corporate general partner is doing business in California to the extent that a partnership in which it owns an interest is doing business here. Therefore, the corporate general partner has a California filing obligation and is subject to the minimum franchise tax ($800).

To the extent the income from the partnership is business income, the next step is to determine whether the corporate partner and the partnership are engaged in a single unitary business. The determination is important because if a unitary relationship exists, then the corporate partner's share of the partnership income is normally combined and apportioned with its other income from the unitary business. If unity is not present, then the partnership income is either allocated specifically by situs or apportioned separately from the corporate partner's other business.

Most states, including California, apply the normal standards (i.e., the three unities test) in establishing whether or not a unitary business exists. It is clear that this is the test to apply for corporate partners, but not so clear where the first tier partner is itself a partnership with second or third tier corporate partners. Without specific guidance, it seems most logical to apply unitary
principles to partnerships that are partners in the same manner as corporate partners. This result is reached by the general principle mandated by the unitary method, which disregards the legal form of business operation. Therefore, comparable treatment should be the result if the state's law requires use of the same apportionment and allocation rules that corporation's use.

Under the three unities test, a business is unitary if there is unity of ownership, unity of operations, and unity of use. (Butler Bros. v. McCollan, 17 Cal. 2d 664, 111 P2d 334 (1941), aff'd, 315 U.S. 501 (1942)). The most difficult of the three requirements as applied to the corporate partner is the unity of ownership tests.

Unity of ownership generally means direct or indirect ownership or control of more than 50% of the voting stock of a taxpayer. Most states, including California, hold that a corporate partner and a partnership will be treated as unitary if their respective activities satisfy the normal standards for establishing a unitary business, other than the unity of ownership requirements. (18 CCR sec. 25137-1) In other words, if a corporate partner owns less than 50% of a partnership and that partnership's business is the same as the corporation's and otherwise meets the unity of use and operations tests, then the partnership and the corporation will be considered to be unitary with one another even though the ownership is less than 50%. Under this rule any ownership interest could qualify.

Under the regulation that allows a corporate partner and the partnership to be unitary regardless of the level of ownership, a question arises regarding the applicability of the unitary concept to corporate limited partners, who by definition under state law cannot be involved in the management of the partnership. The SBE has stated in prior opinions that it would be extremely difficult to overcome the inherent passive investment nature of a limited partnership interest. (See for example the Appeal of Gasco Gasoline 88-SBE-017 (June 1, 1988)). Therefore it is doubtful that a corporate taxpayer with a limited partnership interest would ever be unitary with the partnership.

Tiered structures also present difficult situations. These situations typically involve corporate partners in a partnership that in turn owns an interest in another corporation. The question presented is whether a corporate partner of the partnership can qualify as unitary with the corporation owned by the partnership. In this case the corporate partner must meet the unity of ownership test (i.e., more than 50% ownership) but may apply principles of indirect ownership, which allow the corporate partner to aggregate the partnership's ownership with its own to achieve the necessary ownership requirement. The FTB has issued a legal ruling dealing extensively with this and related issues. (FTB Leg. Rul. 91-1 (Nov. 12, 1991)). The determination of ownership by a corporate partner in a partnership has now been codified in the statute. (Cal. Rev. & Tax. sec. 25105).

A partner is treated as the only entity in control of stock of a corporation to the exclusion of the other partners if the partnership agreement provides that the partner has the power to vote the stock on behalf of the partnership and the stock controlled aggregates to more than 50% ownership.
Unless the partnership agreement provides otherwise, a single general partner in a general partnership is considered to have control of the voting stock held by the partnership to the extent that such partners would receive such stock on dissolution of the partnership. This stock must be aggregated with any stock held or controlled by the general partner in his or her own individual right in order to determine whether the more than 50% rule is met.

The logic behind the above two rules is that in the event of a dispute among partners with respect to voting stock held by the partnership, the general partners can normally force a dissolution of a general partnership. (Cal. Corp Code sec.16801). In the event of dissolution after satisfaction of liabilities, partnership property may be sold and the proceeds distributed, or the property may be distributed in kind to the former partners. Generally a distribution in kind is favored over a sale and distribution of proceeds of sale if the property is readily divisible. Shares of stock are ordinarily readily divisible among the partners, by simple distribution of a proportionate number of shares, which makes such division likely in an action in dissolution of a partnership. Consequently, unless the partnership agreement provides to the contrary, the partners in a general partnership will be considered as controlling the stock held by a partnership in proportion to their interests in the partnership.

Unless the partnership agreement provides otherwise, two or more general partners in a limited partnership are not considered to control voting stock held by the limited partnership, and any stock they may own as individuals is not aggregated with the stock owned by the limited partnership. The general partners are not treated as controlling the stock held by the limited partnership, because the general partners have no right to force dissolution in the event of a dispute (as they do for a general partnership). (Cal. Corp. Code sec. 15908). Therefore, they have no indirect right to ownership and control of the stock.

If the partnership agreement permits a general partner in a limited partnership to exercise voting power over some or all of the voting stock held by the partnership, then the general partner will be considered to control such stock. In addition, if there is only a single general partner in a limited partnership, then that partner will be considered as controlling all of the voting stock held by the partnership. Stock held directly by a single general partner is aggregated with the stock controlled by such general partner through a limited partnership under these provisions in order to determine whether or not the more than 50% test is met.

Limited partners are not considered to either own or control voting stock held by the partnership, because they do not own the stock directly, cannot exercise voting rights with respect to the stock, cannot unilaterally force dissolution of the limited partnership and would not receive such stock in the event of dissolution.

Example.

ABC Corp owns directly 10% of the stock of DEF, a corporation engaged in the same business as ABC and otherwise meeting the unity of use and operations tests required to file under the unitary method. Assume that each of the following situations are independent of each other:
1. ABC Corp is a 30% general partner in P Partnership. P owns directly 60% of DEF. The partnership agreement provides that ABC has the power to vote all of the stock on behalf of the partnership. ABC will be deemed the owner of 60% of the stock through P and 10% of the stock directly. Therefore, ABC owns more than 50% of the stock.

2. ABC Corp is a 30% general partner in P Partnership but has no special voting rights with respect to the DEF stock. ABC will be deemed to own 18% of DEF and 10% of the stock directly which is not enough to qualify to file a combined report under the unitary method.

3. ABC Corp is the only general partner in L, a limited partnership. ABC owns 30% of L, which in turn owns 60% of DEF Corp. As the only general partner, ABC is deemed to own the stock owned by L, and therefore owns 70% of DEF.

4. ABC Corp is a limited partner in L limited partnership. L owns 60% of DEF Corp. ABC is not deemed to own any percentage of DEF though L.

A partnership that owns more than 50% of the voting stock of two or more corporations is generally treated as a concerted group of its partners in determining whether unity of ownership of the two corporations exists. This means that the ownership of all of the partners will be aggregated in order to determine if the more than 50% test is met. This rule does not apply if a partner can exercise control of the voting stock without regard to the other partners.

Example.

P, a general partnership, owns more than 50% of the voting stock of ABC Corp and DEF Corp. P has five partners, each of whom has a 20% interest in P. Unless P's partnership agreement provides otherwise, these five partners are considered to be a concerted group with respect to the stock of both ABC and DEF. If the other two requirements of the unitary method were met, then ABC and DEF would file as a unitary group.

If a corporation has an interest of more than 50% in a general partnership and the partnership agreement does not assign voting power to another partner (as described above), unity of ownership exists between the corporate partners and the corporation whose stock is held by the partnership.

Example.

P is a general partnership that owns more than 50% of the stock of ABC Corp. DEF Corp owns 75% of P. Unless the partnership agreement states to the
contrary, DEF will be deemed to own more than 50% of ABC. If the other unitary tests are met, the two corporations will form a unitary group.

In the above example, this would not be the case if DEF owned less than 50% of P, even if the remaining interest of the partnership were owned by another corporation. Under these rules there is opportunity for tax planning. Taxpayers have flexibility to select whether they wish to report on a combined or separate basis the activities that they intend to operate in joint venture form with a 50% partner.

Example.

The Los Francisco Faultlines Inc. (a professional indoor football team) is planning to undertake a business venture in conjunction with the Kansas City Indians Inc. The business venture otherwise qualifies as a unitary business with Los Francisco and is expected to operate at a loss in the first few years of operation. Los Francisco should initially organize the joint venture as a partnership so that the losses will flow through and be combined with their own income/loss to determine their apportionable income. Once the venture becomes profitable, the partnership should incorporate so that each corporate partner would be deemed to own a 50% share of the business venture and would therefore not meet the ownership requirement necessary to file as a unitary group. If the business venture operated in a state with little or no state tax, then the operation would escape entirely from the burden of state taxation.

If it is determined that the corporate partner and the partnership are unitary, then the partner includes its distributive share of the income and apportionment factors of the partnership with the income and factors from its other unitary activities.

Although the only apportionment formula allowed in 2013 is a single sales factor, the following discussion is retained in the materials in the event of the necessity to file an amended return for years where the three factor formula was used for apportionment purposes.

The property factor is calculated by adding the taxpayer's share of the partnership property to its own property. The value of property that is leased or rented to the partnership by the taxpayer or vice versa is eliminated to the extent of the taxpayer's interest. (18 CCR sec. 25137-1(f)(1)(A). The payroll factor is calculated by adding the taxpayer's share of the partnership payroll to the taxpayer's own payroll.(18 CCR sec. 25137-1(f)(2)). The sales factor must include the taxpayer's share of the partnership's sales. Intercompany sales between the partnership and the taxpayer are eliminated. (18 CCR sec. 25137-1(f)).

Example.

ABC Corp's interest in P Partnership is 20%. ABC is unitary with P and ABC's business income is $1 million. P's business income is $800,000. Therefore, the
unitary income to be apportioned to the states by ABC is $1,160,000 ($1,000,000 + (.20 x $800,000)).

ABC Corp owns property that originally cost $500,000, including a building (original cost $100,000) rented to P for $12,000 per year. P owns property originally costing $400,000. ABC's property factor does not include the value of the rental to P because ABC already includes 100% of the cost of the building in its property factor. ABC also includes $80,000 ($400,000 x .20) of P's property in its property factor. One half of P's property and ABC's property are located in California. Therefore, the property fraction is computed as follows:

\[
\frac{($250,000 + $40,000)}{($500,000 + $80,000)} = 50\%
\]

ABC's own payroll is $1 million, and P's payroll is $800,000. (ABC's share of P payroll is $160,000 ($800,000 x .20)). One fourth of both payrolls is located in California. ABC's payroll factor is computed as follows:

\[
\frac{($250,000 + $40,000)}{($1,000,000 + $160,000)} = 25\%
\]

ABC's sales are $20 million for the year, $5 million of which are made to P. P makes sales of $10 million during the same year, none of which are made to ABC. One third of all sales are made in California.

ABC sales

\[\text{ABC sales} \quad $20,000,000\]

ABC's interest in

\[\text{P Sales (20% x $10,000,000)} \quad $2,000,000\]

Minus:

\[\text{ABC's interest in its sales to P} \quad 1,000,000\]

\[\frac{($5,000,000 x .20)}{1,000,000} = 1,000,000 \quad 1,000,000\]

The denominator of ABC's sales factor

\[\text{The denominator of ABC's sales factor} \quad $21,000,000\]

\[\frac{($6,666,667 + $333,334)}{21,000,000} = .33\]

The income apportioned to California is determined as follows:

\[
\begin{array}{c|c}
\hline
\text{Property} & 50 \\
\text{Payroll} & 25 \\
\text{Sales} & 33 \\
\text{Sales} & 33 \\
\text{Total} & 141 \\
\hline
\end{array}
\]

\[141/4 = 35\%\]

\[35\% \times $1,160,000 = $406,000.\]

The inclusion of the partner's share of the partnership's factors raises additional questions. A common issue is how to determine the partner's "share" of those factors. If the partner gets a
fixed percentage, then that is the percentage to use for this purpose. The much more difficult situation is where the partner gets a fluctuating percentage or receives a different percentage of different items of income/expense.

Example.

Partner A will receive 85% of the profits for the first 10 years or until he recovers his capital contribution. At that point he will receive 25% of the profits. Most states (including California) do not provide guidance in this situation. A logical approach would be to use the percentage share of income earned during the year. This is the approach taken by at least one other jurisdiction. (N.Y. Comp. Codes R. & Regs. tit. 20, 4-6.5).

(1) Unity of Ownership of Individual Partners

Regulation 17951-4 provides specific guidance on how to combine income from multiple flow-through entities and/or sole proprietorships that constitute a unitary business. In the view of the FTB, these regulations serve to clarify existing procedures, and do not create new or different reporting requirements. These regulations apply to tax years beginning on or after January 1, 2001.

The regulation states in general that if a business, trade or profession is carried on within the state and is an integral part of a unitary business carried on both within and without the state, the amount of such income that has its source in the state is determined in accordance with the Uniform Division of Income for Tax Purposes Act (Cal. Rev. & Tax. Code sec. 25120 to 25139). (18 CCR sec. 17951-4(c)). In other words, the complex analysis required to determine if a business is unitary with another, and the even more complex requirements of combined reporting are applicable to an individual taxpayer just like they are to a corporation. With the increasing use of flow-through entities that provide significant tax savings, it was probably only a matter of time before the FTB decided to focus on 18 CCR sec. 17951-4. The following case serves to illustrate the result:

Example.

Ollie, who has recently relocated to Colorado, owns 95% of an LLC that owns and operates three shopping malls. Each of the shopping malls is located in a different state, one each in Colorado, Idaho and California. The shopping malls in Colorado and Idaho make money, but the shopping mall in California loses money. With this organizational form, Ollie ends up apportioning the business income generated by the three shopping malls to California even though his activity in the state generates a loss. In 2010, Ollie decides to organize a separate LLC in California that will own the shopping mall located there, the thought being that the loss activity is now separated from the profitable business and that no income will now be reportable to California (Note that the LLC will owe the state the minimum franchise tax of $800 plus the fee based on gross receipts).
Although 18 CCR sec. 17951-4(c) in its current form would require that Ollie combine the business income of the unitary businesses, this concept in the past has been largely ignored and not followed. Ollie will now be required to combine and apportion the income from the two LLCs just as he did in the past when the activity was reported together in a single LLC.

Although the primary impact of these regulations is on nonresidents, residents will likewise be affected.

Example.

Assume Ollie in the above example is a California resident. Although he is required to report 100% of his share of the flow-through income from the LLCs on his California return, he is eligible for a credit for taxes paid to Colorado and Idaho, but only if California law sources the income to those states. If California requires a combination at the taxpayer level, coupled with apportionment of the net income derived from the three shopping malls, then the income apportioned to the other states will be less and the credit for taxes paid to other states reduced accordingly. (18 CCR sec. 18001-2(c)).

The result in the above examples (technically) is not new. What is new is the ownership percentage that is required before the income of multiple flow-through entities must be combined. The regulation states that if a partner owns less than a 20% capital and profits interest in various partnerships, the partner will not be required to combine the results unless the FTB determines that reporting on a separate entity basis does not clearly reflect income. (18 CCR sec. 17951-4(d)(4)).

If the partner has a 20% or greater capital and profits interest in the partnership then the flow-through business income must be combined at the partner level if the activities are unitary. What is combined is the partner's portion of the income/loss. The apportionment factor is also computed on a combined basis using the partner's proportionate share of the property, payroll and sales of each of the unitary activities. The regulation makes clear that this treatment will apply to sole proprietorships, partnerships and S corporations. (18 CCR sec. 17951-4(d)(5)(A)). Presumably the term “partnership” also includes LLCs and LLPs, but these entities are not specifically referenced in the regulation.

The ownership requirement is key to the determination of unity, and therefore both direct and indirect ownership must be considered. Indirect ownership is defined to include an interest in a partnership that is owned directly or indirectly by a corporation, partnership, estate or trust. Such ownership will be deemed to be owned proportionately by the shareholders, partners or beneficiaries. An individual will also be deemed to own a partnership interest owned by his family. Family is defined to include brothers, sisters, spouse, ancestors and lineal descendants. The regulation also makes clear that attribution of ownership only applies for purposes of determining the 20% capital/profits interest. It does not apply for purposes of determining the income flow-through to the partner. A different rule is applied to determine the ownership
interest in an S corporation. For this purpose the regulations reference the attribution rules set forth in IRC sec. 267(c).

Example.

Ollie is engaged in a sole proprietorship with business income of $100,000. In addition, Ollie directly owns a 15% capital interest in Partnership P. Ollie's sister Lily also owns a 10% capital interest in Partnership P. Ollie's distributive share of business income from Partnership P is $30,000 and Lily's distributive share of business income from Partnership P is $20,000. Partnership P and Ollie's sole proprietorship are engaged in a unitary business and Ollie is actively involved in the operation of both. Since Ollie is treated as constructively owning Lily's interest in the partnership, Ollie is deemed to own 25% of partnership P. Ollie is subject to combination and apportionment, but Ollie will only have to combine his $100,000 proprietorship income and his actual distributive share of business income from the partnership ($30,000). The constructive ownership rules do not affect the actual income that flows through and is reported by Ollie.

Special rules applicable to computation of the payroll factor for entities that offer professional services are also applicable to partnerships and sole proprietorships. These provisions recharacterize 60% of the net income of a sole proprietorship or the distributive share of a partnership as compensation paid to an employee for purposes of the payroll factor only. This provision presumably applies to LLCs and LLPs, but does not apply to S corporations. (18 CCR sec. 17951-4(e).

No special guidance is offered for computation of the property and sales factor other than guidance generally made applicable and described in Cal. Rev. & Tax. Code sec. 25120-25139 (the rules and regulations that govern the application of the UDITPA rules to unitary corporations). Within this general framework, the rules that are most directly applicable are found in 18 CCR sec. 25137-1, the procedures set forth for filing a combined report when a corporate partner is found to be unitary with a partnership.

If the entity's activities and the taxpayer's activities constitute a unitary business under established standards, the business income is apportioned using the three-factor formula consisting of property, payroll, and sales (weighted twice) of the taxpayer and its share of the entity's factors for any year ending within or with the taxpayer's income year. See the above discussion related to a partnership and its unitary corporate partner.

There is no separate guidance in the regulations regarding four difficult areas of combined reporting, specifically:

- NOLs,
- capital loss carryforwards,
- application of tax credits to the combined liability of the group, and
- treatment of intercompany transactions.
Example.

Assume that Ollie's sole proprietorship, the partnership P, and the S corporation B are all unitary. Ollie has been reporting the income of each entity separately on his Form 540 (Individual Income Tax Return for California). Assume that the sole proprietorship has been reporting net operating losses and the partnership and S corporation are both profitable. In prior years, the losses of the sole proprietorship have generated net operating loss (NOL) carry forwards, which Ollie carries into the current year. In the current year, Ollie complies with these new regulations and combines the three businesses. Overall, the unitary business generates a profit and Ollie would like to offset the carryforward NOL against the profit of the combined business. If Ollie is required to apply the general guidelines of UDITPA, the NOL of the sole proprietorship would not be able to offset the income apportioned to the other members of the group, but could offset the income apportioned to the sole proprietorship.

C. Michigan.

Effective January 1, 2012, Michigan imposes a corporate income tax (CIT) on taxpayers that are required to or have elected to file as C corporations with business activity within Michigan or ownership interest or beneficial interest in a flow-through entity that has business activity in Michigan. (Mich. Comp. Laws Ann. sec. 206.623(1); sec. 206.611(5); 206.605(1)). Therefore, partnerships and limited liability companies treated as a partnership are not generally subject to the CIT. However, corporate partners of a partnership or C corporations that are members of a flow-through entity with business activity in Michigan are subject to the CIT.

For a taxpayer that has a direct, or indirect through one or more other flow-through entities, ownership interest or beneficial interest in a flow-through entity, the taxpayer's business income that is directly attributable to the business activity of the flow-through entity must be apportioned to Michigan using a single sales-factor apportionment formula based on the business activity of the flow-through entity unless the flow-through entity is unitary with the taxpayer for apportionment purposes as provided under Mich. Comp. Laws Ann. sec. 206.663 and sec. 206.661(2). If they are unitary, then the apportionment of the flow through entity and the apportionment factors of the corporate entity will be combined to determine the combined apportionment factor for the entity.

The numerator of a taxpayer must include its proportionate share of the total sales in Michigan of a flow-through entity that is unitary with the taxpayer. The denominator of a taxpayer must include its proportionate share of the total sales everywhere of a flow-through entity that is unitary with the taxpayer. A flow-through entity is unitary with a taxpayer when that taxpayer owns or controls, directly or indirectly, more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of the flow-through entity, and that has business activities or operations which result in a flow of value between the taxpayer and the flow-through entity, or between the flow-through entity and another flow-through entity unitary with the taxpayer, or has
business activities or operations that are integrated with, are dependent upon, or contribute to each other. (Mich. Comp. Laws Ann. sec. 206.663(1).

For a taxpayer that is a unitary business group, sales include sales in Michigan of every person included in the unitary business group without regard to whether the person has nexus in Michigan. Sales between persons included in a unitary business group must be eliminated in calculating the sales factor. Effective retroactive to tax years beginning after December 31, 2011, sales between a taxpayer and a flow-through entity unitary with that taxpayer must, to the extent of the taxpayer's interest in the flow-through entity, be eliminated in calculating the sales factor. (Mich. Comp. Laws Ann. sec. 206.663(2)).

Both residents and nonresident individuals of Michigan are subject to Michigan income tax on their share of income from partnerships to the extent the income is attributable to Michigan under the allocation and apportionment provisions (Mich. Comp. Laws Ann. sec. 206.111 through Mich. Comp. Laws sec. 206.115) and must be included in adjusted gross income on the partner's federal income tax return.

In a unanimous decision, the Michigan Supreme Court upheld the taxpayers' position in Malpass v. Department of Treasury ruling that (1) the personal income tax law does not prohibit individual taxpayers from combining profits and losses from unitary flow-through businesses and then apportioning that income on the basis of the business’s combined apportionment factors and (2) for the years at issue, combined reporting could include foreign entities to the extent that the foreign entity and the individual taxpayers in the state were a unitary business. The Department of Treasury had required the income of each entity to be apportioned separately.

By law, Michigan has formulary apportionment, which can be calculated on a separate entity basis or with combined reporting. The court examined the applicable statutory sections to determine that the law does not prohibit individual taxpayers from using combined reporting. The department argued that combined reporting was prohibited because it was not expressly authorized. However, the court noted that neither method was expressly authorized. Furthermore, the department has not promulgated a rule to require separate entity reporting for individual taxpayers. Thus, in the absence of a policy choice by the Legislature, the statute permitted either method. Combined reporting was allowed because it satisfied the statutory requirement that "all business income ... be apportioned to the state."

With respect to foreign entities, the court again turned to the statutory language to decide that apportionment was not limited to the domestic entities of a unitary business. To determine if a business is unitary, the totality of the circumstances, especially the economic realities, functional integration, centralized management, economies of scale, and substantial mutual interdependence, should be considered. Michigan law in effect for the tax years at issue did not contain any limiting language to indicate that combined reporting was appropriate for domestic entities only. (Malpass et al. v. Department of Treasury, Michigan Supreme Court, Nos. 144430, 144431, 144432, 145367, 145368, 145369, 145370, June 24, 2013).

In the Estate of Thomas M Wheeler, et. al., v. Department of Treasury (Michigan Court of Appeals, No. 302251, May 15, 2012) the Court held that an S corporation and a lower-tier
general partnership were unitary, so that the shareholders/taxpayers properly apportioned their income to Michigan under the personal income tax laws. The S corporation made automotive electrical systems and acquired all the business assets of a German business, which was also a manufacturer and assembler of electrical distribution systems. The German business’s operating assets were moved into a partnership as part of the acquisition. The taxpayers received flow-through income from the S corporation and the partnership, which they apportioned. Under the unitary business principle, for a taxpayer to use apportionment, there must be some sharing or exchange of value not capable of precise identification or measurement (beyond the mere flow of funds arising out of a passive investment or a distinct business operation) which makes apportionment reasonable. Reviewing applicable case law, the court observed that Michigan law does not allow separate entities to be treated as a unitary business in the absence of some common ownership at the entity level and that being owned by the same individual taxpayer is insufficient to trigger this relationship requirement. In this case, the court determined that the taxpayer could use the unitary business principle to apportion income. Furthermore, the unitary business principle does not exclude foreign entities. The personal income tax definition of "state" specifically includes foreign countries.

Finally, the two businesses met the test to be considered unitary: (1) under the economic realities, the regularly conducted activities of the businesses were related as they were both engaged in manufacturing and assembling electrical distribution systems; (2) under functional integration, the business functions were blended to promote a unitary relationship as component engineering, manufacturing and industrial engineering, cost estimating, business development, finance, and executive administration were shared; (3) management was centralized; (4) economies of scale were achieved with an expanded customer base, sharing of unique and proprietary processes, and improved financing terms; and (5) under substantial mutual interdependence, acquisition of the German business was essential for the S corporation to remain a Ford supplier. Accordingly, the lower court properly found that the taxpayers apportioned their income under the unitary business principle.

D. New York.

On March 31, 2014, New York enacted a major corporate franchise tax overhaul. The tax reform legislation codified some corporate partner nexus rules and the aggregate method used in computing a corporate partner's tax liability. There are however, some remaining questions regarding carry-over of provisions from prior law.

Before 2015 New York tax law provided that corporations were subject to the corporate franchise tax for the privilege of exercising their corporate franchise, or of doing business, employing capital, owning or leasing property in the state, or of maintaining an office in the state. (N.Y. Tax Law section 209.1, effective for years before January 1, 2015). The regulations provide that if a partnership has nexus (that is, it is doing business, employing capital, owning or leasing property, or maintaining an office in New York state), then all of its corporate general partners are subject to tax. The regulations also state that a foreign corporation is deemed to have nexus if it is a limited partner of a partnership (other than a portfolio investment partnership) that is doing business, employing capital, owning or leasing property, or maintaining an office in
New York, and it is engaged, directly or indirectly, in the participation or in the domination or control of all or any portion of the business activities or affairs of the partnership.

The limited partnership arrangement was spelled out in greater detail and included a foreign corporate partner that has a 1 percent or more interest as a limited partner, and the basis of its limited partnership interest is more than $1 million (as determined under IRC sec. 705). New York regulations also set forth additional factual situations to consider as indications that a foreign corporate limited partner is participating, directly or indirectly, in any of the business activities of the partnership, including:

- intercompany sales or purchases by the foreign corporation, or a member of its affiliated group, and the partnership;
- the foreign corporation, or a member of its affiliated group, and the partnership are engaged in a similar or identical business;
- 50 percent or more of the foreign corporation's assets, or those of a member of its affiliated group, consist of a limited partnership interest in the partnership; and
- the business carried on by the partnership integrally concerns the business of the foreign corporation or its affiliated group. (20 N.Y. Comp. Codes R. & Regs. section 1-3.2(a)(6)(ii)).

Corporate partners are generally required to compute their tax regarding their partnership interests under either the aggregate method or the entity method. (20 N.Y. Comp. Codes R. & Regs. section 3-13.1(a)). In some situations, they are permitted to elect a separate accounting method. These methods are generally the same before and after tax reform. Under the aggregate method, a corporate partner is viewed as having an undivided interest in the partnership's assets, liabilities, and items of receipts, income, gain, loss, and deduction, and the partner is treated as participating in the partnership's transactions and activities. The corporate partner's distributive share of each partnership item and its proportionate share of each partnership asset and liability are included in the computation of the corporate partner's net income base, capital base, minimum taxable income base, and the fixed dollar minimum.

Generally the aggregate method is required if the corporate partner is unitary with the partnership, is a general partner (or managing member), has a 5% ownership interest in the partnership, the partnership interest constitutes more than 50% of its total assets, or its basis in the partnership at the end of the partnership year totals more than $5 million.

The alternative is the “entity method”. Under the entity method, a corporate partner's partnership interest is treated as an intangible asset and the partnership is treated as a separate entity. The sales factor does not include the corporate partner's distributive share of any partnership items.

By making the separate accounting election, the foreign corporate partner is not taxed on income from its own operations; rather, it is taxed only on items of income flowing up to it from
the underlying limited partnership that has nexus with New York. A foreign corporation that makes the separate accounting election therefore does not take into account any gain or loss recognized from the sale of its interest in the partnership for which the separate accounting election was made. The separate accounting election may not be made if the limited partnership and corporate group are engaged in a unitary business and there are substantial inter-entity transactions between the limited partnership and the corporate group.

Effective January 1, 2015, New York adopts tax reform legislation that provides an economic nexus provision, market-based sourcing rules, and unitary water's-edge combined reporting requirements. The measure provides that a corporate partner must use the aggregate method as defined in the regulations of the commissioner, unless another method for computing the tax is required or allowed by the regulations. (N.Y. Tax Law section 210.3, effective January 1, 2015). It is not clear if this means that the separate accounting election allowed under prior law is still intact.

Effective January 1, 2015, a corporation is subject to the corporate franchise tax if it meets the pre-reform physical presence nexus standard or it is deriving receipts from activity in New York, for all or any part of each of its fiscal or calendar years of $1 million or more in the tax year. (N.Y. Tax Law section 209.1(b), effective January 1, 2015). If a partnership is doing business, employing capital, owning or leasing property in New York, maintaining an office in the state, or deriving receipts from activity in the state, "any corporation that is a partner in such partnership shall be subject to tax" (N.Y. Tax Law section 209.1(f), effective January 1, 2015).

The department has released a FAQ addressing this issue in more detail. In responding to the question whether the $1 million threshold is determined at the partnership level or the corporate partner level, the department answered that the "test is determined by combining the general partner's receipts in NY with the partnership's receipts in NY." (N.Y. State Dept. of Tax. and Fin., Corporate Tax Reform FAQs).

Example:

Partnership A has two general partners: partner B who owns 60 percent of the partnership and partner C who owns 40 percent. Partnership A has $600,000 of New York state receipts. Separately, partner B has $700,000 of New York state receipts and partner C has $450,000 of New York state receipts. For purposes of determining nexus only, both partners B and C are treated as having $600,000 from the partnership. Combined with their own receipts, both general partners would have more than $1 million in New York state receipts ($1.3 million for partner B and $1.05 million for partner C). Therefore, both general partners would be subject to tax by New York.

Under the regulations, a partnership's general partners are deemed to have nexus if the partnership has nexus. (20 N.Y. Comp. Codes R. & Regs. section 1-3.2(a)(5). That rule appears to apply for post-reform years as well, so that if partnership A meets the $1 million threshold,
partners B and C should be deemed to have nexus regardless of the amount of New York state receipts they each separately report.

The separate accounting election is only available to corporate limited partners that are not in combined reports. In pre-reform years, New York state was a separate reporting state that permitted or required combined reporting in some situations when substantial intercorporate transactions were present. (N.Y. Tax Law section 211.4, effective for years before Jan. 1, 2015). If substantial intercorporate transactions were not present, a combined report could still be permitted or required if separate reporting would result in distortion, providing some flexibility to the limited partner.

In adopting a unitary water's-edge combined reporting standard, more corporations will find themselves in combined reports than in pre-reform years, and fewer corporate limited partners may be eligible for the election.

In addition, the new legislation provides that "if a corporation is subject to tax under this article solely as a result of its ownership of a limited partner interest in a limited partnership that is doing business, employing capital, owning or leasing property, maintaining an office in this state, or deriving receipts from activity in this state, and none of the corporation's related corporations are subject to tax under this article, such corporation shall not be required or permitted to file a combined report under this section with such related corporations." (N.Y. Tax Law section 210-C.2(c), effective Jan. 1, 2015). This provision appears to be a safe guard, which would prevent corporations related to the limited partner corporation from being brought into the state.

V. Collection of Tax from Nonresidents.

Every state has developed procedures to facilitate collection from nonresident owners of flow through entities. The most common methodology is withholding on distributions (or income sourced to the state). Another common methodology is composite return filing requirements. In a state like Alabama, a pass-through entity is required to file composite returns and make composite payments on behalf of its non-resident members. The entity must report each non-resident member's share of Alabama income (Ala. Code Sec. 40-18-24.2(b)(1)).

In addition, there has been a steady increase in state income tax withholding requirements on pass-through entities. The states that do not require withholding are generally those states that do not have a state income tax.

This section looks at various collection techniques adopted by several states to facilitate collection of the income tax on the taxable income sourced to the state that flows through to a nonresidents.
A. Composite Tax Returns.

Most states allow flow through entities to file composite income tax returns on behalf of nonresident shareholders reporting and paying tax on each participant's pro rata share of income. A composite return is a return filed by a pass-through entity for its eligible nonresident partners, which includes the in-state income from the partnership. The purpose of a composite return is to enable the partnership to file one return in which it computes and reports its state-source income and the tax attributable to eligible nonresident partners. Eligibility can be a factor, as generally the state only allows partners to file as a member of the composite return, if the partnership income is the only income that they earn in that state and they have the same tax year as the partnership.

Although many states permit composite returns, Illinois, Nebraska and Tennessee do not accept them. In states that do permit composite returns, partners must meet the state’s requirements to participate in the composite return. Most often, the deciding factor for participation in a composite return is whether the income from the partnership is a nonresident partner's only source of income from the taxing state. Therefore, if a partner had an investment in two partnerships doing business in California, then he would not be allowed to participate in the composite tax return filed by either partnership, and would have to file his own separate nonresident tax return.

One disadvantage of composite returns is that a nonresident partner's income is taxed at the highest applicable rate. Many of the states that permit composite returns have special rules regarding the computation of tax liability for those that participate in the composite return, which differ from the normal rules for calculating individual income tax liability. For example, most states limit composite returns' use of some credits, net operating losses, and deductions.

However, despite those downsides, composite returns significantly reduce partners' compliance burdens by eliminating the need to file nonresident tax returns and to comply with numerous states' income and estimated tax rules.

1. States that require a composite tax return.

   a) Alabama.

   Alabama has different rules that apply for different types of flow through entities.

   S corporations are permitted to file composite returns and make composite payments on behalf of some or all of its nonresident shareholders. The calendar year return is due on or before March 15th. ( Ala. Code Sec. 40-18-176; Ala. Admin. Code r. 810-3-24.1.-01) However, S corporations are required to file consent agreements (Schedule NRA) for each nonresident member and a composite return is required to be filed on behalf of each nonresident member for whom a consent agreement has not been filed.
Beginning with tax year 2009, a partnership and/or LLC is required to file composite
returns and make composite payments on behalf of its non-resident members. The entity reports
each non-resident member’s share of Alabama income due the 15th day of the fourth month
following the close of the pass-through entity’s taxable year. ( Ala. Code sec. 40-18-24.2(b)(1)).
A nonresident member that has been included in a composite income tax return may file its own
Alabama income tax return and receive credit for Alabama income paid on the member’s behalf
by the entity. Prior to tax year 2009, composite returns were not mandatory.

In computing the amount of the composite payment, the pass-through entity must apply
the maximum tax rate to each nonresident member’s distribute share of income, to include
separately stated income and nonseparately stated income. The nonresident member’s
distributive share of expenses, deductions, and losses should not be considered in computing the
amount of the composite payment. The entity may not offset income or gain of a nonresident
owner or member with the loss of another owner or member. A net operating loss carry forward
may not be used to offset income or gain. (Ala. Admin. Code r. 810-3-3-24.2-01(2)(c)).

A member of a pass-through entity that is itself a pass-through entity (lower-tier pass-
through entity) is subject to the same requirement to file a composite return with respect to the
distributive share of income of the lower-tier pass-through entity. (Ala. Code Sec. 40-18-24.2(c)(1)).

The entity must furnish to its non-resident members annually (no later than the 15th day
of the third month after the end of its tax year), a record of the amount of Alabama income tax
remitted on behalf of such member.

A single member limited liability company (SMLLC) that is treated for federal income
tax purposes as a disregarded entity and taxed as a sole proprietorship, with all income reported
on the single member’s federal personal income tax return, must report all profits (or losses) of
the LLC on the sole member’s Alabama personal income tax return.

b) Connecticut.

Every S corporation doing business in Connecticut, or having income derived from or
connected with sources within the state, must file Form CT-1065/CT-1120SI, Connecticut
Composite Income Tax Return, regardless of the amount of its income (or loss). (Conn. G. S.
sec. 12-726(b)).

A partnership, including a limited liability partnership (LLP), and a limited liability
company (LLC) treated as a partnership for federal income tax purposes, must file Form CT-
1065/CT-1120SI, Connecticut Composite Income Tax Return, if it filed federal Form 1065, and
does business in Connecticut or has any income derived from or connected with Connecticut
sources. (Conn. G. S. sec. 12-726). A partnership that has a substantial economic presence in
Connecticut, without regard to physical presence, is considered to be doing business in the state.

Form CT-1065/CT-1120SI is due no later than the 15th day of the fourth month
following the close of the tax period (i.e., April 15 for a calendar-year filer).
c) Indiana

For tax years beginning after 2007, owners of pass through entities who are nonresidents are required to be a part of a composite return filed by the pass through entity, if it does business in Indiana. The requirement to be part of a composite return applies even if the individual has other Indiana-source income that is not part of the composite return. If an individual has no other Indiana-source income and is included in a flow through entities composite return, the individual will not have to file an individual Indiana income tax return. (Information Bulletin #39 and #72).

Corporations and partnerships may not be included in a composite return.

d) Louisiana

Louisiana does not recognize S corporations. Therefore, the mandatory composite return-filing requirement applies only to partnerships (and entities taxed like partnerships). In general, each entity treated as a partnership for income tax purposes that engages in business activities in Louisiana must file a composite return (that is, Form R-6922) if it has an underlying nonresident partner, unless:

- All nonresident partners are corporations, partnerships, or tax exempt trusts; or
- All nonresident partners (other than corporations, partnerships, and tax exempt trusts) have a valid agreement on file with the LDR in which the partner has agreed to file an individual return and pay income tax on all income derived from or attributable to sources in Louisiana. (La. R. S. Sec. 47:201.1).

- Each partnership that is not required to file a composite return because all its partners have filed agreements to file on their own behalf, must make an initial filing in which it files all agreements with the LDR by the composite return due date. Each partnership must also register for an account number with the LDR prior to making an initial filing. (Reg. sec. 1401(C)(5)(b))

- If credits earned by the partnership are being claimed on the composite return, all nonresident partners must be included on the composite return. (Reg. Sec. 1401(B)(3), Tit. 61, LAC) However, corporate partners and partners who are themselves partnerships cannot be included in composite returns filed by a partnership. These partners must file all applicable Louisiana tax returns, and must report all Louisiana source income, including income from the partnership in those returns. (Reg. Sec. 1401(B)(2), Tit. 61, LAC)

The composite return is due on the date set forth for all income tax returns other than a corporation income tax return (i.e., May 15 of the year following the close of the calendar year, or the 15th day of the fifth month after the close of the fiscal period). (Reg. sec. 1401( C)(2)) The LDR may grant a reasonable extension of time to file a composite return, not to exceed six months, from the date the return is due.

For these purposes, a "partnership" is any association that is treated as a partnership for state income tax purposes, including, but not limited to:
- A general partnership
- A registered limited liability partnership; or
- A limited liability company.

The filing of an accurate and complete partnership composite return will relieve a nonresident partner properly included in this return from the duty to file a Louisiana personal income tax return, if the nonresident partner does not have any income from Louisiana sources other than the income reported in the composite return. (Reg. sec. 1401(C)(4)).

In addition, for taxable periods beginning after 2012, when a composite return reflects an overpayment, the overpayment must be paid to the partnership that filed the composite return. (La. R. S. sec. 47:201.1(F)).

2. States that do not allow a composite return.

Generally states that do not assess an income tax on individuals do not authorize the filing of a composite return. Here is a list of each state where a composite return is not permitted.

   a) States with no personal income tax.

   The following states to not assess a personal income tax and therefore do not allow the filing of a composite return by flow through entities on behalf of nonresident owners. These states include Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

3. States that have not authorized the filing of a composite return for some or all pass through entities.

   a) Illinois.

   Effective for tax years before 2014, an Illinois composite income and replacement tax return may be filed and tax paid on behalf of participating nonresident individuals, trusts, and estates who derive income from Illinois and who are partners, S corporation shareholders, or underwriters who transact insurance business under a Lloyd’s plan of operation. (35 ILCS 5/502(f); 86 Ill. Admin. Code 100.5100(a)). Nonresidents with Illinois source income other than from a partnership or subchapter S corporation may, but need not, be included in a composite return.

   The composite return option is eliminated effective for tax years ending on or after December 31, 2014. Amounts that would have been reported on the composite return must be reported on the 2014 returns filed by the S corporation, partnership, or fiduciary. (Informational Bulletin FY 2014-10, Illinois Department of Revenue, January 2014).
b) Nebraska

Nebraska does not provide for the filing of a composite income tax return by an S corporations or partnerships on behalf of nonresident individual shareholders. A flow through entity with nonresident owners is required to either (1) obtain and attach to its tax return a signed agreement from each nonresident shareholder, stating that the shareholder will report and pay tax on his or her share of Nebraska source income or (2) in the absence of such an agreement, withhold and remit tax on the nonresident shareholder's share of Nebraska source income. The amount remitted will be allowed as a credit against the shareholder's Nebraska income tax liability. (R. S. sec. 77-2734.01(4) and (5)).

c) New Mexico.

Composite returns are not authorized under New Mexico law. However, for tax years beginning before 2011, the owners of a pass-through entity could elect to have the entity file a composite income tax return on behalf of certain individual owners, subject to prior approval by the Department of Revenue.

d) Oklahoma

There is no Oklahoma provision that authorizes S corporations to file composite returns on behalf of their nonresident shareholders. Partnerships with two or more partners may elect to file a composite return for their nonresident partners. The income tax liability for the nonresident partners will be computed and paid on the partnership return. For taxable years beginning on or after January 1, 2013, individual partners, trust partners, corporate partners, S corporation partners, and partnership partners may be included in the composite return. Nonresident partners included in a composite return cannot have other Oklahoma source income.

e) Utah

S corporations must withhold and remit tax on its nonresident individual shareholders', resident and nonresident business entity shareholders’, and resident and nonresident trust and estate shareholders' shares of the corporation's income that is apportioned to Utah. (Utah Code Ann. sec. 59-10-1403.2).

Partnerships are also required to pay or withhold tax on behalf of all resident and nonresident business entity, estate, and trust partners and nonresident individual partners (Utah Code Ann. Sec. 59-10-1403.2).

4. States that allow but do not require the filing of a composite tax return.

Nonresident shareholders, partners, and members are presented with a difficult compliance burden, particularly in the case of large multi-state flow-through entities. Limited partners may be obligated to file returns and pay taxes on their income in virtually every state,
even if their individual shares of the business entities income is quite small. The result, in many instances, is lack of compliance. To deal with this issue (and the related loss of revenue), many state taxing authorities have adopted a composite return filing procedure, even though they do not require same. The following states allow (but do not require) the filing of a composite return.

\[ a) \quad \text{California.} \]

Nonresident partners/shareholders/members can elect to be included in a composite return filed by the business entity, however filing a composite return is not required. The return is subject to the following conditions: (Cal. Rev. & Tax. Code sec. 18535)

- The income included in the return must be the only California-source income of the partner (unless the partner participates in another partnership filing a California composite return).
- The partnership must notify each partner of the right to elect to participate in the return on an annual basis, and each participating partner must consent in writing to inclusion.
- The partnership and partners must agree that the partnership will pay any deficiencies (including penalties) assessed with respect to the composite return and that the partnership will act on behalf of the partners in all proceedings.
- No deductions or credits unrelated to the partnership may be taken.
- Taxes for each electing nonresident must be paid at the highest California marginal tax rate (now 12.3%).
- The partnership must ensure that estimated tax payments and returns are filed.

The procedure only makes sense if the partnership income is the nonresident's only California-sourced income. Individuals with taxable income in excess of $1 million who are subject to an additional 1% tax for mental health services can now be included in the filing of a group return. Their income will be taxed at 13.3% rather than the 12.3% rate assessed generally. (Cal. Rev. & Tax. Code sec. 18535).

The pass through entity is responsible for allowing each nonresident individual shareholder the annual option of being included in a group nonresident return, and for informing the individuals of the terms and conditions for being included in a group nonresident return. To qualify, a nonresident shareholder must be a nonresident for the full taxable year. The irrevocable election to file a group nonresident return is made on FTB 3864, Group Nonresident Return Election, which must be attached to the Form 540NR filed for the group. The group nonresident return must be filed for a calendar year reporting all of the individual’s distributive share of California-source income from the business entity’s taxable year ending in the calendar year for which the group return is filed. This is true, even if the pass through entity files on a fiscal-year basis. (FTB Pub. 1067, Guidelines for Filing a Group Form 540NR Return) The due date for the return is April 15, although the state provides an automatic filing extension to October 15 without making any written request for an extension. (Instructions, Form 540NR, California Nonresident or Part-Year Resident Income Tax Return)
A nonresident who is a shareholder of multiple California pass through entities can still participate in the group returns of each entity. However, the shareholder may not elect to participate in one entity’s group return and not in the other. The nonresident must agree to participate in both entity’s nonresident group return. An S corporation filing on behalf of both nonresident directors and shareholders should file only one group nonresident return. (FTB Pub. 1067, Guidelines for Filing a Group Form 540NR Return)

Capital losses claimed on the group return are applied at the individual level. Consequently, each nonresident is treated as a single individual and is limited to a $3,000 capital loss. Conversely, the business entity completes a single Form 3801, Passive Activity Loss Limitations, for the group return. Net operating loss carryovers cannot be claimed on a group return, nor can a deduction for a contribution to a deferred compensation plan. Only credits directly attributable to the entity’s business activities can be claimed on the group return. (FTB Pub. 1067, Guidelines for Filing a Group Form 540NR Return)

The group return is filed on a 540NR long form. A Schedule 1067A, Nonresident Group Return Schedule, and a FTB 3864, Group Nonresident Return Election must be attached. A new election must be signed and attached to the group return each year. The return must be filed on a calendar year basis and must report all California-source distributions made to the nonresident shareholders during the corporation’s tax year that ends during the calendar year. Form FTB 3519, Automatic Extension for Individuals is used to request an extension. (FTB Pub. 1067, Guidelines for Filing a Group Form 540NR Return)

B. Withholding

Withholding on distributions to nonresident shareholders, partners, or members is the most common methodology employed by the states to address compliance and collection problems that result from partners who live out of state. Some states have responded to this situation by requiring that the in-state entity withhold on distributions to nonresident partners, while other states effectively require partnerships to pay their nonresident partners' taxes. If the flow-through entity has to fund the nonresident’s tax liability, then the result can be cash flow problems for the entity. This can result under state tax regimes that impose an estimated tax payment system that requires the flow-through entity to make quarterly payments of estimated tax in respect of nonresident owners. This type of regime can cause confusion because it requires that the flow-through entity be able to identify the taxpayer and where the taxpayer is located. In a tiered entity structure, an LLC might only know that it is owned by another LLC. If this LLC is in fact a single member LLC, then the taxpayer is an individual who may be a nonresident.

In addition, states differ in how they impose withholding requirements. For example, some states exclude corporations and other partnerships from nonresident withholding. Further, when determining the amount of income subject to withholding, some states will choose withholding rules that use personal income tax apportionment factors while other states might choose withholding rules that use corporate income tax apportionment factors. This can cause a disconnect between the amount withheld and the amount actually owed which could cause the partnership to be subject to penalties for under-withholding.
The risk of under-withholding brings fears of interest and penalties. Many states impose interest and penalties if a partnership fails to properly withhold from its nonresident partners. In United Wisconsin Grain Producers LLC v. Wisc. Dep't of Revenue, (Docket No. 10-W-242, Tax Appeals Commission (Aug. 24, 2011)), the question was whether the state had the right to assess interest and penalties against the taxpayer if the tax liability was ultimately paid by the partner. The court upheld the assessment of interest against the taxpayer on the basis that the statute clearly established the taxpayer’s liability and did not provide the agency with the flexibility to abate interest. The Wisconsin statute states: Section 71.775(4)(f), Wis. Stats. (2005-06) “If a pass-through entity subject to withholding under this section fails to withhold tax as required by this section, the pass-through entity shall be liable for any tax, interest, and penalties. If a nonresident partner, member, shareholder, or beneficiary of the pass-through entity files a return and pays the tax due, the pass-through entity shall not be liable for the tax, but shall be liable for any interest and penalties otherwise applicable for failure to withhold, as provided under ss. 71.82(2)(d) and 71.83.”

Each state also has a variety of exemptions and waivers. An investment partnership is one category, recognized by several states, which generally creates such an exception. These partnerships generally limit asset investments to stocks bonds and other qualified investments. This type of income flows through as investment income, typically sourced to the state of residence of the individual investor. In some states, this same characterization carries over to the nonresident investor exempting them from the state’s tax. The following states exempt the distributive share of nonresident partners of investment partnerships (as defined in varying ways) from income taxation: Alabama, Arkansas, California, Georgia, Idaho, Illinois, Kentucky, Maryland, New Jersey, New York, North Carolina, Ohio, and Texas. A few states, such as Connecticut, Minnesota, and New Mexico, do not exempt nonresident partners of investment partnerships but have rules that effectively allocate that income to the domicile of the nonresident partner. Virginia, on the other hand, exempts nonresident partners of investment partnerships from income taxation by taking the position that pass-through entities established solely to invest in intangible personal property, with no employees or tangible property in the state, are not considered to be carrying on a trade or business in the state. Therefore, the nonresident partner’s distributive share of income is not taxed in the state.

Another common exclusion is a de minimis limit based on the partner’s share of pass through entity income (generally $1,000 to $1,500);

This section illustrates these issues by describing the withholding/estimated tax payment systems used by states which each have their own unique reporting requirement.

1. California.

California's system of withholding illustrates how most states have addressed this problem. California employs a pure withholding regime on shareholders of an S corporation and partners in a partnership that requires the S corporation/partnerships to withhold at a specified rate on distributions to nonresident shareholders/partners. With respect to LLCs, California can also require withholding of the actual tax due from the nonresident member if the member does
not file a consent to be taxed in the state. These rules are described in more detail in the next section.

\( a) \) **California Partnerships and S Corporations**

California requires withholding on distributions of current or prior year income to domestic nonresident S corporation shareholders under rules that parallel those applicable to nonresident partners. (Cal. Rev. & Tax. Code sec. 18662).

S corporations and partnerships must withhold at the rate of 7% on distributions of California-source income to nonresident shareholders, including distributions of current year and prior years' California-source income. The prior years' income is not subject to withholding if it has been previously reported on the shareholder/partner California return.

Withholding is not required if distributions of income from California sources to a nonresident shareholder/partner are $1,500 or less during the year. If distributions exceed $1,500, the entire amount of distributions, not just the amount exceeding $1,500, is subject to withholding.

\( b) \) **Persons/Entities Subject to Withholding**

Domestic (nonforeign) nonresident shareholders/partners include individuals who are nonresidents of California, as well as partnerships, nonresident estates and trusts, and S corporations and corporations that do not have a permanent place of business in California (18 CCR sec. 18662-2). However, withholding is not required for distributions to shareholders that are:

- tax-exempt entities under either California or federal law; or
- insurance companies. (18 CCR sec. 18662-1).

For withholding purposes, a trust is a nonresident trust if no trustee is a California resident. An estate is a nonresident estate if the decedent was not a California resident on the date of death. The FTB may grant a waiver of withholding if the nonresident trust or estate can show that it is filing California fiduciary returns and complying with the withholding requirements for distributions to nonresident beneficiaries.

\( c) \) **Income Subject to Withholding**

All distributions, including property, that represent California-source income are subject to withholding. (18 CCR sec. 18662-2) For distributions of property, the amount subject to withholding is based on the fair market value of the property distributed. Withholding is not required, however, for distributions that do not represent California-source income, or that are returns of capital or of previously reported California-source income.
A distribution is deemed made first from distributable income and second as a return of capital. If the distribution is made from income that is only partially sourced to California, then the S corporation/partnership must make a reasonable approximation of the ratio of its income from California sources to its worldwide income to determine the amount subject to withholding. The FTB will accept reasonable methods for computing the allocation percentage. Reasonable methods include using the prior year's ratio or apportionment factors, annualizing current year data, and using actual year-to-date figures.

In general, if income is generated in a prior year and is not entirely distributed in that year, the amounts distributed during the current year will be considered distributions of prior years' income. The balance is deemed to be from the current year's income.

Example.

Paul Pyramid is a shareholder in ABC S corporation. Paul, now a resident of Arizona, filed and paid California tax on his $5,000 share of the income earned by the S corporation in Year 1. In Year 2, Paul received a distribution of $10,000, which included the distributive share from Year 1. Paul should file Form 590-P (Nonresident Withholding Exemption Certificate for Previously Reported Income) with the S corporation so that no withholding will be taken out of the portion of the distribution that is from income previously reported and taxed by California. The distribution will be deemed to come first from Year 1. The S corporation or partnership may rely on this certification to waive the withholding obligation on that prior year income.

Note that if a California S corporation/partnership has a tax loss but a positive cash flow (for example from the sale of California real estate), the S corporation/partnership can distribute the positive cash flow to a nonresident shareholder and not withhold as long as the S corporation/partnership continues to have a tax loss for the year. Withholding on distributions of California-source income is required, however, even if the S corporation/partnership generated losses in prior years. The determination whether NOL carryover and deductions are allowable is made at the shareholder level. Shareholders who think they will have an overall NOL and owe no California taxes should file a request for waiver of withholding.

\textit{d) Reporting Requirements}

Tax withheld on California-source payments is remitted to the FTB on a quarterly basis (similar to estimated tax payments) using Form 592, Quarterly Resident and Nonresident Withholding Statement. Form 592 includes a Schedule of Payees section that requires the withholding agent to identify the payment recipients (vendor/payee) and the income and withholding amounts. This schedule allows the FTB to allocate the withholding payments to the taxpayer (payee) upon receipt of the completed Form 592. Withholding agents must provide the payees with paper Forms 592-B at the end of the year that show the total amount withheld for that year.
e) **Determining Residency**

Because withholding is only required on taxable income distributed to nonresident shareholders, S corporations and partnerships must determine whether or not individual shareholders are California residents. To make this determination, the FTB recommends sending shareholders/partners an FTB Form 590, the California withholding exemption certificate, and asking them to complete the form and certify that they are either California residents or entities not subject to withholding. Any shareholder that does not complete and return the FTB Form 590 is considered a nonresident subject to withholding. The S corporation/partnership need not send these forms to the FTB, but must keep them on file in case the FTB requests the information. (18 CCR sec. 18662-7).

**Example.**

Chris, Molly, and Fred are shareholders in the Big Farm S corporation. The S corporation sends each of the shareholders a Form 590 Withholding Exemption Certificate. The form requests certification of California residency. Chris, who lives in New York, does not return the form. According to the S corporation records, Molly lives in Carmel, California. The S corporation is not required to obtain Form 590 from any shareholder who has a California street address, and therefore Form 590 is not required from Molly. Fred lists his address as a P.O. Box number located in California. Since a valid California street address does not include a California Post Office Box, a broker address, or an “in care of” address, Fred will need to complete Form 590.

Although the S corporation/partnership need not secure an FTB Form 590 every year from every shareholder/partner, it should secure one whenever a new shareholder is added. Also, the S corporation/partnership must consider whether a new FTB Form 590 is necessary whenever a shareholder/partner indicates any change in residency, such as an address change.

f) **Penalties**

The FTB will not impose taxes, interest, and penalties for failure to withhold before notifying an S corporation/partnership of its withholding obligations. The FTB will not impose penalties on S corporations/partnerships whose estimate for determining the portion of a distribution that is California-source income is later proved inaccurate if the S corporation/partnership made a good faith effort to comply with the withholding requirements.

An S corporation/partnership that fails to withhold, under withholds, or fails to remit withholding is liable for the greater of:

- the amount actually withheld; or
- the amount of taxes due from the shareholders, but not in excess of the amount required to be withheld. (Cal. Rev. & Tax. Code sec. 18662(d)).
Interest is assessed on the amount required to be withheld from the due date of the withholding payment to the date paid. In addition, the S corporation/partnership would be liable for penalties as if the withholding due to the FTB was the S corporation's tax liability. These penalties would include the underpayment penalty, late filing penalty, and negligence penalties. (Cal. Rev. & Tax. Code sec. 18673). Although the S corporation is ultimately liable for underwithholding, the FTB generally will look to the S corporation for any unpaid tax only if collection of the tax is in jeopardy.

Example.

Sally and Pat are shareholders in Buy Low, a California S corporation. They all live in Nevada. The S corporation does not withhold on distributions to nonresident shareholders. Sally filed her California return on a timely basis and paid the California tax due. Buy Low could be liable for interest and penalties for failure to withhold. Pat filed his California return but was unable to pay the tax. In this case, Buy Low could be liable for the amount of tax due, up to a maximum of the amount required to be withheld, and penalties and interest.

\[g\]  Waivers

The FTB may grant a waiver of the withholding requirements or permit an S corporation to withhold at a reduced rate in certain situations (18 CCR sec. 18662-3.)

- The shareholder consistently files California returns and makes estimated tax payments when required;
- The partner of the partnership is an S corporation, and the S corporation ultimately passes through the income to entities other than S corporations (such as individuals, trusts or estates);
- The shareholder is included in a composite return. Individual nonresident shareholders/partners may elect to file a composite (group) return in lieu of filing an individual Form 540 NR (Cal. Rev. & Tax. Code sec.18535.);
- The S corporation/partnership is in the process of implementing a withholding program and is encountering administrative problems. These requests are handled on a case-by-case basis.

To request a waiver or a reduced withholding rate, either the S corporation/partnership or the shareholder/partner must fill out and submit FTB Form 588 (Nonresident Withholding Waiver Request) or FTB Form 589 (Nonresident Reduced Withholding Request). Form 588 is used to request a waiver of withholding, while Form 589 is used to request a reduction in the 7% withholding amount that is applicable to California source payments made to nonresidents. (Cal. Rev. & Tax. Code sec.18662). Approval is not automatic, and the FTB may deny the waiver. The payee must complete these forms before receiving payment for services and must complete the form based on the special circumstances that would justify the reduced withholding. After the FTB reviews the Form 589, it will issue a letter to the payee and the withholding agent notifying them of its determination and the amount to be withheld.
Note that there is no provision to waive withholding for foreign (non U.S.) partners, although this issue may come up less frequently for S corporations because nonresident aliens cannot qualify as shareholders of an S corporation.

\[ h) \quad \text{California LLCs} \]

LLCs are subject to withholding requirements that are similar, but not identical, to those imposed on partnerships. An LLC is required to withhold at the rate of 7% on amounts paid to nonresident domestic members if the distribution exceeds $1,500 during the calendar year. (Cal. Rev. & Tax. Code sec. 18662).

The LLC is required to withhold at the highest personal income tax rate on distributions to nonresident foreign members. (Cal. Rev. & Tax. Code sec. 18666).

If the LLC fails to file a nonresident member agreement to file a California return, the LLC must pay withholding on behalf of the nonresident member in an amount equal to the highest marginal tax rate in effect multiplied by the member's distributive share of LLC income and reduced by any withholding amount previously paid under either of the withholding requirements discussed above. (Cal. Rev. & Tax. Code 18633.5). This is called the nonconsenting nonresident's withholding tax. Although this does not result in double withholding, it may result in additional withholding tax on behalf of nonresident domestic members for whom an agreement was not filed. The withholding applies to those domestic nonresident members that do not satisfy the $1,500 reporting requirement of the domestic member withholding tax and also applies to the difference between the highest tax rate and the 7% required withholding rate generally. In addition, the nonconsenting nonresident withholding tax is imposed on the nonresident's distributive share of income allocable to California.

**Example.**

Joey lives in Montana and owns as interest in a California LLC. He refuses to sign the Form 3832 and consent to file a return in California. His distributive share of income allocable to California is $1,000. The total distribution for the current year is $800. The LLC is required to withhold $56 on the distribution ($800 x 7%). In addition, the LLC is required to pay an additional $67 because the member is subject to nonconsenting nonresident withholding at the rate of 12.33% on the distributive share regardless of whether or not the income is distributed.

If an LLC has a nonconsenting, nonresident member, the LLC must complete Schedule T (Form 568) to compute the nonconsenting nonresident member's tax liability. Any nonconsenting nonresident member's tax paid by the LLC is treated as a payment made by the nonresident member and the LLC treats the tax paid like a distribution. If an LLC files Schedule T and pays the tax for the nonresident member, the nonresident member must still file a personal income tax return. Filing of Schedule T by the LLC does not satisfy the California return filing requirement.
These payments by the LLC on behalf of the nonresident member are in the nature of estimated tax payments. This can cause cash flow problems if the LLC generates income but little cash flow. Examples of this scenario include cancellation of debt income, which can trigger significant income but no cash inflow. In addition, payment of the out-of-state member's tax obligation allows the out-of-state member to enjoy a cash flow benefit that is not available to in-state members. LLCs should avoid such a situation, and if it arises, then treat the tax payment made on behalf of the out-of-state member as a loan to the member.

Withholding on entities that own an LLC also causes problems. If the LLC is owned by another LLC that is owned by California residents, then no withholding may be required. However, it is entirely possible that the first tier LLC does not know who the members of the second LLC are. In this case, since the ultimate members are not subject to withholding, no withholding would be required.

2. New Jersey.

New Jersey effectively imposes withholding requirements on pass-through entities with nonresident owners by requiring partnerships, including limited liability companies (LLCs), limited liability partnerships (LLPs), and S corporations, to pay a nonresident partner tax. Under the New Jersey Statutes, all partnerships that are not qualified investment partnerships or investment clubs, and that are not listed on a U.S. national stock exchange, are subject to tax on the pro rata shares of taxable New Jersey source income allocable to their nonresident partners. (N. J. Rev. Stat. sec. 54:10A-15.11(a)). Note that the withholding is based on the owner’s share of the New Jersey source income, not the amount distributed.

The rate is 6.37% for nonresident noncorporate partners (e.g., individuals, trusts, and estates), and 9% for corporate nonresident partners, of the allocable share of entire net income. The term “nonresident corporate partner” refers to a partner that is not an individual, an estate or a trust subject to taxation pursuant to the “New Jersey Gross Income Tax Act”.

If a partnership is the owner of a partnership interest, the 9% rate applies to the income allocable to that interest because a partnership is considered a “nonresident corporate partner.” (N. J. Admin. Code sec. 18:7-17.5(a)).

The following types of partnerships are exempt from the nonresident partner tax:

- Partnerships listed on a United States national stock exchange (publicly traded partnerships);
- Qualified investment partnerships;
- Investment clubs;
- Partnerships with no New Jersey source income. To qualify for this exception, all operations and facilities must be located outside New Jersey. (New Jersey Division of Taxation Technical Bulletin No. TB-55, 04/06/2005).
3. Georgia.

Historically, Georgia nonresident withholding has been required monthly in connection with actual distributions and annually in connection with distributive shares (i.e., distributions credited but not paid). Now, however, under legislation effective for tax years beginning after 2011 (H.B. 965, 5/1/12 (L. 2012, Act 687), §2, amending Ga. Code Ann. §48-7-129), all withholding is required only annually on the nonresident member's share of the taxable income sourced to Georgia—whether or not distributed. Payment is due on or before the due date, without extensions, for filing the entity's income tax return.


Michigan recently amended its exemption from flow-through entity withholding (S.B. 65, 4/16/13 (L. 2013, P.A. 15)). Effective retroactive to 1/1/13, a flow-through entity that receives an exemption certificate from a member other than a nonresident individual (previously, more narrowly, from a corporation) is not required to withhold tax on that member's distributive share of business income. The exemption must certify that the member will pay the required corporate income tax on the distributive share of the business income received from any flow-through entity in which the member has an ownership or beneficial interest. Finally, the law provides that the Michigan Department of Treasury may require the member to file the exemption certificate and provide a copy to the flow-through entity. Previously, the corporation had to file the exemption certificate with the Department and provide a copy to the flow-through entity.

5. New York

New York does not impose withholding requirements on distributions made by partnerships, limited liability companies (LLCs) or S corporations to their nonresident partners, members or shareholders. However, certain entities (partnerships, LLCs treated as partnerships for federal income tax purposes, or S corporations that have partners, members or shareholders who are nonresident individuals or C corporations) that have any income derived from New York sources are required to pay estimated tax on the New York source income on behalf of the nonresident partners, members or shareholders. Estimated tax is a partner's, member's or shareholder's distributive share or pro rata share of the entity's income derived from New York sources, multiplied by the highest rate of tax prescribed by N.Y. Tax Law, Section 601, for partners, members or shareholders who are individuals, or by N.Y. Tax Law, Section 210.1(a), for partners, members or shareholders that are C corporations, and reduced by each partner's, member's or shareholder's distributive or pro rata share of any credits (N. Y. Tax Law 658( c)(4)(A)).

For a fiscal-year partnership or New York S corporation, estimated tax payments must be based on the partner's or shareholder's distributive share of partnership or S corporation income for the fiscal year that ends in the calendar year.

The estimated tax payments required to be made by partnerships, limited liability companies, and S corporations are due on April 15, June 15, September 15, and January 15 of the next year. These entities can pay the entire amount due with the first payment (April 15), or pay in four equal installments. The payments must be made by these dates whether the
partnership, limited liability company, or S corporation keeps its books on a calendar-year basis or a fiscal-year basis. (New York Technical Service Bureau Memorandum TSB-M-04(1)I (Feb. 25, 2004)).

For purposes of this provision, New York source income means the New York source income of a nonresident individual who is a partner, member, or shareholder, as described in section 631 of the Tax Law, less the partner's, member's or shareholder's share of certain partnership related deductions allocated to New York State. Items of income, gain, loss, and deduction derived from or connected with New York sources includes items attributable to:

- the ownership of any interest in real or tangible personal property in New York;
- a business, trade, profession or occupation carried on in New York;
- in the case of a shareholder of an S corporation where the election provided for in N.Y. Tax Law Section 660(a) (relating to taxes on built-in gains and excess net passive income as provided in Code Section 1366(f)(2) and (3)) is in effect, the ownership of shares issued by the corporation, to the extent determined under N.Y. Tax Law Section 632;
- winnings from a wager placed in a lottery conducted by the division of the lottery, if the proceeds from such wager exceed $5,000;
- gains from the sale, conveyance or other disposition of shares of stock in a cooperative housing corporation in connection with the grant or transfer of a proprietary leasehold by the owner, whether the shares are held by a partnership, trust or otherwise; or
- for taxable years beginning on or after January 1, 2010, income received by nonresidents from installment sale contracts entered into before a New York S corporation terminated its taxable status in New York, (N. Y. Tax Law 631(b); New York Technical Service Bureau Memorandum TSB-M-10(9)I (Aug. 31, 2010).

These amounts include the partner's, member's or shareholder's share of the federal partnership deductions for medical insurance and contributions to IRA, Keogh, and Simplified Employee Pension (SEP) plans allocated to New York. These deductions are allocated to New York in the same manner as the partnership, limited liability company, or S corporation income is allocated to New York. For purposes of this provision, New York source income does not include any deductions that are required to be treated as itemized deductions on the partner's, member's, or shareholder's federal income tax return. Also, New York source income does not include the partner's federal deduction for one-half of the self employment tax, because this deduction is not treated as a partnership deduction for federal income tax purposes.

In general, this income is the sum of the items of income, gain, loss and deduction entering into an individual's federal adjusted gross income that are attributable to a business, trade, profession, or occupation carried on in New York State and any New York adjustments. Partnerships, limited liability companies, and New York S corporations use this definition of New York source income even when making estimated tax payments on behalf of partners or members who are C corporations.

Every partnership, limited liability company, or New York S corporation subject to these provisions will be required to file an information return to report and pay the amount of
estimated tax paid on behalf of each partner, member, or shareholder that is a nonresident individual or a C corporation for federal income tax purposes. Within thirty days after the estimated tax is paid, the partnership, limited liability company, or New York S corporation must notify its partners, members, or shareholders of the amount of estimated tax paid on their behalf.

6. Indiana

Partnerships are required to withhold on the distributive shares of income paid or credited to their nonresident partners. (Ind. Code sec. 6-3-4-12; 45 Ind. Admin. Code 3.1-1-1-107; Withholding Instructions, Indiana Dept. of Revenue Information Bulletin No. 49; Indiana Dept. of Revenue; Information Bulletin No. 31.) S corporations are also required to withhold from dividends and other payments or credits to the accounts of their nonresident shareholders. (Ind. Code 6-3-4-13(a); 45 Ind. Admin. Code 3.1-1-1-109; Withholding Instructions, Indiana Dept. of Revenue, Information Bulletin No. 49; Indiana Dept. of Revenue, Information Bulletin No. 30).

In 2008, in Riverboat Development, Inc. v. Indiana Department of State Revenue, (881 N.E.2d 107 (Ind. Tax Ct. 2008), rev. den. 2008 Ind. LEXIS 791 (Aug. 28, 2008)), the Indiana Tax Court held that the income that an Indiana nondomiciliary S corporation received from its membership interest in an Indiana LLC did not constitute adjusted gross income from sources within Indiana and therefore, the S corporation was not required to withhold Indiana personal income tax for its nonresident shareholders. The taxpayer was an S corporation that was not domiciled in Indiana, nor did it conduct any business in the state. It was a member of an Indiana limited liability company (LLC) that operated a riverboat casino in the state. The Department of Revenue (DOR) determined that the taxpayer's income was derived from the riverboat casino and that, therefore, this income, which was passed through to the S corporation's shareholders was taxable by Indiana. Furthermore, the DOR argued that because the S corporation had distributed income subject to Indiana tax, it was required to withhold personal income tax on behalf of its nonresident shareholders, which it failed to do. However, the Tax Court held that the income was derived from the S corporation's membership interest in the LLC and that such interest was tangible personal property, which was subject to Indiana adjusted gross income tax only if the taxpayer's commercial domicile was in the state. Therefore, because the S corporation was not domiciled in the state, the income from the LLC was not taxable by Indiana and the S corporation was not required to withhold income taxes for its nonresident shareholders.

As a result of this case, Indiana Code Section 6-3-2-2 was amended by HEA 1001-2009(ss) effective retroactively to Jan. 1, 2009, for taxable years beginning after Dec. 31, 2008, to provide that income from a pass-through entity is considered Indiana source income as if the person, corporation, or pass-through entity that received the income had directly engaged in the income-producing activity in Indiana. Income that is derived from one pass-through entity and is passed through to another pass-through entity does not change the characteristics or attribution provisions of the income. The Department of Revenue issued guidance to implement this change, which included the following example, effectively overruling the decision in Riverboat:

Example.
An LLC treated as a partnership for tax purposes and domiciled in Indiana is engaged in manufacturing automobile parts. All sales are to another Indiana manufacturer. A nonresident S corporation is a member of the Indiana LLC. The nonresident S corporation provides a distributive share of income to its nonresident individual shareholders. The Indiana LLC’s income that passes to the S corporation and then to the shareholders is income derived from the sale of automobile parts to an Indiana manufacturer and is treated as such at the S corporation and individual shareholder levels. The nonresident S corporation shall file a composite return for all of the nonresident shareholders and include the income attributable to the distributive shares from the Indiana LLC (and any other Indiana-source income of the S corporation) on the composite return with the amount of tax due being remitted by the nonresident S corporation.

7. New Mexico.

New Mexico pass-through entities are required to make quarterly withholding tax payments on net income distributed to their nonresident owners. Certain employers must file quarterly withholding information returns. These requirements apply to taxable years beginning on or after January 1, 2011. The withholding rate is equal to the maximum personal income tax rate for the tax year (currently 4.9%).

Previously, a pass-through entity had to withhold and pay income tax for all nonresident owners who had not provided the entity with an agreement to take responsibility for paying New Mexico income taxes, unless the pass-through entity demonstrated that failure to withhold was due to a reasonable cause.

Under the new legislation, a pass-through entity must make quarterly withholding tax payments on net income distributed to every nonresident owner. Net income is defined as the income reported to an owner by the pass-through entity for federal income tax purposes. While an owner may still agree to pay the withholding tax, the pass-through entity will be liable for the tax if the owner fails to pay.

A reasonable cause exception is also available under the new legislation. In addition, if the amount to be withheld from an owner's share of net income in any calendar quarter is less than $30, then no withholding is required.

The withholding rate will be set by the New Mexico Taxation and Revenue Department (TRD); however, the rate cannot exceed the higher of the maximum personal income tax rate for the tax year or the maximum corporate income tax rate for the tax year (currently 7.6%). A pass-through entity can base the amount it withholds on the prior tax year's net income if that year was a full year.