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ISSUES RELATING TO FLOWTHROUGH ENTITIES

Introduction

Use of flowthrough entities

Closely held businesses are often organized as flowthrough entities (FTEs). In addition, FTEs are widely used within the organizational structure of large, widely held multistate and multinational businesses.

For federal income tax purposes, an FTE is generally not a taxpayer. Instead, the FTE is a conduit through which income, deductions, and credits flow to its owners. As a result, the owners generally avoid double taxation when they withdraw earnings or appreciated assets from the business. Most states follow the flowthrough treatment of such entities, but there are many exceptions. Some states tax the income of FTEs at the entity level instead of or in addition to taxing the flowthrough income.

Types of FTEs

Common FTEs:

- General partnership
- Limited partnership (LP)
- Limited liability partnership (LLP)
- Multi-member limited liability company (LLC)
- Single-member limited liability company (SMLLC)
- Subchapter S corporation (Sub S)
- Qualifying Subchapter S subsidiary (QSSS or Qsub)

Quasi-FTEs

Some entities that are taxpayers in their own right are allowed to deduct some or all income distributed or distributable to their owners from their own tax base, thus achieving a single level of tax on that income. These may be thought of as quasi-FTEs.

Some examples of quasi-FTEs:

- Estates
- Trusts, including business trusts
- Registered investment companies (RICs)
- Real estate investment trusts (REITs)
- Real estate mortgage conduits (REMICs)

Owners of FTEs: Terminology

The owners of an FTE are called by different terms depending on the form of the FTE. Partnerships are owned by partners; LLCs by members; and S corporations and Qsubs by stockholders. Unless the context relates only to one type of FTE, the term "owner" will be used in this material to mean partner, member, or stockholder.

Trends in state taxation of FTEs and their owners

IRS statistics show that between 2000 and 2008, the number of partnerships (including LLCs taxed as partnerships) in the U.S. increased by almost 53%, while the number of S corporations rose by 41.5%. The number of general partnerships actually declined over that period, while the number of limited partnerships increased only slightly. The big increase was in LLCs taxed as partnerships, which increased 164% between 2000 and 2008.[1]

As of 2013-14 there were about 3.5 million partnerships (including LLCs taxed as partnerships)[2] and more than 4 million S corporations[3] in the US. These figures are not significantly different from 2008.

- **Increased withholding and composite return requirements**

The proliferation of FTEs after the 1986 repeal of the *General Utilities*[4] doctrine created a dramatic increase in the number of FTEs operating in more than one state, and having owners residing in multiple states. As a result, states soon noticed the difficulty of enforcing compliance by nonresident individual owners.

In 1991, **California** instituted a program of withholding 7% of California source income distributed to nonresident partners (including members of LLCs taxed as partnerships). Other states soon followed suit, either requiring withholding or requiring the entity to pay the tax on behalf of nonresident owners.

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[1] IRS business statistics can be found at http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data (accessed 5/31/2013). The IRS figures do not identify LLCs taxed as S corporations, which are included in S corp numbers.

[2] http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Statistics-by-Entity-Type

[3] http://www.irs.gov/uac/SOI-Tax-Stats-Table-1-Returns-of-Active-Corporations,-Form-1120S

[4] In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935) the U.S. Supreme Court held that a corporation was not required to recognize gain when it distributed appreciated property to its stockholders. Statutory provisions enacted before 1986 had reversed the *General Utilities* ruling except for the one-year liquidation rule of former IRC Sec. 337, which was repealed by the Tax Reform Act of 1986.

In 2003 the Multistate Tax Commission issued a model nonresident partner withholding statute, which prompted several more states to enact withholding laws. Almost all states that impose individual income taxes now have such provisions. In some cases, withholding can be avoided if the nonresident owners execute and file a consent to jurisdiction and agree to file returns and pay the tax. If a nonresident owner fails to file and pay, the FTE may be contingently liable. In a few states the FTE is primarily liable for the nonresident owners' tax.

Most states imposing comprehensive individual income taxes allow nonresident owners to elect to be included in a composite return filed on their behalf by the FTE. In some states, the entity is required to file a composite return on behalf of all nonresident individual partners and pay the tax on their behalf.[5] On the other hand, effective for years ending on or after December 31, 2014, **Illinois** repealed its composite return provision and replaced it with a more comprehensive withholding rule.[6]

- **State imposition of entity-level taxes on FTEs**

The first state statute enabling the formation of LLCs was enacted by the state of **Wyoming** in 1977. After the IRS ruled in 1988 that a Wyoming LLC would be taxed as a partnership as long as it failed two of the four "corporate characteristics" tests of former Treas. Reg. § 301.7701-2,[7] other states hastened to enact LLC statutes in response to enthusiastic lobbying by business interests. By 1997 all states had enacted statutes authorizing the formation of LLCs and prescribing rules for their governance.

[5] For years beginning after 2008 and ending before December 31, 2014, **Illinois** required FTEs to include a composite return on behalf of nonresident owners, on Form IL-1000, with its replacement tax return. Out-of-state owners that are businesses could elect out of inclusion in the composite but individual owners could not. See 2013 Form IL-1000 and Form IL-1000-E. For years beginning after 2011, the **Vermont** Commissioner of Taxes may require an FTE with more than 50 owners to file a composite return on behalf of its nonresident owners. Vt. Stat. Ann. 32 §5920(b). After 2000, **Louisiana** requires a composite return on behalf of all nonresident individual members who do not file with the Department an agreement to make timely returns and payment. La. Rev. Stat. Ann. § 47:201.1. Since 2007, **Indiana** requires a composite nonresident individual return including all nonresident individual partners. Ind. Code § 6-3-4-12(h). **Alabama** requires a composite return and payment of tax by the partnership beginning in 2009.

[6] 35 ILCS 502(f) and 709.5(f) as amended by L. 2013, H3157 (P.A. 98-0478), effective 01/01/2014.

[7] Limited liability, centralized management, free transferability of interests, and continuity of life

To the extent that enterprises that would otherwise have been organized as C corporations choose to operate as LLCs taxed as partnerships or S corporations, there is a revenue loss at the federal level. In a long series of private letter rulings on LLCs issued between 1988 and 1996, the IRS and Treasury appear to have given little thought to the potential revenue impact, leaving that issue to Congress. Congress, in turn, seemed unperturbed by the potential revenue loss.

Beginning January 1, 1997, the "check-the-box" regulations treat any unincorporated business entity as a partnership (or disregarded entity, if it has only one owner) unless it elects to be treated as a C corporation.[8] Exceptions are provided for entities organized in certain foreign countries, which are *per se* corporations under the regulations.

In the early days of LLCs (and their cousins, LLPs and LLLPs) it was expected that these structures would be used primarily by small businesses. Since the advent of check-the-box, which gives entities that provide limited liability to all of their owners an automatic option to avoid corporate income taxes, many very large organizations have taken advantage of that opportunity.[9]

A Congressional Budget Office study estimates that the federal treasury lost $76 billion in revenue in 2007 due to S corporations and LLCs reporting as FTEs rather than corporations.[10] That year there were almost as many FTEs as corporations with more than $50 million of gross revenue.[11] In a working paper presented at the April 2016 New York University Tax Policy Colloquium, the authors estimated that if 2011 total business income had been earned by the same business structures (mostly C corporations and sole proprietorships) as existed in 1980, federal revenue would have increased by $100 million.[12] Evidently, after all this time, some authorities at the federal level are noticing the revenue effects of check-the-box.

[8] Treas. Reg. § 301.7701-3.

[9] Examples are Koch Industries, with revenues exceeding $100 billion and 80,000 employees, and Cargill with 160,000 employees. Construction firm Bechtel is another example, along with GMAC and Kaiser Permanente. http://www.prlog.org/11980873-the-biggest-llcs-in-the-usa-2012-edition.html, accessed 03/31/2015. Lucasfilm Ltd. was a sole-stockholder S corporation when it was acquired from George Lucas by Disney for $4 billion in 2012. Hamilton, Amy, *The Year Partnership Issues Take Center Stage?,* State Tax Notes, April 11, 2016 (80 State Tax Notes 141)

[10] *Taxing Businesses Through the Individual Income Tax, Appendix B,* Congressional Budget Office, December 2012, https://www.cbo.gov/sites/default/files/112th-congress-2011-2012/reports/43750-TaxingBusinesses2.pdf

[11] *In Tax Overhaul Debate, Large vs. Small Companies,* New York Times, May 24, 2013, http://www.nytimes.com/2013/05/24/business/in-tax-overhaul-debate-its-large-vs-small-companies.html?pagewanted=all&_r=1&

Net income from flowthrough businesses has exceeded C corporation net income almost every year since 1998. In 2011, flowthrough income was $1.3 trillion, which was 63.9% of total business income.[13]

As LLC statutes were adopted by the states, a few considered the potential revenue loss and either decided to absorb it (*e.g.*, **New York**) or imposed a toll charge for use of the LLC structure (*e.g.*, **California**). Some states already imposed entity-level taxes on partnerships (*e.g.*, the **Illinois** personal property tax replacement tax, the **Michigan** Single Business Tax, and the **New Hampshire** dividends and interest tax and business profits tax), and those were generally also applied to flowthrough LLCs.

In recent years, more states have imposed entity-level taxes on limited liability entities. **Tennessee**, **Ohio**, **Kentucky** and **Texas** are examples.

• Adoption of simplified merger and conversion statutes

Since 2000 a number of states have enacted laws that allow a wholly-owned subsidiary to be easily converted into an FTE, often an SMLLC. Rather than going through the steps of organizing a new LLC and merging an existing partnership or corporation into it, or transferring the assets of an existing entity into an LLC, many states now allow the simple filing of a certificate of conversion. In that case, generally the LLC is not considered to be a new entity, as it would be in a traditional merger, but is deemed to be the same entity as the transferor. As a result, in some cases, sales or use tax on the transfer of assets can be avoided.

However, the federal check-the-box regulations specify that converting an unincorporated entity taxed as an S or C corporation, or a corporation organized under state law, to a flowthrough or disregarded entity results in a taxable transaction. The "corporation" is deemed to have distributed its assets and liabilities to its stockholders in liquidation, and in turn the stockholders contribute the assets and liabilities to a newly formed partnership.[14] The tax treatment of such a change of classification is determined with reference to the relevant Code provisions and tax principles.[15]

[12] Richard Prisinzano,U.S. Treasury Department, and Danny Yagan, University of California at Berkeley Economics Department, et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay?*, http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/NYU-2016-Business-in-US-Analysis-of-tax-paid.pdf.aspx

[13] http://taxfoundation.org/article/overview-pass-through-businesses-united-states

[14] Treas. Reg. § 7701-3(g)(1)

Thus if the entity taxed as a corporation has appreciated assets, the gain on the distribution of those assets in liquidation will be recognized at the entity level. The owners will have capital gain to the extent of the excess of the fair market value of the distributed assets and liabilities over their basis in the entity. Then their basis in the "partnership" will be the fair market value of the assets and liabilities contributed to it.

- **Creative ways of limiting liability**

Multiple LLCs

Businesses are organized as limited liability entities primarily to protect their owners' other assets from claims of the creditors of the business. In this regard, LLCs have an advantage over corporations. If a corporation is sued, its creditors can reach only the assets of the corporation, not those of the stockholders.[16] However, creditors of the stockholders can reach their assets, including the stock of the corporation, and stand in the stockholders' shoes. Once the creditors control the corporation, they can sell or pledge its assets to satisfy their claims.

An LLC, by contrast, may provide both outside-in and inside-out liability protection. The LLC's creditors cannot reach the members' other assets, and in addition, creditors of the members of the LLC can obtain only a charging order, which gives them an economic interest in the LLC but does not transfer the membership interest or give the creditors the power to control the entity, sell its assets, etc. In order to maximize this protection, many advisers counsel clients to form a separate LLC for each property or activity. For example, a real estate business may be organized with an LLC for each piece of property. As a result, creditors of each LLC can reach only that LLC's assets; the assets of the other LLCs are protected.

[15] Treas. Reg. § 7701-3(g)(2)

[16] Assuming, of course, that the corporation is not determined to be the alter ego of the stockholders.

A single-member LLC (SMLLC) may not provide the same protection. A 2003 bankruptcy court decision allowed a trustee to sell property held by an SMLLC and distribute the proceeds to the creditors of the bankrupt individual owner. Thus an SMLLC may protect the owner's other assets from claims by the LLC's creditors, but an SMLLC's assets may not be protected from claims by the owner's creditors. The court noted that if the LLC had other members, only the bankrupt member's distributions would have been available to the trustee.[17]

The state of **Nevada** enacted legislation in 2011 that specifies a charging order as the sole remedy for creditors of an SMLLC.[18] **Wyoming** has a similar statutory rule. Legislation updating the **Delaware** Limited Liability Company Act confirms that a charging order is the only remedy available to a creditor of an LLC member, and provides that the law applies to single-member as well as multiple-member LLCs.[19]

Series LLCs

To simplify these structures, **Delaware** and other states have enacted "series LLC" statutes.[20] These laws allow the formation of a single LLC with a number of separate "series" (like cells or compartments), with separate liability protection for each series.

Series LLCs raise a number of technical questions under both federal and state tax law. On the federal side, many of the questions are answered by the regulations proposed by the IRS in September 2010.[21] These proposed regulations provide some clarification as to when a series organization will be treated as a single entity or multiple entities for federal income tax purposes. When the regulations are finalized, more states may move to authorize the formation of series LLCs and provide guidance as to their treatment for state tax purposes.[22]

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[17] *Ashley Albright*, 291 BR 538, Bankr. D. Colo. 4/4/03. Also see *Olmstead v. Federal Trade Comm.,* 2010 Fla. LEXIS 990 (June 24, 2010) and *In re Jonas*, 2012 WL 2994724 (Bkrtcy.D.Mont., Slip Copy, July 23, 2012). http://goo.gl/06dz1

[18] SB 405, Ch. 455, 2011 Stats. Of Nev. See https://trustprovident.com/nevada-extends-charging-order-protection-to-single-member-llcs-an-interview-with-steven-j-oshins-esq-protection-to-single-member-llcs-an-interview-with-steven-j-oshins-esq/, accessed 03/31/2015.

[19] **Delaware** L. 2013, H126 (c. 74), effective 08/01/2013

[20] **Illinois, Iowa, Kansas, Missouri, Montana, Nevada, Oklahoma, Texas, Tennessee, Utah,** the **District of Columbia,** and **Puerto Rico**.

[21] Prop Reg §301.7701-1(a)(5)

[22] Ely, Bruce et al., *An Update on the State Tax Treatment of LLCs and LLPs,* State Tax Notes, Feb. 15, 2016 (79 State Tax Notes 505).

In general, the proposed regulations treat each series or cell in the organization for tax purposes as if it were a separate entity formed under state law. Each series may "check the box" electing to be taxed as a C or S corporation, a partnership, or a disregarded entity, regardless of the election made by any other series or by the series organization itself (the umbrella entity, as opposed to the series within it). The series organization is not required to file a federal information return unless it has its own income, deductions, credits, etc. independent of the series within it.

A task force appointed by the America Bar Association's Taxation Section has surveyed the states in order to inform the IRS and the public as to whether, and to what extent, the states intend to conform to the proposed regulations. It issued a preliminary report on April 30, 2013.[23]

The task force surveyed all 50 states and received responses from 31 by the date of its report. Not all responding states answered all of the task force's questions.

Twenty-two states so far said they will conform to the federal classification of a series within a series organization; 6 states were undecided. Texas did not respond to the survey but has ruled that a series LLC will be treated as a single entity for margin tax purposes. One series within a series LLC organization cannot file a separate margin tax return.[24]

For employment tax purposes. 9 states responded that they would treat each series as a separate employer.

For sales and use tax purposes, 13 states said they will consider a transfer of taxable property between two series or between a series and the series organization to be a taxable transaction. Nine states were undecided.

Details are available in the task force report (see note below). There is still a great deal of uncertainty on many of these issues.

The **California** FTB has stated that a series LLC organization will be treated as a single LLC, subject to only one $800 minimum tax, unless BOTH of the following apply:

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[23] Ramelli, Rudolph R., *ABA Tax Section Submits Comments on Series Entities,* State Tax Notes, May 20, 2013 (68 State Tax Notes 627)

[24] Texas Policy Letter Ruling No. 201005184L, 05/05/2010. Also see Ely, et al., *State Tax Treatment of LLCs and LLPs: Update*, 75 State Tax Notes 533, March 2, 2015.

- The holders of the interest in each series are limited to the assets of that series on redemption, liquidation, or termination, and may share in the income only of that series.

- Under state law, the payment of the expenses, charges, and obligations of the series is limited to the assets only of that series.[25]

- **State tax issues raised by new federal partnership audit procedures**

For years beginning on or after January 1, 2018, Congress has replaced the TEFRA[26] partnership audit procedures with new rules. The 2015 Budget Act[27] provides for audit and payment of assessment at the partnership level. Under the new rules, the IRS will examine the partnership return for the taxable year (the "reviewed year"), and the adjustments will be taken into account in the year the audit or judicial proceeding becomes final (the "adjustment year").

As a result, the cost of the partnership adjustments will be borne by the partners in the adjustment year, some of whom may not have been partners in the reviewed year. Alternatively, the partnership may elect to send notices to the reviewed-year partners, who would then calculate the additional tax due for the reviewed year; the underpayment would then be added to the partner's tax liability for the adjustment year. This is familiarly known as the "push-out" election and relieves the partnership from liability for the additional tax.

In the alternative, the partnership may provide information to the reviewed-year partners that enables them to prepare and file amended reviewed-year returns and pay the tax deficiency. This is known as the "pay-up" election. To the extent that the partnership can document the filing of amended returns by the partners or show that partners are not taxable (e.g., exempt organizations), the partnership will be relieved of liability.

These new rules will pose problems for states, whether or not they conform to them. State tax officials are already considering how to react.[28]

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[25] FTB Publication 3556, rev 4-2011, sides 4-5

[26] Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 96 Stat. 324

[27] .Bipartisan Budget Act of 2015, P.L. 114-74, 129 Stat. 584

[28] See Bergmann, et al., *Adapt or Adopt? New IRS Partnership Audit Rules Affect States,* State Tax Today, Jan. 16, 2016 (2016 STT 15-9), and MTC Counsel Bruce Fort's Dec. 10, 2015 presentation to the MTC's fall uniformity meeting,

State tax issues arising from flowthrough entities

The use of FTEs as business structures gives rise to many potentially significant state tax issues, including the following:

- Does state law conform to the federal law exempting the FTE from income tax at the entity level and imposing the tax at the owner level? If not, what taxes are imposed at the entity level? Is the entity subject to a net worth tax or other business activity tax?

- How is the flowthrough income taxed to:

  - Resident owners?
  - Nonresident owners?
  - Corporate owners?

- In what states is the entity required to file income tax returns?

  - States where the FTE does business or derives income
  - States where the owners reside
  - The state where the FTE is organized

- Does state law impose restrictions on the kinds of activity that can be engaged in by an FTE? For example, can an FTE, or only a certain type of FTE, be licensed as a construction contractor, a financial institution, or an alcoholic beverage distributor?[29]

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http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2015/Uniformity-Committee-Agenda-12-2015/partnershippresentation3a.pdf.aspx

[29] In **California**, an LLC can engage in any business except banking, insurance, trust company operations, or professional services requiring licensing by the state (Cal. Corp. Code sections 13401, 13401.3, and 17375). Due to some confusion as to the definition of "professional services" for this purpose, it appears the Secretary of State registered some LLCs that may not qualify under the law. The FTB has indicated that an LLC that is determined by a court to be illegal because it is engaged in a professional services business will not be eligible for a refund of the LLC minimum tax or fee. See Wright, K., *Out-of-State LLCs and LLC Members -- Beware the Long Arm of California!*, 42 State Tax Notes 527, November 6, 2006. According to the FTB Tax Advocate, an LLC can perform services requiring a license, certification, or registration, but only if the law requiring the license specifically allows an LLC to be the licensee. For example, an LLC cannot perform dental services, even if the member actually performing the service is a licensed dentist. See https://www.ftb.ca.gov/professionals/taxnews/2014/August/Ask_the_Advocate.shtml. **Delaware, Illinois** and **Pennsylvania** are examples of other states that do not allow LLCs to engage in certain activities such as banking and insurance.

State Conformity to Federal Flowthrough Status

State conformity to IRC Subchapter K

With respect to partnerships, virtually all states adopt or conform to Subchapter K of the Internal Revenue Code. Federal rules governing contributions to and distributions from partnerships, special allocations, calculation of the partner's basis, and the flowthrough of the partner's distributive share of income, gain, loss, credit, etc. apply for state tax purposes. State adjustments may be required in the computation of partnership income, e.g., depreciation differences, tax-exempt interest income, etc.

State conformity to "check-the-box" rules

Most states have conformed to the federal "check-the-box" regulations, allowing unincorporated businesses such as LLCs to elect to be taxed as corporations. An entity that does not elect corporate treatment will be taxed as a partnership if it has more than one owner. A non-electing entity with only one owner (SMLLC) is disregarded; it is not treated as an entity separate from its owner for income tax purposes.

There are some exceptions. For example, **Texas** imposes its corporate franchise tax on LLCs and SMLLCs as if they were C corporations. LLC income does not flow through to members. Also, beginning with returns due in May 2008 (based on results for years ending in 2007), the Texas franchise tax applies to all businesses, except for sole proprietorships, general partnerships, businesses with less than $300,000 in revenue or less than $1,000 in tax liability, and certain unincorporated passive entities.[30] Another example is **Washington**, which for business and occupation tax (and sales and use tax) purposes treats an LLC as a taxpayer (a "person" or "company") regardless of its federal classification as a partnership, corporation, or disregarded entity.[31]

LLCs, LLPs, and limited partnerships may be subject to state franchise taxes measured by net worth, even though treated as flowthroughs for income tax purposes. LLCs electing corporate treatment under the check-the-box rules are subject to **North Carolina's** franchise tax.[32] **Wyoming**[33] imposes its "annual report license fee" on LLCs. **Tennessee** imposes its franchise tax on LLCs, LLPs, and limited partnerships.[34]

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[30] HB3, Laws 2006

[31] Wash. Rev. Code § 82.04.030

[32] N.C. Gen. Stat. section 105-114(b)(2).

[33] Wyo Stat. §§ 17-16-1630(a) and 17-29-209(a)

[34] Tenn Code Ann. §§ 67-4-2105(a) & 2106(a)

Before January 1, 2017, **Louisiana's** franchise tax does not apply to any unincorporated limited liability entity, even if it has elected corporate treatment for income tax purposes. An LLE electing C or S corporation status is not subject to franchise tax.[35] However, for tax periods beginning after December 31, 2016, the franchise tax has been expanded to apply to all entities that are taxed as C corporations for federal income tax purposes.[36]

The recent trend is to repeal or phase out these taxes. For example, **Kansas** imposed its franchise tax on LLCs, LLPs, and LPs before the tax was repealed.[37] **Pennsylvania's** capital stock and franchise taxes apply to LLCs;[38] however, the tax is phased out effective January 1, 2016.

State conformity to federal S corporation status

An S corporation is a corporation organized under state law that elects the flowthrough status provided by Subchapter S of the Internal Revenue Code[39] for federal income tax purposes. Most states conform to the federal treatment of S corporations. In most conforming states, qualifying S corporations are exempt from tax at the corporate level (except, in some cases, for taxes on built-in gains and excess net passive income that are taxed at the corporate level under federal law), and pass all items of income and deduction through to their individual stockholders.

Note that S corporation status is irrelevant at the corporate level in states that do not impose taxes on or measured by corporate net income.

A few jurisdictions do not recognize the flowthrough nature of S corporations, but tax them as Subchapter C corporations. Examples are **Texas, New Hampshire**, the **District of Columbia**, and **New York City**. **Louisiana** taxes S corporations as C corporations, but excludes income on which Louisiana income tax has been paid by the S corporation's stockholders.[40]

[35] La. Rev. Info. Bulletin No. 03-015, 08/25/2003 ;La. Priv. Ltr. Rul. 05-015 (Dec. 28, 2005); Filing Requirements for Partnerships and Sole Proprietorships, Dept. of Rev., 09/29/2010.).

[36] Act No. 12, 2016 Extra Sess. (1st Extra. Sess.) HB 19 (March 10, 2016)

[37] Kan. Stats. Ann. §§79-5401(a)(2) as amended by 2007 HB 2264. The franchise tax applied only to entities (corporations, LLCs, LLPs, LPs, business trusts) with taxable equity, net capital accounts, or corpus of $1 million or more, and was capped at $20,000 per year. The tax was imposed at rates that declined annually beginning in 2005 and phased out entirely after December 31, 2010.

[38] Pa. Stat. Ann. 72 §7601(a) This tax was scheduled to phase out at the end of 2010; however, in 2009 it was extended for three more years, and further extended by 2013 legislation. Act 50 of 2009 (L. 2009, H1531), Act 52 of 2013 (L. 2013, H645). The tax expires as of December 31, 2015. Pa. Stat. Ann. 72 §7607.

[39] IRC §§ 1361-1379

[40] La. Rev. Stat. Ann. § 47:287.732(B)

State requirements for recognition and election of S corporation status

Many states recognize the federal S election without further action by the corporation or its stockholders.

A few states allow the taxpayer the choice to remain a C corporation for state purposes. Some of these states require a separate state election, made by filing either a copy of the federal election form or a special state form, in order to perfect S corporation status. The state election must be filed by a specified date; failure to file the state election results in default to C corporation status. **New Jersey**[41] and **New York**[42] appear to be the last states in this category. **Pennsylvania** had a similar rule before 2006.[43]

Election out of S status

A few states allow an "election out" of S corporation status at the corporation's option.

Georgia

Georgia does not require a separate state S election, but treats a federal S corporation as a C unless all of the stockholders are Georgia residents, or all of the nonresident stockholders execute consent agreements to pay tax on their distributive shares of Georgia source income. The corporation must file consents for all nonresident stockholders with its first Georgia income/franchise tax return, and for any nonresident individuals who become stockholders in a subsequent year with that year's S corporation return. A federal S with nonresident stockholders therefore could effectively "elect out" of S treatment if all of the nonresident stockholders do not consent. Resident shareholders of such a corporation may make a state adjustment on their individual income tax returns to avoid double taxation, but only if the corporation has actually filed a Georgia corporate income tax return and paid tax.[44]

[41] N.J.R.S. § 54:10A-5.22(c)

[42] N.Y. Tax Law § 660(a)

[43] Pa. Stat. Ann. 72 § 7307.1(b)

[44] Ga. Code Ann. § 48-7-27(d)(2); S Corporation Instructions, Form IT-611S, Individual Income Tax Instructions, Form 500, p. 12, item 10.

California

In **California** before 2002, a federal S corporation could elect to be treated as either an S or a C corporation under certain circumstances. However, beginning January 1, 2002, all federal S corporations are treated as S corporations for California purposes. Any federal S corporation that had previously elected C corporation status for California purposes was required to convert to S status on its 2002 return.[45]

A C corporation that was involuntarily converted to S status for its first year beginning on or after January 1, 2002 is considered to have made its California S election on the same date as its federal election. Thus it has no taxable built-gain or net passive investment income unless it has them for federal purposes.[46]

In addition, the tax on PII is not imposed on any S corporation that has no excess net passive income for federal purposes.[47]

Current law denies the carryforward or carryback of an NOL from a C corporation year to an S year, and limits the carryforward of credits earned as a C corporation to 1/3 of their value when utilized in an S year. As a result, S corporations that had elected C treatment for California purposes and were forced to convert to S status in 2002 lost any NOL and two-thirds of the credit carryforwards to which they would otherwise have been entitled. However, unexpired C corporation NOLs can be offset against built-in gains that are taxed at C corporation rates.

State-Only S Treatment

To date, no state allows S treatment to a corporation that does not have a valid federal S election in force.[48]

[45] AB 1122, Ch. 35, Laws 2002.

[46] AB 2328, Ch. 782, Laws 2004

[47] Calif. Rev. & Tax. Code § 23811(a)

[48] **Indiana** once provided "special corporation" status for corporations that qualified to be S corporations but had not made an S election. These corporations were exempt from the former Indiana gross income tax, although they were subject to the adjusted gross income tax and the supplemental income tax. The gross income tax and the special corporation status were repealed effective for years beginning on or after January 1, 2003.

State jurisdiction to tax FTEs and their owners

State jurisdiction over flowthrough entities

In general, the due process and commerce clause standards of nexus and taxability applicable to C corporations also apply to businesses carried on in FTE form.

The fact that a state recognizes the flowthrough status of a limited partnership, LLC, or other FTE does not necessarily mean that there is no tax imposed at the entity level. Many states impose entity-level taxes on FTEs.

P.L. 86-272 may protect the entity itself from income-based taxes.[49] However, other business activity taxes (e.g., fixed-dollar minimum taxes, the **California** LLC fee, franchise taxes measured by net worth) are not subject to P.L. 86-272 protection.

Most states require an FTE to file an information return under one or more of the following conditions:

- The FTE is organized under the laws of the state.
- The FTE is doing business in the state.
- The FTE has income from sources in the state.

Partnership return filing requirements

In addition to the conditions listed above, approximately 13 states require a partnership to file a state information return if there is a resident partner, even if the partnership has no other nexus with the state. These states include **Hawaii,**[50] **Maine, Missouri, New Jersey**, **New York**, **Oregon**, **Utah,** and **West Virginia.** In **Nebraska**, filing is required only if there is a resident general (not limited) partner.[51]

[49] 15 U.S.C.A. §§381-384

[50] Haw. Admin. Rules § 18-235-95(b)(1)

[51] Neb. Admin. R. & Regs § 25-002.02

California law requires "every partnership" to file a return.[52] This provision could be read to require every partnership in the world to file a California return. Obviously the state cannot require a partnership that has no nexus to file a return. As a practical matter, California requires partnerships that are organized, registered, doing business, or deriving income from sources in California, or making an election on behalf of a resident partner, to file returns. There is no requirement to file if the only contact with the state is the existence of a California resident partner.[53]

Tiered partnerships

- Does the existence of a lower-tier partnership (P2) doing business in the state create a filing requirement for the upper-tier partnership (P1) that is a partner in P2? Evidently it does, since P1 would have source income derived from its interest in P2.

- Next question: assuming P1 is a limited partnership, is it subject to the minimum tax? See below for discussion of attribution of "doing business" by the partnership to the out-of-state partner.

Penalties for failure to file partnership returns or pay tax

Failure to file penalties

A number of states impose penalties for failure to file partnership returns. Some of these penalties are similar to the federal penalty imposed by IRC § 6648 ($50 per partner per month, for a maximum of 5 months).

States imposing per-partner-per-month penalties include **California, Idaho, Oregon, Delaware,** and **NY.** Effective for years beginning in 2011, the **California** penalty is increased from $10 to $18 per partner per month, and the maximum number of months is increased from 5 to 12.[54]

Other states impose penalties in flat amounts, or a certain amount per month or per day, without reference to the number of partners. Many of these penalties are nominal, while a few are more substantial. A few of the daily or monthly penalties are capped, but most are not.

Some examples: **Arizona, North Dakota, Connecticut, Florida, Indiana, Mississippi, New Jersey, Indiana.**

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[52] CRTC § 18633(a)(1)
[53] https://www.ftb.ca.gov/forms/2013/13_565bk.pdf, Item D, p. 6
[54] CRTC §19172

Late file/late pay penalties

In states that impose taxes on partnerships at the entity level, penalties for late filing and late payment, based on the tax required to be shown on the return (before or after prepayment credits), are generally imposed.

Examples include the **District of Columbia** and **New York City** unincorporated business taxes, the **Illinois** personal property tax replacement tax, the **New Hampshire** business profits/business enterprise taxes, the **Texas** margin tax, and the **Ohio** commercial activity tax.

State elections on partnership returns

Many elections are required to be made at the partnership level, such as choice of accounting method, choice of reporting year, election out of the installment method, inventory accounting methods, amortization of startup costs, depreciation methods, etc. Failing to make a special state election could trigger higher taxes for the partners or burdensome administrative inquiries.

Although many states automatically accept federal elections, a few require specific state-level elections or statements. For example:

- **Hawaii** requires a partnership that elects to be excluded from the application of Subchapter K of the IRC to make a separate state election.[55]

- Although **Louisiana** generally follows federal law, an election that is made for federal tax purposes must also be separately made on the state return.[56]

The opportunity to make an election for state purposes that is different from the federal election may be beneficial. For example, where the partners' NOL utilization is limited for state purposes, electing out of installment treatment for state purposes to avoid increasing a partner's NOL may save tax dollars. **California** allows such inconsistent elections for some purposes.[57]

[55] Hawaii Regulation §18-235-95

[56] La. Rev. Stat. Ann. §§ 47:203B and 47:220.1.

[57] Cal. Rev. & Tax. Code §17024.5(e)

Filing requirements for LLCs

Multiple-member LLCs

Multiple-member LLCs electing to be treated as partnerships are considered in many states to be subject to the same filing requirements as partnerships.

However, an LLC is not the same kind of entity as a partnership. LLC laws provide that the members own a pro rata "membership interest," not an undivided interest in the underlying assets. A unit of interest in an LLC may be considered more like a share of stock in a corporation than a partnership interest.

Clearly the state where an LLC is organized or qualified to do business, or where it has due process/commerce clause nexus and is not protected by P.L. 86-272, may require it to file an information return. The state's power to require an information return solely on the basis that there is a resident member, without other connections to the state, may be questionable. Nevertheless, several states continue to require an LLC to file a return based solely on the existence of a resident owner.

Penalties for failure to file partnership returns presumably also apply to LLCs electing to be treated as partnerships. In addition, some states impose special non-filing penalties on noncompliant LLCs. For example, **California** Rev. & Tax. Code § 19135, before 2013, imposed a penalty of $2,000 per year on any foreign corporation that has not qualified to do business in the state, is doing business there, and that fails to file a return within 60 days after notice and demand by the Franchise Tax Board. Effective January 1, 2013, the penalty is extended to apply to any foreign corporation or LLC that has not qualified to do business or that has been forfeited, does business in the state, and fails to file a return within 60 days after notice and demand. The penalty now also applies to any domestic corporation or LLC that has been suspended but continues doing business and fails to file after notice and demand.[58]

[58] Ch. 313, Stats. 2012, § 3.

Single-member LLCs

An SMLLC is not a partnership. If it does not elect to be taxed as a corporation, it is disregarded for federal income tax purposes as an entity separate from its owner. Most states follow the federal "check-the-box" classification of SMLLCs. As a result, an SMLLC is not required to file an information return in the states where it does business or derives income. However, the single member, whether individual or corporate, is generally required to file an income tax return including the SMLLC's activities.

The **California** Franchise Tax Board issued a legal ruling early in 2011 affirming that if a disregarded entity (SMLLC or Qsub) is doing business in California, its owner is doing business and is subject to the personal income tax or the corporate franchise tax.[59] **California** requires an SMLLC to file its own Form 568 to report and pay the $800 minimum tax and the LLC fee.

An exception to the general rule is **Alabama**, which requires an SMLLC to file a partnership information return and a K-1 for its owner.[60]

State filing requirements for S corporations

Generally, an S corporation must file a return in the state where it is incorporated and in each state where it has due process/commerce clause nexus and is not protected by P.L. 86-272. A state's jurisdiction to require an S corporation to file a return based solely on the existence of a resident shareholder may be questionable. **Maine** previously had such a statute, but it was repealed in 2012.[61]

Jurisdiction to tax owners of FTEs

In general

A state has the power to tax all of the income of its residents and all property and business transactions within its borders.[62] Thus the state can tax all income of a resident individual, estate or trust, and can also tax all income of nonresidents that arises from sources within the state.

State jurisdiction over business activities is governed by due process and commerce clause principles and the limitations imposed by P.L. 86-272.

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59 FTB Legal Ruling 2011-1, 1/11/2011

60 Alabama Regulations, Reg. 810-3-28-.01(1)(a) and (b), as amended April 30, 1998

61 Me. Rev. Stats. § 5421, repealed by L. 2012, c. 655

62 See *Shaffer v. Carter*, 252 U.S. 37, 40 S. Ct. 221, 1920.

State taxation of resident individual owners

States can tax all income of residents, including income earned before, but received after, establishing residence in the taxing state.[63] Residence provides a sufficient basis under the due process clause to permit a state to tax all income regardless of source.[64] Enjoyment of the privileges of residence in the state is inseparable from responsibility for sharing the costs of government.

Most states that impose individual income taxes include all income of resident taxpayers, from whatever source, in the tax base. However, a few states, by statute, exempt some or all income of residents from out-of-state sources. Residents of **Michigan**, **New Mexico** and **Oklahoma** are not taxed on income from real and tangible personal property, business activities, and gain or loss on sale of real property located in another state, whether held directly or through an FTE. For years beginning after 2012, **Kansas** excludes business income of individual taxpayers reportable on Form 1040 lines 12, 17 or 18 and Schedules C, E and F.[65]

Nonresident individual partners

The **aggregate** partnership theory of ownership is based on the principle that the partnership is an aggregation of its owners. This was the common-law approach. Under an **entity** theory, the partnership is considered an entity separate and distinct from the partners, who own only an interest in the entity, not an undivided interest in the entity's assets and operations. The Revised Uniform Partnership Act, and the Revised Uniform Limited Partnership Act, which have been adopted by most states, take the entity approach.

Subchapter K of the Internal Revenue Code applies a mixture of the aggregate and entity theories of partnerships. For example, it applies the aggregate principle by providing nonrecognition of gain or loss on contributions to and distributions from partnerships. On the other hand, the computation of partnership taxable income and the treatment of gain or loss on transfers of partnership interests apply the entity concept.

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[63] *Lawrence v. State Tax Comm.,* 286 U.S. 276, 52 S.Ct. 556 (1932); *Hardy v. State Tax Com'r,* 258 N.W.2d 249 (N.D. 1977).

[64] *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937).

[65] K.S.A. 79-32,117(c)(xix)

States generally assert jurisdiction to tax partnership income of nonresident partners under the aggregate theory. In general, states do not distinguish between general and limited partners for this purpose.

In states that require nonresident individuals to file returns only if tax is owed, a nonresident may not be required to file an income tax return if the FTE's activity results in a loss in that state. In order to make that determination, however, the nature of the loss must be considered, i.e., whether it is a passive loss and whether the presence of portfolio income may still result in a filing requirement and tax due. It may be wise to file voluntarily in some states to record and preserve losses, and to begin the running of the statute of limitations.

If an FTE is doing business in more than one state, a nonresident owner's income from sources within the state is generally calculated by an allocation and apportionment method similar to UDITPA.[66]

Nonresident individual LLC members

Most states assert jurisdiction to tax the distributive share of a nonresident member of an LLC (or SMLLC) that has elected partnership treatment (or to be disregarded) for federal income tax purposes, to the extent that it arises from sources within the state. A survey conducted by the law firm of Baker & McKenzie in July 1998 found almost all states taking that approach, whether the LLC is member-managed or manager-managed.

The aggregate theory, however, is out of place in the LLC context. An LLC clearly is an entity separate and distinct from its members, and owns its own property and activities. Members own interests in the entity, not undivided interests in the LLC's assets.[67]

Of course, if a state could not tax a nonresident's distributive share of LLC income, it could simply legislate an entity-level tax on LLCs. Another approach, used by almost all states today, is to require nonresident partner withholding (equally applicable to LLC members) or mandatory composite returns filed by the LLC on behalf of nonresident owners.

[66] Uniform Division of Income for Tax Purposes Act, available at www.mtc.gov (Article IV of the Multistate Tax Compact).

[67] See Rosen, Arthur, *Is Flow-Through Nexus For Nonresident Members Of LLCs Legitimate?*, State Tax Notes, Dec. 21, 2015 (78 State Tax Notes 905), and Ely, Bruce et al., *Blurred Lines: State Taxation of Nonresident Partners,* State Tax Notes, Aug. 29, 2016 (81 State Tax Notes 689)

Nonresident individual S corporation stockholders

An S corporation is an FTE only because of a special federal income tax rule allowing it to elect that status. For all other purposes, including the nature of the stockholders' interests, it is a corporation organized under state law (or an LLC organized under state law electing to be taxed as an S corporation). In general, states do not assert jurisdiction over nonresident stockholders. Owning stock in General Motors does not make a person a **Michigan** taxpayer.

Nevertheless, states that recognize the FTE status of S corporations universally assert jurisdiction over nonresident stockholders. Courts in **California**[68] and **Iowa**[69] have upheld the state's power to impose the tax.

Even if jurisdiction over the nonresident stockholders is not questioned, states face practical problems in identifying and enforcing compliance by nonresidents. As a result, most states that treat S corporations as FTEs require one or more of the following:

- Written consent to jurisdiction by the nonresident stockholders to be filed with the S corporation's return as a condition of maintaining S status.[70]

- Imposition of either primary or secondary liability on the corporation for the tax on income allocated to nonresident shareholders. Examples are **Delaware** (primary liability to corporation);[71] **Mississippi** (corporation liable if nonresidents fail to file consents and pay tax);[72] **Oklahoma** (corporation liable if nonresidents fail to file and pay),[73] and **Idaho** (corporation taxed on any income not properly reported by a nonresident stockholder).[74]

[68] *Valentino, et al. v. FTB,* Cal. Ct. of Appeal, 4th Dist, No. D036034, March 23, 2001

[69] *Camacho v. Iowa Department of Revenue and Finance*, Supreme Court of Iowa, 666 NW2d 537, 6/11/2003

[70] *E.g.,* former Cal. Rev. & Tax. Code § 23801(b)(1) – repealed effective May 28, 2002

[71] Del. Code Ann. Tit. 30, § 1902(b)

[72] Miss. Code Ann. § 27-7-29(b)

[73] Okla. Stat. Tit. 68, § 2365

[74] Idaho Code § 63-3022(3)(k)

- Requirement for S corporation to withhold state income tax from nonresidents' distributive shares, whether or not actually distributed. Examples are **California** (after 2001), **Georgia, Indiana, Nebraska** (unless stockholder consents to jurisdiction), and **Minnesota.** In some states, withholding satisfies the state income tax filing requirement of nonresident stockholders who have no other income from sources within the state.

Calculating source income taxable to nonresident individual owners

Nonresident individuals generally are subject to tax on income with a source in the taxing state.

For corporate tax purposes, income is generally apportioned and allocated to a state in accordance with UDITPA or other similar provisions. Business income is apportioned to the state by means of a mathematical formula. Income that is classified as nonbusiness under UDITPA or that is specifically allocated by state law, or that cannot be apportioned under U.S. Constitutional standards, is allocated to its situs. If such income arises from intangible assets, it is usually allocated to the commercial domicile of a corporate recipient.

Some states (e.g., **Michigan, Illinois**) determine the source of income for individuals by allocation and apportionment rules similar to UDITPA. Others apply somewhat different rules.

In **California** and other states, the source of income to a nonresident is determined under rules such as the following:[75]

- Income from real and tangible personal property has its source at the location of the property.

- Income from a trade or business has its source where the business is carried on. If a nonresident carries on a single trade or business in more than one state, income is sourced in accordance with the UDITPA or other corporate apportionment rules.

- Income from personal services has its source where the services are performed.

[75] See, *e.g.,* Cal. Rev. & Tax. Code §17951 *ff.*

- Income from intangible assets has its source at the residence of the owner, unless the intangible has acquired a business situs somewhere else.

Corporate owners with no other connection to the state

In almost all states, the ownership of a partnership interest by a corporation subjects the corporation to a filing requirement, regardless of whether any tax is owed. Most states do not distinguish between general partners and limited partners or LLC members.

A few states have held that a corporate limited partner does not have nexus as long as it has no other connections to the state. However, most of these rules have been rescinded or modified to specify that certain actions by a limited partner will create taxability. In addition, some states that do not attribute nexus to a corporate limited partner now impose income-based taxes on FTEs at the entity level.

- **Texas** has no individual income tax, and previously exempted limited partnerships from its franchise tax. It also is one of a few states that do not consider a corporate limited partner with no other connection to the state to have nexus. However, beginning with the 2008 privilege year (based on 2007 financial data), the franchise (margin) tax is imposed on most limited partnerships.

- In **Alabama**, as of July 1998, the policy of the Department of Revenue was that a corporate LLC member or limited partner that had no other connection with the state did not have nexus with Alabama. In 2006, the Alabama Court of Civil Appeals held that a nonresident individual limited partner did not have sufficient Due Process connection with the state to allow it to tax the partner's flowthrough income from a partnership doing business in Alabama.[76] However, in 2008 the law was amended to require a “Subchapter K entity” with one or more nonresident owners to file a composite return and make a composite tax payment with respect to all of its nonresident owners, unless the entity is a qualified investment partnership or a publicly-traded partnership taxed as such for federal income tax purposes. Nonresident corporate or individual nonresident partners may file Alabama returns and claim their proportionate share of tax paid by the partnership as a credit.[77] The assessment of tax at the entity level has been upheld by the Alabama courts.[78]

[76] *Lanzi v. Alabama DOR,* Ala. Ct. of Civ. App., 968 So 2d 18 (2006)

- **Tennessee** does not consider a corporate limited partner with no other connection to the state to have nexus. However, effective in 1999, Tennessee's excise (income) tax applies to all entities other than sole proprietors and general partnerships. Limited partnerships and LLCs are specifically included as taxable entities.

- In 1988 the **New York** State Tax Commission issued several advisory opinions to the effect that a corporate limited partner with no other connection to the state was not subject to the corporate franchise tax.[79]

  However, in 1990 the Division of Taxation promulgated a regulation specifying that a corporate limited partner that participates in, controls or dominates all or any portion of the partnership's business activities is subject to the tax.[80] A limited partner that owns at least a 1% interest in the partnership, or whose interest has a value in excess of $1 million, is conclusively determined to have the requisite participation, control or domination. The regulation also describes additional factual situations in which a limited partner is conclusively subject to the tax, and other facts that are to be considered as indications that the requisite participation, control or domination exists.

- **Massachusetts** also has a *de minimis* rule. A corporate limited partner with no other connection to the state does not have nexus arising from the partnership's activities in Massachusetts as long as the corporation does not own more than a 5% limited interest in the partnership. In addition, the partner's share of the partnership's Massachusetts property, its Massachusetts payroll, and its Massachusetts sales must be less than $10,000 each.[81]

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[77] Ala. Code § 40-18-24.2

[78] *Tsitalia LLC v. Alabama,* BIT. 12-492 (Admin. Law Div. 2/1/2013); *K & W Producers v. Alabama,* BIT. 12-811 (Alabama Tax Tribunal, 8/11/2015)

[79] See, *e.g., Med-Tech Ventures, Inc.* (Advisory Opinion), State Tax Commission, Petition No. C871027A, April 19, 1988, TSB-A-88(10)C

[80] 20 NYCRR 1-3.2(a)(6)

[81] 830 CMR § 63.39.1(8)(d)(1)

- The **Louisiana** Court of Appeal held in 2011 that a foreign corporation with no connection to the state other than a limited partner interest in a partnership that did business there was not subject to the Louisiana franchise tax.[82] However, 2016 legislation expands the reach of the franchise tax to corporate partners, effective for years beginning on or after January 1, 2017.[83]

- Historically, the **New Jersey** Division of Taxation regarded a partnership as an entity separate from its corporate partners. A partnership interest, general or limited, did not create nexus for a corporate partner.[84] A regulatory change effective for years beginning after July 31, 1997 provides that a general partner, or a limited partner that takes an active part in the management of the partnership, is subject to the corporation business (income) tax.

  In 2002 New Jersey enacted a comprehensive reform of its corporation business tax law. Under the new law, any entity that has due process/commerce clause nexus with the state and derives income from sources there is subject to the tax. Partnerships and LLCs taxed as partnerships are required to withhold the CBT from out-of-state corporate partners' distributive shares of income from New Jersey sources. The amounts withheld are credited to the account of the partner and may be claimed as a credit against its tax liability.

  However, New Jersey regulations still provide that a foreign corporation that has no connection with the state other than a limited partner interest in a partnership doing business in the state is not subject to the CBT unless it (1) is also a general partner in the partnership; (2) takes an active part in the control or management of the partnership's business; (3) is otherwise doing business in the state; or (4) is integrally related with the partnership.[85]

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[82] *Utelcom Inc. v. Bridges,* 77 So 3d 39 (2011)

[83] La. Rev. Stat. Ann. § 47:601(A)(3), as amended by L. 2016, 1st Ex. Sess., Act 12, §2

[84] *State Tax News*, May/June 1991.

[85] N.J.A.C. § 18:7-1.9, §18:7-7.6(c)

So far, the New Jersey courts are interpreting condition (4) by looking only to the corporation that is the immediate owner of the limited partner interest, and not to integration with the corporate group as a whole. Thus if a passive intermediate holding company, based in a tax-friendly state, is formed to hold the LP interest, its income will not be subject to the CBT, regardless of the relationship between the partnership and other members of the affiliated group. As a result the LP's income will escape the CBT.[86]

- The **California** Franchise Tax Board has always asserted jurisdiction to tax the flowthrough income of a corporate partner in a partnership, general or limited, that does business in California. Historically, the FTB took the view that a corporation whose only connection to California is a limited partner interest in a partnership doing business in California is itself doing business and is subject to the California franchise tax (CFT) which imposes an $800 minimum. However, the State Board of Equalization ruled to the contrary in 1996.[87] A corporate limited partner is, however, subject to the corporation income tax, which has no fixed-dollar minimum.[88]

[86] *BIS LP v. Director, Div. Of Tax*., Docket No. A-1172-09T2, NJ Superior Ct., Appellate Div., 8/23/2011. The case was remanded to the Tax Court to determine whether the plaintiff, which was the corporate limited partner, or the partnership itself (which had paid the tax on the partner's behalf) was entitled to the refund ordered by the appellate division. The partnership had not filed a claim for refund, and the statute of limitations had expired. The Tax Court issued a summary judgment in the plaintiff's favor, finding that the Director's position was "outrageous, egregious, preposterous" (quoting *Seinfeld*). *BIS LP, Inc., v. Director, Div. of Tax*., 27 NJTax 58, 10/25/2012. The Appellate Division agreed with the Tax Court. *BIS LP, Inc. v. Director, Division of Taxation*, N.J. Super. Ct. App. Div., Dkt. No. A-1647-12T3, 04/11/2014.) The Legislature responded by amending the law to provide that payments made by a partnership on behalf of a nonresident partner are refundable only to a partner that has itself filed a New Jersey tax return, reported the NJ source income, and claimed credit for the tax paid by the partnership. N.J.S.A. 54:10A-15.11(b), as amended by P.L. 2014, c.13, effective for years ending on or after July 1, 2014. In a later case, the Tax Court held a foreign corporation holding a limited partner interest in a New Jersey partnership was itself doing business in NJ and therefore had nexus. The limited partner corporation was in the same line of business (grocery stores) as the partnership, and all of its officers, directors, and management and administrative personnel (with the exception of local store management) were employed at its corporate headquarters in New Jersey. *Village Super Market of PA, Inc. v. Director, Div. Of Tax,* Tax Court of NJ, 021002-2010, 10/23/2013. In a footnote, the court states that the unitary business principle is irrelevant to its determination of nexus in this case (fn. 25). Presumably, if the plaintiff in *Village Super Market* had formed a passive holding company subsidiary in Delaware or Nevada to hold the limited partner interest in the NJ partnership, its flowthrough income would have escaped New Jersey taxation.

[87] *Appeal of Amman & Schmid Finanz AG, et al.,* Cal. St. Bd. of Equal., April 11, 1996

[88] *Appeal of Reitman Atlantic Corp.,* Cal. St. Bd. of Equal., May 31, 2001, fn 9.

However, after 2010, the "factor presence" rules of CRTC § 23101 define "doing business" for franchise tax purposes. Sec. 23101(d) provides that for this purpose, the property, payroll and sales of the taxpayer include its distributive share of the property, payroll and sales of flowthrough entities. As a result, corporate limited partners whose distributive share of the factors exceeds the threshold amounts, or more than 25% of the taxpayer's factors, is now subject to the franchise tax rather than the corporate income tax.

Despite *Amman & Schmid*, the **California** FTB took the position that a business entity, including a corporation, that is a member of a multi-member LLC doing business in California is itself doing business and subject to the franchise tax. In July 2014 the FTB issued a legal ruling explaining its position.[89] According to the ruling, under California law even a non-managing member of a manager-managed LLC is doing business, because unlike limited partners, LLC members have the power to fire the manager.

The FTB's position was challenged by an Iowa corporation with no California connection other than a passive membership in a California LLC, and the Fifth District Court of Appeal sustained the trial court's ruling in a published decision in favor of the taxpayer.[90] The FTB announced that it would not appeal the decision, and will follow it in cases *with the same facts.*[91]

Swart was an Iowa corporation that operates a 60-acre farm and cattle feeding business in Kansas. In 2007 it acquired a 0.2% interest in a California LLC that acquires, holds, leases and disposes of capital equipment. Swart acquired its interest after the founding members of the LLC had decided that it would be manager-managed. Swart was not a manager and had no power to take part in the management, control, business decisions, or operations of the LLC. It was purely a passive investor. Swart had no connection with California other than its passive interest in the LLC. The FTB in its notice declares that it will follow the appellate court decision in cases with the same facts.

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[89] FTB Legal Ruling 2014-01, July 14, 2014
[90] *Swart Enterprises, Inc. v. FTB*, 7 Cal. App. 5th 497, 01/17/2017
[91] FTB Notice 2017-01, 02/28/2017

Tiered entities

Some states require the filing of a return by an owner who owns an interest in an FTE that owns an interest in another FTE doing business in that state -- a tiered structure. The activities of the bottom-tier entity will subject its owners to nexus and may, in turn, subject the owners of the top-tier entity to nexus. Whether those top-tier owners will have any income apportioned to them depends on how the state taxes the activities of an FTE to its owners.

- **New Jersey** regulations state that the corporate partner in a partnership that, in turn, owns an interest in a partnership that does business in New Jersey has nexus and taxable income arising from the lower tier partnership's activities.[92]

- The **New York** Commissioner of Taxation and Finance issued an advisory opinion stating that the source and character of income flowing from a lower tier partnership is not affected by the fact that it passes through one or more upper tiers before reaching the corporate owner.[93]

- A corporation that owned a tiered limited partner interest in a partnership that operated restaurants in **North Carolina** was held to be "doing business" in the state for purposes of income taxation and the general business franchise tax. The Department of Revenue ruled that a limited or general partner in a partnership that is, in turn, a general or limited partner in a partnership that is "doing business" in North Carolina is itself "doing business" in the state.[94]

- By contrast, the **Indiana** Tax Court held that a **Kentucky** S corporation was not required to withhold Indiana individual income tax on its stockholders' distributive shares of income passed through from an Indiana LLC (taxed as a partnership) that operated a riverboat casino and hotel in Indiana. The income was not from an Indiana source because it arose from an intangible, the S corporation's interest in the LLC, and not from the LLC's activities in Indiana. The Indiana Supreme Court denied the Department of Revenue's petition for review.[95]

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[92] N.J. Reg. 18:7-7.6.

[93] *BT Capital Partners, Inc.* (Advisory Opinion), Commissioner of Taxation and Finance, Petition No. C970220B, TSB-A-97(11)C, May 19, 1997.

[94] Docket No. 97-548, North Carolina Department of Revenue, April 24, 1998.

[95] *Riverboat Development, Inc. v. Indiana Dept. of Revenue*, 881 NE2d 107, 02/22/2008, Ind. S. Ct. review denied 08/28/2008

Entity-level state taxes on flowthrough entities

MTC draft model statute abandoned

The Multistate Tax Commission considered a draft model statute that would impose corporate income tax on any FTE (LLC, partnership, S corporation) to the extent it is owned by an entity that is not subject to income tax. This proposal was aimed primarily at flowthrough entities owned by insurance companies, which in most states are subject to a gross premiums tax in lieu of an income tax.[96] It addressed a perceived inequity in that income from business and investment activities carried on through FTEs owned by insurance companies escapes state corporate income taxes, while similar activities carried on through FTEs by non-insurance corporations are subject to the tax.

In response to energetic opposition from the insurance industry, the National Conference of State Legislatures, and legislators from various states, the MTC terminated this project in May 2013.[97]

Entity-level state taxes imposed on partnerships and LLCs electing partnership treatment

A number of states, while treating partnerships as flowthrough entities, also impose taxes at the entity level. These entity-level taxes generally also apply to LLCs that elect to be taxed as partnerships.

California

California imposes a minimum tax on limited partnerships for the privilege of doing business or being registered as a limited partnership in the state. The tax is $800. It is due on the original due date of the return; no estimated tax prepayment is required. A limited partnership for this purpose is any partnership with at least one general and one limited partner.[98]

What constitutes "doing business" for this purpose?

- "Doing business" is as defined for corporations by CRTC § 23101, regulations, and case law.[99]

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[96] Griffith, Cara, *Potential Effects of the MTC Draft Model Passthrough Entities Statute*, 59 State Tax Notes 803 (April 18, 2011)

[97] Hamilton, Amy, *MTC Terminates Passthrough Model Statute,* 68 State Tax Notes 507 (May 13, 2013)

[98] Cal. Rev. & Tax. Code § 17935

[99] Cal. Rev. & Tax. Code § 17935

- A partnership is "doing business" if it is actively engaging in any transaction within California for the purpose of financial or pecuniary gain or profit.

- Effective for years beginning after 2010, thresholds for "doing business" are established. An entity is "doing business" if (a) it is organized or commercially domiciled in California; (b) it has California sales in excess of the lesser of $500,000 or 25% of its total sales; (c) its real and tangible personal property in the state exceed the lesser of $50,000 or 25% of its total real and tangible personal property; or (d) it pays compensation to employees in California in excess of the lesser of $50,000 or the total compensation paid by the entity. The property, payroll and sales dollar thresholds are adjusted annually for inflation.[100] The property, payroll and sales of the entity include its distributive shares of property, payroll and sales of flowthrough entities.[101]

- If a partnership, or a general partner acting on behalf of the partnership, has California activity of its own, the partnership is "doing business" in California.

- If neither the partnership nor a general partner acting on its behalf has activities in California, the activities of an agent, independent contractor, investment manager, etc. acting on behalf of the partnership will be taken into account. Thus the standard would appear to be approximately the same as the standard for imposition of use tax collection.[102]

- The above standards would apply to general or limited partnerships engaged in investment activity.

Even though a partnership may be required to file a return and pay the minimum tax, nonresident partners will be taxed only on their distributive share of California source income. A partnership may be "doing business" for this purpose without generating California source income. A "qualified investment partnership" as defined in the statute[103] does not generate California source income for its nonresident partners.[104]

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[100] For taxable year 2015, the threshold amounts are $536,446 $53,644 sales and $53,644 property or payroll.

[101] CRTC § 23101 as amended by Stats. 2009, c. 10 (3rd Ex. Sess.), § 7 ; Stats. 2009, c. 17 (3rd Ex. Sess.), § 7 .) Similar "factor presence" standards have been proposed by the MTC (see http://www.mtc.gov/Uniformity.aspx?id=524) and have been enacted by several other states, including **Colorado, Connecticut, Michigan, Ohio, Oklahoma** and **Washington.**

[102] See *Scripto v. Carson*, 362 U.S. 207 (1960); *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992)

[103] Cal. Rev. & Tax. Code § 17955 (added by SB 723, 1993)

LLCs and SMLLCs

LLCs and SMLLCs that elect partnership or disregarded entity treatment are also subject to the $800 minimum tax.[105] An LLC must pay the minimum tax by the 15th day of the 4th month of the taxable year.

In addition, **California** calculated a revenue loss of $254 million over the 4 fiscal years following enactment of LLC legislation in 1993, after imposition of the $800 minimum tax, and achieved estimated revenue neutrality by adopting a fee structure. The fee is based on (not measured by) "total income." Before 2001, the fee was recomputed by the FTB each year, beginning in 1999, to an amount calculated to achieve revenue neutrality.

The FTB's study would have resulted in a small decrease in the fee for 2001. However, the law was amended in 2001[106] to fix the fee for 2001 and subsequent years at the levels shown below.

Total Income	1996-1998	1999	2000	After 2000
$0-$250,000	0	0	0	0
$250,000-$500,000	500	865	1,042	900
$500,000-$1,000,000	1,500	2,595	3,126	2,500
$1,000,000-$5,000,000	3,000	5,190	6,251	6,000
Over $5,000,000	4,500	7,785	9,377	11,790

An LLC's distributive share of gross receipts of a lower tier LLC that were taken into account in determining the lower tier LLC's fee is not included in the calculation of the upper tier LLC's fee.[107]

The fee does not apply to LLCs or SMLLCs that elect to be taxed as corporations. The fee (but not the $800 minimum tax) is deductible from income passed through to members.

[104] States that exempt nonresident partners' distributive shares of income from investment partnerships include **Alabama, Arkansas, California, Georgia, Idaho, Illinois, Kentucky, Maryland, New Jersey, New Mexico, New York, North Carolina, Ohio, and Texas**. Ely, Grissom & Houser, "*State Tax Treatment of LLCs and LLPs 2008,* 49 State Tax Notes 813

[105] Cal. Rev. & Tax. Code § 17941

[106] AB 898, Ch. 391, Stats. 2001

[107] For information and examples, see California FTB Tax News No. 06/01/2013, 06/01/2013.

What is "total income"?

CRTC §17942 defines "total income" for LLC purposes as "gross income, as defined in Section 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer." In a 2016 Legal Ruling, the FTB clarified that the adjusted basis of real property held for sale in the ordinary course of business is "cost of goods sold" for this purpose. By contrast, the adjusted basis of real property held for investment is not "cost of goods sold" and is not added back to gross income.[108]

The infamous LLC fee controversy

As originally enacted, the LLC fee was based on total income from all sources -- before apportionment. It seemed obvious that this violated the commerce clause of the U.S. Constitution because it was internally inconsistent. If other states had the same rules, an LLC doing business only in California would pay the fee only once, while an LLC that also did business in other states would pay it multiple times.

The LLC fee was challenged in three lawsuits:

- *Northwest Energetic Services,* involving an LLC that was registered but did no business and had no nexus with California.[109]
- *Ventas Finance I LLC,* an LLC that did business within and without California. [110]
- *Bakersfield Mall LLC,* an LLC that did business only within California.[111]

The FTB provided instructions for filing protective claims for refund of the fee at www.ftb.ca.gov and held such claims pending resolution of the litigation. In the meantime, a statutory fix for the fee was enacted in 2007, as discussed below.

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[108] FTB Legal Ruling 2016-01, July 14, 2016

[109] *Northwest Energetic Services, LLC v. California Franchise Tax Board*, California Superior Court County of San Francisco, Dkt. No. CGC-05-437721, 03/02/2006; (January 31, 2008) 159 Cal.App. 4th 841, mod. (Mar. 3, 2008). The California Supreme Court denied the FTB's petition for review of the constitutional issue on June 11, 2008.

[110] *Ventas Finance I LLC v. FTB,* CGC-05-44000I, 11/07/2006.

[111] *Bakersfield Mall, LLC v. FTB*, CGC-07-462728, 04/25/2007.

Northwest Energetic Services

In January 2008, the First District Court of Appeal ruled in favor of the taxpayer in *Northwest Energetic Services.* That case is now final.

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Statutory fix

In the meantime, the Legislature resolved the issue going forward, and limited claims for refund for prior years.[112]

The law provides that for years beginning on or after January 1, 2007, the basis for the fee is calculated by following California's version of the UDITPA rules for assigning sales to the numerator of the sales factor in the apportionment formula,[113] other than provisions that exclude receipts from the sales factor.[114]

In addition, the law provides that if the prior law is finally adjudicated to be unconstitutional, as it has been, refunds for prior years (for which timely claims for refund are filed) will be limited to the excess of the fee paid over the amount that would have been paid if the new rules had applied in prior years.[115]

The new law salvaged the LLC fee, reducing the annual revenue arising from it to about $350 million from $400 million.[116]

Ventas Finance I LLC

This case, filed in the same San Francisco superior court as *Northwest Energetic*, involved an LLC that did business within and without California.[117] The trial court held that the fee is unconstitutional for want of apportionment. The First District Court of Appeal agreed, but limited the refund to the amount that exceeded what would have been due if an apportionment formula had been applied. The California Supreme Court denied the petition for review on Nov. 12, 2008, and the U.S. Supreme Court denied the plaintiff's petition for certiorari.[118]

[112] AB 198, Ch. 381, Stats. 2007.

[113] CRTC §§ 25135-25137

[114] CRTC § 17942(b)(1)(B)

[115] CRTC § 19394

[116] FTB's projection of revenue from the LLC fee for fiscal year 2014-15 is $427 million.
https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/Revenue_Estimating_Exhibits/05022014.pdf

[117] *Ventas Finance I LLC v. FTB*, Docket No. 05-440001, San Francisco Superior Court

Bakersfield Mall and CA-Centerside

These cases involve taxpayers that had all of their activity within California. They have been coordinated and are on appeal in the Fifth Circuit Court of Appeal. The same attorneys represent the taxpayers in both cases. According to the FTB's March 2017 litigation roster, the cases are now fully briefed and the parties await the scheduling of oral argument.

Ohio

Ohio Imposes a Commercial Activity Tax, measured by gross receipts, which for most corporations has replaced the corporate franchise tax (which was measured by income or net worth). The CAT, which was phased in beginning July 1, 2005 and is fully effective for years beginning on or after July 1, 2010, applies to all businesses with $150,000 or more of annual gross receipts, however organized. Thus everything from a sole proprietorship to General Motors is covered. The tax is $150 plus .26% of Ohio gross receipts in excess of $1 million.

Texas

As part of a major overhaul of the state's entire tax system in order to comply with court-mandated revision of school funding, Texas replaced its dual-measure franchise tax with a "gross margin" tax beginning with returns due in 2008 (based on financial results for years ending in 2007). The tax applies to all active businesses except sole proprietorships, general partnerships, and exempt organizations. Certain passive entities are not subject to the tax. Taxable entities with gross receipts less than $300,000 or tax liability less than $1,000 owe no tax.

[118] *Ventas Finance I LLC v. Calif. FTB*, Cal. Ct. App. (2008) 81 Cal Rptr 3d 823 , Dkt. Nos. A116277, A117751, 08/11/2008 , petition for cert. denied, U.S. S. Ct., Dkt No. 08–1022, 04/06/2009.)

Kentucky

In an unprecedented 5-day special session in June 2006, the Legislature enacted a reform of its business tax structure.[119] For years beginning on or after January 1, 2007, flowthrough treatment is restored for LLCs, LLPs, LPs, and S corporations (which had been taxed as corporations under a previous reform that was in effect in 2005 and 2006). Withholding is required for nonresident individual owners, and for corporate owners if the corporation's only connection with Kentucky is its interest in an FTE doing business in the state.

H1 imposed a Limited Liability Entity Tax (LLE Tax), which applies to all corporations and limited liability FTEs. The LLE Tax has a fixed-dollar minimum of $175, and is measured by either gross receipts or gross profits. Entities with gross receipts or gross profits from all sources of $3 million or less pay only a $175 minimum. Entities with gross receipts or gross profits between $3 million and $6 million enjoy a reduction in the LLE tax calculated by a formula. The LLE tax in excess of $175 is allowed as a credit against the corporate income tax or the individual income tax of an FTE owner.

Illinois

Illinois imposes its personal property tax replacement tax, which is measured by net income, on partnerships and LLCs electing partnership treatment at a rate of 1.5 percent of net Illinois income.[120]

Michigan

The **Michigan** Single Business Tax, applicable to years beginning before 2008, was imposed on all "persons," including partnerships and LLCs, with business activity in the state.[121] Income passed through from FTEs that was included in an individual owner's federal adjusted gross income was also included in the Michigan individual income tax base, subject to a subtraction for business income apportionable to other states. A corporate or other business owner, however, subtracted FTE income from its SBT tax base.

[119] H1, 6/28/06

[120] Ill. Rev. Stat. Ch. 120, § 2-201(c) and (d)

[121] Mich. Comp. Law Ann. § 208.6(1) and 208.31). The Michigan SBT is repealed for years beginning after 2007.

For years beginning on or after January 1, 2008 and before January 1, 2012, Michigan imposed the "Michigan Business Tax," replacing the SBT. The MBT had two components, a tax on net income and a tax on modified gross receipts, which were applied cumulatively. Like the SBT, it was imposed on all business enterprises, however organized.[122] Net income passed through from flowthrough entities to individual owners was still included in the Michigan individual income tax base, subject to a deduction for income allocated or apportioned outside Michigan (or addition for out-of-state losses). However, a corporation or other MBT taxpayer subtracted from its tax base income or gross receipts flowing through from another entity that was subject to the MBT or would be subject if it did business in Michigan.[123]

Effective for years beginning on or after January 1, 2012, Michigan has repealed the MBT and replaced it with a corporate income tax on C corporations. There is no entity-level tax on limited liability entities unless they elect C corporation status.

New Hampshire

In **New Hampshire**, a 7 percent business profits tax (BPT) is imposed on partnership and LLC income apportioned to the state.[124] Interest and dividend income attributable to resident partners is subject to a 5 percent New Hampshire levy at the partnership or LLC level.[125]

Partnerships and LLCs are also subject to the New Hampshire Business Enterprise Tax (BET), which is imposed on the sum of compensation, interest and dividends paid by any entity engaged in business activities in the state. The rate is 0.25% of the apportioned base. Partnerships and LLCs are taxable business enterprises.[126]

The BET is allowed as a credit against the BPT, though not in excess of the amount of BPT due.[127] The net result is that the taxpayer pays the BPT or the BET, whichever is greater.

[122] Mich. Comp. Law Ann. § 208.1113(3)
[123] Mich. Comp. Law Ann. § 208.1201(2)(e)
[124] N.H. Rev. Stat. Ann. §§ 77-A:1.III(c), 77-A:3.
[125] N.H. Rev. Stat. Ann. §§ 77:3, 77:14.)
[126] N.H. Rev. Stat. Ann. § 77-E:1, E:2.
[127] N.H. Rev. Stat. Ann. § 77-A:5, X

New York City

New York City imposes an unincorporated business tax on many types of businesses carried on by individuals or partnerships, including LLCs electing to be taxed as partnerships.[128] Residents of the city are subject to a resident income tax, and no deduction is allowed for income that was subject to the unincorporated business tax.

Tennessee

Tennessee partnerships, including LLCs taxed as partnerships, are subject to the state's income tax on interest and dividends. Such income is not taxed to an individual resident owner. (Tennessee taxes individuals only on interest and dividend income.)

To help close a $365 million budget gap, the Tennessee corporate excise (income) tax was extended in 1999 to all entities other than sole proprietorships or general partnerships.[129] Limited partnerships, LLCs (including SMLLCs), and LLPs are specifically included in the list of taxpayers.[130] The law is generally effective for years beginning on or after July 1, 1999.

Amounts subject to self-employment tax in the hands of the owners of an FTE are deductible from the base, but may not reduce it below zero.

To avoid double taxation, a taxpayer may deduct from the excise tax base any flowthrough income from an entity that is subject to the tax and files a return.

Tennessee also imposes a franchise tax at the rate of .25% of net worth. The tax was formerly imposed only on corporations. The 1999 amendments also impose the tax on LLCs, LLPs, and limited partnerships.[131] Entities that are disregarded for federal income tax purposes are not disregarded for Tennessee franchise and excise tax purposes, unless the single member is a corporation.[132] The franchise tax provisions have the same effective dates as the excise tax provisions discussed above.

[128] NYC Code § 11-502(a))

[129] "Excise Tax Law of 1999," Ch. 406 (H.B. 1676), Laws 1999, applicable to tax years beginning on or after July 1, 1999.

[130] Tenn. Code. Ann. § 67-4-2004(16)

[131] "Franchise Tax Act of 1999," Ch. 406 (H.B. 1676), Laws 1999.

[132] Tenn. Code Ann. §67-4-2106

District of Columbia

The **District of Columbia** imposes an unincorporated business franchise tax on partnerships, LLCs, LLPs, proprietorships, and other unincorporated businesses, other than professional organizations, based on taxable income.[133] Distributive shares of income subject to the unincorporated business tax are not included in calculating the District of Columbia individual or corporate income tax base.

Minnesota

Minnesota subjects S corporations and partnerships, other than farming partnerships, to a minimum tax based on Minnesota source property, payroll and sales (apportionment factor numerators).[134] (Subchapter C corporations are also subject to this minimum tax, in addition to the corporate income tax.) The tax ranges from $0 for an entity with total Minnesota property, payroll and sales less than $500,000, to $5,000 for total property, payroll and sales over $20 million. In a tiered structure, a partner's distributive share of a lower tier partnership's property, payroll and sales are not included in the property, payroll and sales of the partner.

New Jersey

Beginning in 2002, **New Jersey** imposes a fee of $150 per partner on all entities taxed as partnerships (including LLCs and LLPs) deriving income from New Jersey sources. The total fee for any entity is capped at $250,000 and is due with the entity's annual tax return.

Taxes imposed at S corporation level

Income taxes and fees

A few states, while recognizing the flowthrough status of S corporations, nevertheless impose some kind of tax on the S corporation at the corporate level.

[133] D.C. Code Ann. § 47-1808.1

[134] Minn. Stats. § 290.0922

California

California recognizes S corporations effective for years beginning on or after January 1, 1987. However, the corporate franchise tax is imposed on S corporation income allocated and apportioned to California at a reduced rate of 1.5 percent, but not less than the minimum tax of $800.[135]

An S corporation that is a financial corporation is subject to tax at the rate of 1.5% plus the differential between the financial and general corporate rates (currently, 2%, for a total of 3.5%). S corporations are NOT subject to the alternative minimum tax.

Massachusetts

Taking a leaf from California's book, **Massachusetts** enacted legislation effective for tax years ending on or after December 31, 1989,[136] imposing corporate income taxes on S corporations at rates that vary with gross receipts as follows:

Less than $6 million	0.0%
At least $6 million but less than $9 million	1.83%
$9 million or more	2.75%

The rate for S corporations with gross receipts of $9 million or more is the difference between the rate applicable to C corporation income, minus the rate imposed on Part B taxable income of individuals. For S corporations with gross receipts between $6 and $9 million, the rate is 2/3 of the rate applicable to larger S corporations.[137] The rates above apply for tax years 2015 and 2016.

S corporations are also subject to the net worth/property component of the excise tax at the rate of $2.60 per $1,000 of the corporation's tangible property or net worth, and to the fixed-dollar minimum tax of $456 regardless of profitability.

135 Cal. Rev. and Tax. Code § 23802

136 H 6126, 7/26/89

137 Mass. Gen. L. Ch. 63 §32D(a)(ii)

S corporation income subject to corporate-level tax for federal income tax purposes (e.g., built-in gain) is subject to the 8% net income tax that is imposed on C corporations.[138]

S corporation income also passes through to the stockholders, whether or not distributed.

Michigan

S corporations, like all business organizations not specifically exempt, were subject to the Michigan Business Tax (for years beginning on or after January 1, 2008 and before January 1, 2012) and the Michigan Single Business Tax (for years beginning before 2008). Income passed through from an S corporation to the stockholder for federal income tax purposes is included in income subject to the Michigan individual income tax, subject to a deduction for income allocated or apportioned outside Michigan (or addition for out-of-state losses). After 2011, the corporate income tax does not apply to an S corporation unless it is a financial institution or an insurance company.[139]

Illinois

Illinois exempts S corporations from the corporate income tax but imposes its personal property tax replacement tax on them at the rate of 1.5 percent of net income allocated and apportioned to Illinois.[140]

New York

For years beginning on or after January 1, 2003, S corporations are subject only to the fixed-dollar minimum tax. Before 2008, the amount of the minimum tax varied depending on the level of total gross payroll (within and without New York). For years beginning on or after January 1, 2008, the tax varies from $25 for corporations with **New York** gross receipts under $100,000 to $4,500 for those with NY gross receipts over $25 million.[141]

An S corporation is not subject to the New York Metropolitan Commuter Transit District Surcharge of 17 percent.

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[138] The Massachusetts corporate tax rate was 9% for years beginning before 2010, reduced to 8.75 percent for years beginning in 2010, 8.5 percent for years beginning in 2011, and 8 percent for years beginning on or after Jan. 1, 2012. Massachusetts Technical Information Release No. 08-11, 08/15/2008.

[139] Corporate Income Tax FAQs—Filing requirements 23 04/11/2012

[140] Ill. Rev. Stat. Ch. 120, ¶ 2-205(c)

[141] N.Y. Tax Law § 210(1)(d)(1)

Connecticut

For years beginning on or after January 1, 2002, S corporations (and limited partnerships, LLCs and LLPs) organized or qualified to do business in Connecticut must pay an annual business entity tax of $250.[142] Beginning January 1, 2013, the tax is due only every other year. For the 2013 and 2014 years, the tax was due April 15, 2015.[143]

New Jersey

New Jersey has phased out its corporate level tax on S corporations.[144] Effective for years ending on or after July 1, 2007, S corporations are subject only to the fixed-dollar minimum tax, which varies from $375 for New Jersey S corporations (i.e., corporations with valid New Jersey S elections in place) with less than $100,000 of New Jersey gross receipts to $1,500 for those with over $1 million.[145]

Taxes on built-in gains and net passive investment income

Some states impose corporate-level taxes on built-in gains (BIG) and excess net passive investment income (PII) to the extent those items are subject to federal income tax under IRC §§ 1374 (BIG) and 1375 (PII). The tax on BIG or PII is generally imposed at the rate that applies to C corporations.

- In **Alaska, Arizona, Arkansas, California, Florida, Georgia, Hawaii, Indiana, Idaho, Iowa, Maine, Massachusetts, Minnesota, Nebraska, New Jersey, New Mexico, North Dakota, Oklahoma, Rhode Island, South Carolina,** and **Utah** both BIG and PII are subject to state tax to the extent federally taxable and apportioned or allocated to the state.

- States that do not tax BIG or PII at the corporate level include **Connecticut, Delaware, Kansas, Missouri, Montana, Nebraska, New York, Illinois**, and **West Virginia.** S corporations are not subject to the **Michigan** corporate income tax.

[142] Conn. Gen. Stat. § 12-284b(b)

[143] Connecticut Special Notice No. 2013(1), 05/13/2013

[144] N.J. Rev. Stat. § 54:10A-5(c)(2)(ii)

[145] N.J. Rev. Stat. § 54:10A-5(e), as amended effective for years beginning on or after January 1, 2012

– Built-in gains are subject to the federal corporate income tax if the property is disposed of within the "recognition period," previously 10 years from the date of the S election by a corporation that previously was a C.[146] The 2009 Recovery Act[147] shortened the recognition period to 7 years for BIG property disposed of in years beginning in 2009 and 2010. The Small Business Jobs Act of 2010[148] shortened the recognition period to 5 years for property disposed of in years beginning in 2011. Congress extended the 5-year provision through 2014 by later legislation. Finally, the Protecting Americans from Tax Hikes (PATH) Act of 2015 made the 5-year provision permanent.[149]

– States that automatically conform to federal law changes ("moving conformity" states) may have conformed to these changes. States that must enact legislation to update their federal conformity may not have conformed.

States that tax BIG and have not conformed to the shortened recognition periods include **Alabama** and **California. Alaska, Arkansas, Idaho, Hawaii, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Minnesota, New Jersey, Utah,** and **Vermont** conform for all years.

Allocation and apportionment

For purposes of calculating income subject to state tax at the corporate level, states generally use the rules of allocation and apportionment of multistate income that apply to C corporations.

Consolidated or unitary combined returns

Elective consolidation rules generally do not apply to S corporations, since they are generally tied to the federal consolidated return rules. Some states allow or require S corporations to be included in a unitary combined report, while others forbid it.

[146] IRC § 1374(d)(7)
[147] P.L. 111-5
[148] P.L. 111-240
[149] P.L. 114-113, 12/18/2015

- **California** does not allow an S corporation to be included in a combined report, although the FTB may recompute its income on a combined report basis under certain circumstances. It appears that this recalculation would not affect the amount of California income passed through to a nonresident stockholder, but only the amount subject to the corporate-level tax.

- **Arizona** will include an S corporation in a combined report to the extent of its income subject to tax at the corporate level, i.e., BIG and PII.

- **Illinois** requires S corporations that are unitary with other corporations to be included in a return filed on a unitary basis, but they must file a separate return based on that method; i.e., a combined return is not allowed, but unitary combined apportionment is applied to each separate entity.

- **Nebraska** law provides for S corporations to be included in a combined report calculation and flow through to the stockholders the pro rata shares of income apportioned to the state.[150]

Net worth or capital stock taxes

S corporations are subject to franchise taxes measured by net worth, or capital stock taxes, in a number of states, even though they are exempt from corporate-level taxes measured by income.

It may be possible to avoid a net worth or capital stock tax by organizing an LLC and electing S corporation treatment, instead of organizing a corporation to begin with. That works in **Louisiana**, for example, until 2017.[151]

[150] Neb. Rev. Stat § 77-2734.01(2)(a)

[151] Louisiana Revenue Information Bulletin No. 04-023, 12/01/2004

State taxation of corporate owners

State income tax issues for corporate owners

Corporations cannot own stock in S corporations (except that an S corporation may own 100% of the stock of a QSub). Therefore, corporate ownership issues involve corporate partners and corporate members of LLCs and SMLLCs. State statutes, regulations, and rulings dealing with corporate partners are generally assumed to be applicable to corporate members of LLCs that elect partnership treatment, although that may not be the case in every instance.

Issues facing corporate owners of FTEs include:

- How the FTE income or loss will be allocated or apportioned in each of the states involved.

- What the overall result of those allocations and apportionments will be, i.e., whether the lack of uniformity among the states will cause more or less than 100 percent of the corporate owner's income from the FTE to be taxed.

States that must be considered

States that must be considered include those in which the corporation:

- Has no nexus for income tax purposes with the state other than as a result of the operation of the FTE.

- Has nexus for income tax purposes from its own operations, although the FTE is not operating within the state.

- Has nexus for income tax purposes from both its own and the FTE's operations.

Flowthrough of income to corporate owner

In most jurisdictions that impose corporate income taxes or franchise taxes measured by net income, there is a flowthrough of the income (or loss) from an FTE to the corporate owner.

There are a few jurisdictions, however, in which there is no flowthrough. For example:

- Under the former **Michigan** Business Tax, a corporation's income or loss from an FTE was removed from the corporation's tax base whether or not the FTE was itself subject to the MBT.[107]

- Under the **New Hampshire** Business Profits Tax, a corporate owner deducts from its gross business profits those amounts that are subject to the N.H. tax at the FTE level.[108]

- Likewise, under the **District of Columbia** Income and Franchise Tax Law, a corporate owner deducts its distributive share of trade or business net income that is subject to the District's unincorporated business franchise tax.[109]

Allocation and apportionment of corporate partner's flowthrough income

Some states have not addressed in their statutes, regulations, or case law the issue of how to allocate or apportion a corporate owner's distributive share of partnership or LLC income in the multistate context. In those states, the only way to analyze the question is to construe general statutory provisions, whether UDITPA or non-UDITPA, keeping in mind the allocation and apportionment regulations that have been adopted by a few states with similar statutory schemes.

Among those states that have adopted regulations for the apportionment and allocation of FTE income in the hands of a corporate owner, there is no uniformity. A number of different methods can be observed.

Apportionment at the partnership level

One approach is to determine, at the partnership level, whether the partnership's income or loss is business or nonbusiness. If it is nonbusiness income to the partnership, it is allocated, usually to the state where the partnership's activities are conducted, or possibly to the partner's commercial domicile. If the income (or loss) is business income to the partnership, arising from activities conducted in more than one state, it is apportioned at the partnership level to determine how much is allocated to each state by the corporate partner.

There are a few states that apportion a corporate partner's flowthrough income at the partnership level. Examples are **Arkansas,**[110] **Louisiana,**[111] and **Oklahoma.**[112]

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[107] Mich. Comp. Law Ann. § 28.1201(2)(e). The MBT was repealed effective for years beginning on or after January 1, 2012, and replaced with a corporate income tax. A corporate partner's distributive share of partnership income flows through to the partner under the current tax regime.
[108] N.H. Rev. Stats. Ann. § 77-A:4V
[109] D.C. Code Ann. § 47-1802.2(a)(2)(D)
[110] Ark. Code Ann. §26-51-504(a)(1) ; Ark. Code Ann. §26-51-202(a) ; Ark. Corp. Inc. Tax Regs. §1.26-51-802(b)

Apportionment at the partner level with factor relief

A more common approach is to make the business/nonbusiness determination at the partner level. If the partnership income or loss is business income or loss in the hands of the corporate partner, it is aggregated with the corporation's other income or loss and then is subject to apportionment and allocation at the corporation's level. Most states that take this approach will also allow or require the partner's distributive share of the partnership's apportionment factor values to be included in computing the partner's factors ("factor relief").

State courts have required factor relief even though not provided for in the statute or regulations.[113]

States providing some form of factor relief include **Alabama, Alaska, Arizona, Idaho, Indiana, Iowa, Minnesota, Montana, Maryland, Nebraska, New York, Ohio, Pennsylvania, Rhode Island, Tennessee, Utah** and **Wisconsin**.

Apportionment at partner level without factor relief

In a few states, business income from a partnership is included in the partner's apportionable income but no factor relief is provided, except for inclusion of the distributive share of partnership income in the denominator of the sales factor.

- Under the former (pre-2007) **Texas** franchise tax, income from partnerships and joint ventures was included in apportionable income, and the taxpayer's distributive share of net profit (but not losses) was included in the denominator of the sales factor. The distributive share was assigned to the numerator of the state where the partnership's day-to-day operations were conducted.[114]

The legal form of the partnership may affect a business or nonbusiness income determination at the partner level. Income from limited partnerships may be considered passive investment income and thus more likely to be specifically allocable to either the partner's commercial domicile or the state of the partnership's activities. General partnerships are more likely to be viewed as functionally integrated with the corporate partner's business and thus generate income subject to apportionment.

[111] La. Rev. Stat. Ann. § 47:287.93(A)(5)

[112] Okla. Stat. 68 §2362(b) ; Okla. Stat. 68 §2363

[113] *Homart Development Company v. Norberg,* 529 A.2d 115 (R.I. Supreme Ct., 1987)

[114] 34 Tex. Adm. Code § 3.549

States that appear to distinguish between business and nonbusiness income based on the partnership's legal form include **Georgia**, **Illinois**, and **North Dakota**.

Unitary business determination

Some states provide factor relief if the FTE and the corporate owner are engaged together in a unitary business, disregarding ownership requirements. Examples are **Idaho**,[115] **Illinois**,[116] **California**,[117] and **New Jersey.**[118] These states generally distinguish between business and nonbusiness income at the FTE level. Nonbusiness income is allocated to its situs or to the commercial domicile of the entity (**Idaho)** or the commercial domicile of the owner (**California, Illinois).** Business income is added to the owner's other unitary business income and apportioned by a combined formula that includes the owner's profit-and-loss or equity interest in the property, payroll, and sales of the FTE.

California

The California regulation governing allocation and apportionment of partnership income is a special formula adopted under the authority of Cal. Rev. & Tax. Code § 25137 (UDITPA § 18).

The first step is to divide the partnership's income *at the partnership level* between business and nonbusiness income. The corporate partner's share of each item of nonbusiness income is allocated in accordance with the UDITPA rules as if received directly by the partner.

In order to deal with its share of the business income of the partnership, the corporate partner must determine whether its activities and those of the partnership constitute a unitary business, disregarding the usual ownership requirements.

- If there is no unitary relationship between the partnership and the corporate partner, the partnership's business income is apportioned at the partnership level by the partnership's factors and is reported accordingly by the corporate partner.

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[115] Id. Reg. § 27,5

[116] Ill. Reg. § 3700(d) and Ill. Income Tax Act § 305

[117] 18 Cal. Code of Regs. § 25137-1

[118] NJ Rev. Stat. § 54:10A-15.6(a); NJ Rev. Stat. § 54:10A-15.7(a). If the partner and partnership are not engaged in a unitary business, the corporate partner must consent to inclusion in its New Jersey taxable income of its distributive share of partnership income apportioned to New Jersey in accordance with the partnership's factors.

- If the corporation and the partnership are engaged in a unitary business, the corporation's share of the business income or loss of the partnership is added to the corporation's other unitary business income. In addition, the partnership's apportionment factors (property, payroll and sales) are "pulled through" to the extent of the corporate partner's percentage interest, and added to the numerators and denominators of the partner's apportionment factors.

- If the corporation and the partnership are not unitary, then the corporation's share of the partnership's business income is treated as income from a separate trade or business. If the partnership does business within and without the state, the corporate partner's share of its income is apportioned in accordance with the partnership's factors.[119]

Illinois

Illinois treatment is similar to California's.[120] However, the Illinois regulation does not contemplate the possibility that the partnership might be engaged in a unitary business with the corporate partner and also have nonbusiness income. If the partnership is not in a unitary relationship with the corporate partner, it appears that its nonbusiness income from intangibles is allocated to the commercial domicile of the partner.

The Illinois regulation was upheld by the Circuit Court of Cook County in 2001.[121]

[119] Language clarifying this point is included in a draft revision of Reg. 25137-1 proposed by FTB staff. The proposed revisions also include replacing references to "income year" with "taxable year" in accordance with current statutory law; clarifying that intercompany sales between a partnership and any member of the corporate partner's unitary group (not just the partner itself) are eliminated in computing the sales factor; and defining "interest in the partnership" as the partner's percentage interest in the profits or losses of the partnership in effect for the year in question. The proposal also clarifies that the rules apply not only to partnership interests owned directly by a taxpayer corporation, but also to indirect interests in lower-tier partnerships. Three interested parties meetings have been held on this proposed regulation, most recently on July 8, 2014. A formal regulatory hearing was anticipated in the spring of 2017, according to the FTB rulemaking calendar; nothing has been scheduled to date. https://www.ftb.ca.gov/law/regs/25137/07082014_Proposed_Language.pdf, accessed 05/20/2017.
[120] Ill. Reg. § 3380(d)
[121] *BP Oil Pipeline Co., et al. v. Zehnder, et al.,* Nos. 98 L 50300 and 00 L 50255, May 25, 2001.

Idaho

Idaho also takes an approach similar to California's, although like Illinois, it does not contemplate dividing income between business and nonbusiness at the partnership level. However, in Idaho, if the income is nonbusiness income to the corporate partner, it is allocated at the partnership level. Thus, nonbusiness income from intangibles appears to be allocated to the commercial domicile of the partnership, rather than that of the corporate partner.[122]

Indiana

If a partnership and its corporate partner are engaged in a unitary business, **Indiana** includes the partner's distributive share of the partnership's business income in the partner's adjusted gross income subject to apportionment, and includes the partner's distributive share of the partnership's property, payroll and sales in the apportionment factors.[123] The regulation was upheld by the Indiana Tax Court.[124]

New Jersey

New Jersey applies the "flow-through" method (factor representation) to a corporate partner if the partnership and the corporate partner are engaged in a unitary business.[125]

New Jersey, a non-UDITPA state, distinguishes between "operational" and "nonoperational" income. Operational income is apportioned, while nonoperational income is allocated to its situs. The characterization of income as operational or nonoperational is made at the partnership level.[126] Presumably nonoperational income from intangibles would be assigned to the commercial domicile of the partnership, although the regulation does not specify.

Attribution of "doing business" to corporate partner

Many states, including **California**, impose taxes on corporations doing business in the state. If a corporation has no connection to the state other than an interest in a partnership or LLC operating there, is it a taxpayer under a "doing business" standard?

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[122] Id. Reg.§ 27,5

[123] IAC Title 45, reg. 3.1-1-153.

[124] *Hunt Corp. v. Department of Revenue,* 709 N.E.2d 766 (April 20, 1999)

[125] N.J.A.C. § 18:7-7.6

[126] N.J.A.C. § 18:7.7-6(j)

California

Before 1996 the Franchise Tax Board took the view that a corporate partner in a partnership doing business in California is, itself, doing business and therefore subject to the $800 minimum franchise tax. Application of this principle to a corporation whose only connection with California was a limited interest in a limited partnership doing business in the state was successfully challenged in the *Appeal of Amman & Schmid Finanz AG, et al.,*[127], and the FTB's petition for rehearing was denied.

A law change effective in 2011 negates the result in *Amman & Schmid* for some taxpayers. California has adopted the "factors presence" definition of "doing business," as proposed by the MTC model statute. An entity that is "doing business," under California law, is subject to the franchise tax rather than the corporate income tax. The property, payroll and sales of the entity include its distributive shares of property, payroll and sales of flowthrough entities.[128]

Thus a corporation whose distributive share of an FTE's property, payroll or sales in California exceeds the levels set by the new statute will be "doing business" as defined by the law and subject to the $800 minimum franchise tax.

The FTB continues to assert franchise tax liability for corporate general partners. Also, while a corporate limited partner may not be subject to the franchise tax, it remains subject to the corporate income tax (which has no fixed dollar minimum) on any California source income arising from the partnership.[129] The same would presumably be true in the case of a corporate LLC member that is not "doing business" under the criteria established by the Court of Appeal in the *Swart Enterprises* case.[130]

[127] Cal. St. Bd. of Equal., April 11, 1996

[128] CRTC § 23101 as amended by Stats. 2009, c. 10 (3rd Ex. Sess.), § 7 ; Stats. 2009, c. 17 (3rd Ex. Sess.), § 7

[129] *Appeal of Reitman Atlantic Corp.,* Cal. St. Bd. of Equal., May 31, 2001, fn 9.

[130] The FTB's position that a corporate LLC member with no other connection with California is always "doing business" (see FTB Legal Ruling 2014-1, July 22, 2014) was successfully challenged in *Swart Enterprises, Inc. v. FTB,* 7 Cal. App. 5th 497, 01/17/2017; FTB Notice 2017-01, 02/28/2017. The FTB will follow *Swart* in cases with the same facts.

Missouri

Missouri imposes a franchise tax, measured by the par value of outstanding capital stock and surplus, upon corporations "engaged in business" in the state.[131] Southwestern Bell Telephone Company (SWBT), which had operated a telecommunications system in Missouri and all 49 other states for many years, went through a reorganization in 2001. It created a new Delaware corporation (Holdings), which then created a single-member LLC (LLC). SWBT then converted to a limited partnership, with Holdings as 99% limited partner and LLC as general partner. As a result Holdings was the sole owner of SWBT, 99% directly and 1% indirectly through LLC. SWBT continued to operate its business as before. As a limited partnership, SWBT was not subject to the Missouri franchise tax.

The Missouri Dept of Revenue asserted franchise tax liability against Holdings for years 2003 through 2005. The Administrative Hearing Commission determined that Holdings was not "engaged in business" in Missouri because it had no property or other assets in Missouri. However, the Missouri Supreme Court held that Holdings was "engaged in business" because it managed the assets of SWBT. It did not matter whether those assets belonged to Holdings directly or indirectly through LLC and SWBT.[132]

Issues in combining partnerships and corporations

The unitary principle of state taxation as applied by combined reporting states requires taxable income to be calculated with reference to the income and apportionment factors of all of the members of a unitary group. Theoretically, such a combined report should include the income and factors of every entity that is engaged in the unitary business. When individuals and flowthrough entities are involved, however, there are limitations on the use of a combined report.

As noted above, when a partnership and the corporate partner are engaged in a unitary business, disregarding ownership requirements, California "combines" the partnership with the corporation to the extent of the corporation's interest in its net income and apportionment factors.

[131] Mo. Rev. Statutes § 147.010

[132] *Southwestern Bell Telephone Company v. Mo. Dept. of Revenue,* 454 S.W.3d 871 (Mo. Supreme Ct. 2015)

Can a limited partner interest be unitary?

For purposes of 18 Cal. Code of Regs. 25137-1, unity is determined by "established standards." Applying such standards, the question arises whether a limited partner, who by definition cannot be involved in the management of the partnership, can be engaged in a unitary business with the partnership.

In *Appeal of Gasco Gasoline, Inc.*,[133] the SBE stated that "it would be extremely difficult to overcome the inherent passive investment nature of a limited partnership interest." The taxpayer, a vertically integrated oil business, invested in a number of oil exploration and drilling partnerships, some of which were limited interests. The partnerships were in the same line of business with the partner, and it was the taxpayer's intent to use the wells as a source of crude oil. However, in fact, only one well ever produced any oil and the taxpayer did not purchase any of it. Both the Superior Court and the Court of Appeal (unpublished decision) agreed that the partnerships were not unitary with the corporate partner.

In two later cases, California courts found unity in factual situations very similar to *Gasco*.[134] However, both of those cases involved working interests in oil and gas wells held directly by the taxpayer's subsidiary, rather than through limited partnerships.

Also, in a series of unpublished decisions in the mid-1990's, the Court of Appeal found a unitary relationship in situations very similar to Gasco's but where the taxpayer did actively participate in its oil and gas interests.

[133] Cal. St. Bd. of Equal., June 1, 1988

[134] See *Richmond Wholesale Meat Co. v. Franchise Tax Board* (unpublished), California Court of Appeal, First Appellate District, July 14, 1995, 36 CA4th 990, 42 CRptr 854, and *Yellow Freight System, Inc. v. Franchise Tax Board*, San Francisco Superior Court No. 955046, December 29, 1994.

For example, in *For Better Living, Inc. v. FTB*,[135] a corporation involved in several unitary lines of business wanted to expand into the oil industry. FBLI intended to acquire working interests, but in order to gain credibility with the oilfield operator it started out by investing in limited partner interests. Two primary managers of FBLI were very active with these ventures, visiting the sites frequently and following the progress of individual wells via daily drilling logs. Later FBLI acquired direct working interests and participated actively in their management. The Court of Appeal found that the limited partner interests produced business income, and that although FBLI could not participate directly in their management, there were sufficient centralized management and centralized departments to create a unitary relationship with FBLI's other businesses.

Combining a corporation with noncorporate stockholders

18 Cal. Code of Regs. § 25137-1 addresses only combination of a partnership with its corporate partner. There are no rules for combining corporations with stockholders that are partnerships, individuals, or other non-corporate entities.

The Court of Appeal effectively authorized the combination of a corporate subsidiary with its partnership stockholder in *Hugo Neu-Proler International Sales Corporation v. FTB*.[136] In FTB Legal Ruling 91-1[137] the FTB indicated it considered this case to be limited to its particular facts. In general, the FTB would not "fold up" corporations whose stock is held by a partnership through the partnership to the corporate partners. To do so would be to treat C corporations as if they were partnerships.

Cal. Rev. & Tax. Code § 25105, as amended by Ch. 1243, Laws 1994, applicable to income years beginning on or after January 1, 1995, addresses the issues of unity of ownership of stock held by partnerships.

- Sec. 25105 defines a "commonly controlled group" includable in a combined report (provided they are engaged in a unitary business).

[135] Case No. A070544

[136] 195 Cal. App. 3d 326 (1987)

[137] 410:BRL:CL-91-397, November 12, 1991

- A commonly controlled group includes any two or more corporations if more than 50% of the voting stock of each corporation is owned or controlled by the same person.[138] A "person" for this purpose includes a limited partnership.[139] Thus if more than 50% of the voting stock of each of two or more corporations is held by a limited partnership, the corporations may be combined with each other, but not with the partnership or its partners.

- Stock owned by a partnership is constructively owned by a general partner in proportion to the partner's capital interest in the partnership.[140] Thus in the *Hugo Neu* scenario, each of the general partners would constructively have owned 50% of the stock of the DISC, and it could not have been combined with either of them. But if one general partner owned 51% and the other 49%, the DISC (as a whole, not just 51% of it) would be combined with the 51% partner.

- If a member of a commonly controlled group, or stockholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the partnership is constructively held by the limited partners to the extent of their capital interests.[141] Thus if another member of the commonly controlled group is a limited partner, its percentage share of ownership is taken into account in determining whether the corporation is combinable with the group.

■ **Example**

Mr. X owns more than 50% of the stock of Corporation A and Corporation B. B owns 40% of the stock of Corporation C. 30% of C's stock is held by Limited Partnership LP, in which A is a 1% general partner and B is a 60% limited partner. Can A or C, or both, be included in a combined report with B, assuming they are all engaged in a unitary business?

[138] Cal. Rev. & Tax. Code § 25105(b)(2)
[139] Cal. Rev. & Tax. Code § 25105(f)(2)
[140] Cal. Rev. & Tax. Code § 25105(e)(3)
[141] Cal. Rev. & Tax. Code § 25105(e)(4)

Answer: Because A is a general partner in LP and also a member of a commonly controlled group with Corporation B, the Corporation C stock held by LP is constructively owned by B to the extent of its 60% interest in LP. B therefore owns 40% of C directly, plus 60% of 30%, or 18%, through LP, for a total of 58%. A constructively owns another 1% of LP's 30% interest in C. As a result, the AB commonly controlled group collectively owns, directly and indirectly, 58.3% of C. C can be combined with A and B.

Note that the result would be the same if Mr. X were the general partner in LP, rather than A, because he is a stockholder of A and B. ■

What if some of the partners are individuals, rather than corporations? The taxation of individuals is governed by the Personal Income Tax Law. A resident is taxed on all income, regardless of source; therefore, combination and apportionment would have no significance for a resident, except in determining the source of income for purposes of the credit for taxes paid to another state. If the individual is a partner in a partnership that owns stock in one or more corporations, and the individual, the partnership, and the corporations are all engaged in a single unitary business, there is no provision that would pull the corporations' income and apportionment factors up through the partnership to the individual partners.

■ **Example**

Mr. X, a nonresident of California, owns 100% of the stock of C Corporation, which does business within and without California. Mr. X is a 99% limited partner in partnership P, which owns real and tangible personal property that is leased to C for use in its business. C Corporation has a 1% general partner interest in P. How will C, P, and Mr. X be required to report for California tax purposes?

Answer: C Corporation's California corporate franchise tax return will include its own income and apportionment factors, plus 1% of the income and apportionment factors of P. One percent of the intercompany rent paid to P by C will be eliminated from P's sales factor and C's property factor.

P will be required to file a California partnership return, assuming it owns property in California. Mr. X will file a California personal income tax return and pay tax on his 99% share of P's net income, apportioned by P's factors. If P has no property in California, neither P nor Mr. X will have a California filing requirement. ■

The **North Dakota** Supreme Court reached a similar conclusion in *True v. Heitkamp.*[142] There, the taxpayer sought to include a number of partnerships, S corporations, and C corporations in a combined report. All of the entities were owned by members of the True family, with more than 50% held by the patriarch, H. L. True. The court denied combination, holding that North Dakota law did not provide for the combination of noncorporate taxpayers, and that corporate taxpayers could be combined only if a single entity controlled all the businesses *and was itself a member of the unitary group*. Since Mr. True, as an individual, could not be included in the combined report, no combination was possible. The decision distinguishes *Rain Bird* and *Hugo Neu-Proler International* because the California statute required only "direct or indirect ownership or control," and does not require the controlling entity to be included in the combined report.

Other multistate partnership issues

- If the corporate partner has a short period return in which no partnership year end falls, is any partnership income taken into account for that year? Probably not in **California**, due to California's conformity to IRC § 706(a) (partner's distributive share of partnership income is included in the partner's return for the taxable year with or within which the partnership's taxable year ends).

- Can all activity in one state be allocated to a certain partner or partners, e.g. those who reside in that state? Such an allocation is fine under the partnership tax rules, as long as it has substantial economic effect; however, the regulations say the partnership has to apportion its income.[143]

[142] 470 N.W.2d 582 (5/21/91)

[143] This is another issue that may be addressed by the proposed FTB regulations.

State taxation of individual owners

Resident individual owners

In general, states that recognize FTE status tax a resident owner on his or her entire distributive share of income, regardless of where the FTE conducts business or derives income. The state of residence usually allows a credit for taxes paid to other states on the same income. The taxpayer, in order to obtain the credit, generally must be taxed on the same item of income in both states in the same taxable year.

A few states tax a resident only on his or her pro rata share of income allocated and apportioned to the state, e.g., **Michigan**, **Nebraska**, **New Mexico**, **Oklahoma**.

FTE income attributed to the state of residence escapes taxation entirely in some states that do not impose individual income taxes, such as **Florida, Texas, Wyoming, South Dakota, Washington,** and **Nevada**. Some of those states tax the income of limited liability entities at the entity level, or impose minimum taxes or fees on them.

Credits for taxes paid to other states on S corporation income

Virtually all states that tax a resident stockholder's entire distributive share of S corporation income will allow credit for taxes paid to other states on S corporation income.

Some states also allow residents credit for taxes paid to other states by the S corporation. This may include taxes paid to one or more of the following:

- States that do not recognize S status
- States where the corporation has elected out of S status
- States requiring payment of taxes by the corporation on behalf of a nonresident stockholder
- States imposing taxes on S corporations at the corporate level, such as tax on BIG or PII and the **California** or **Massachusetts** corporate-level tax

Corporation's payment of tax on behalf of S corporation stockholder

Where an option is permitted to have the nonresident stockholders' tax paid by an S corporation, whether directly or via a composite return, the corporation and stockholders should consider the ramifications of corporate-level payment.

If the tax is paid by the S corporation, all stockholders bear the burden of that tax, including residents who already are taxed directly by the state on 100 percent of their pro rata share. This results, in part, because there is no mechanism in Subchapter S (in contrast to Subchapter K governing partnerships) to specially allocate items of income or loss among stockholders.

At least for federal tax purposes, payment by the corporation reduces the accumulated adjustments account (AAA) and the amount taxed to all stockholders, not just nonresidents.

The **California** Franchise Tax Board staff found in 1986, when it tried to ascertain the federal effect of a withholding requirement for nonresident stockholders, that the IRS would not guarantee in writing that the payment of state taxes on behalf of some stockholders and not others would not create two classes of stock and invalidate the S election. Although the IRS appears never to have raised this issue, there may be some risk. Nevertheless, in 2002 California repealed its requirement that nonresident shareholders consent annually in writing to the state's jurisdiction to tax their flowthrough income, and instituted a withholding requirement for nonresident S corporation stockholders.

Stockholders who are residents of states that do not allow credit for taxes paid to other states at the corporate level will forfeit the credit if they do not pay the tax directly.

Other issues for resident S corporation stockholders

S corporation distributions

- For federal purposes, distributions from S corporations to their stockholders are tax-free to the extent of the stockholder's basis in the corporation. Any additional distribution is taxed as a gain from the sale or exchange of property. If the corporation has C corporation earnings and profits, an additional limitation is imposed on tax-free distributions to the extent of the accumulated adjustments account (AAA), which generally consists of corporate earnings that have been passed through to and taxed to the stockholders. Any distribution in excess of the AAA amount is taxed as a dividend to the extent it does not exceed the accumulated earnings and profits. Distributions in excess of both AAA and accumulated earnings and profits are taxed as gain from the sale of property.[144]

- Some jurisdictions do not recognize S corporation status or did not in the past. As a result, distributions of income earned during the time when S corporation status was not recognized will be treated as dividends. A separate state AAA calculation may be required.

A distribution that constitutes a dividend for state income tax purposes will generally be taxed only by the stockholder's state of residence.

Gain or loss on sale of S corporation stock

Gain or loss on the sale or other disposition of S corporation stock generally has its source at the residence of the stockholder. However, the basis of the stock for state purposes may (or may not) differ from the basis for federal purposes.

- **Example**

Federal law imposes a corporate-level tax on built-in gains (BIG) realized by an S corporation that was previously a Subchapter C corporation.[145] The corporate-level tax is treated as a loss sustained by the S corporation, and passes through to the stockholders as a deduction.[146] **New York** does not impose a corporate level tax on built-in gains, and does not allow the stockholders to deduct their distributive shares of the federal BIG tax. After a NY state audit added the federal income tax back to the stockholders' taxable income, stockholders requested a corresponding increase in their basis in the S corporation's stock.

[144] IRC § 1368
[145] IRC § 1374
[146] IRC § 1366(f)(2)

New York law defines taxable income as federal taxable income plus and minus certain specified adjustments.[147] There is a specified adjustment for the addback of the federal income tax deduction for an S corporation stockholder,[148] but there is no provision for adjustment in the basis of the S corporation stock or in the gain or loss on its disposition. Therefore the stockholders were denied the basis adjustment.[149] ■

Nonresident individual owners

Source of income

Nonresidents are subject to state income tax only on income arising from sources within the taxing state. In general, source income is defined as follows:

- Income from real or tangible personal property, including gain or loss on the sale or other disposition of such property, if the property is located in the state.

- Income from business activities carried on in the state. If a unitary business is conducted in more than one state, income is usually apportioned among the states by a formula similar to UDITPA.

- Income from personal services performed within the state.[150]

- Income from intangible personal property with a business situs in the state. An intangible has a business situs when it is an asset of a business carried on at a particular location. For example, the accounts receivable, checking and savings accounts, and investments of a business have a situs in the state where the business is carried on. Stock certificates pledged as security for a loan to a business carried on in the state, and held by the lender in the state, also have a business situs in the state. Income from licensing the use of intangible property such as patents, copyrights, etc. may have a business situs at the place where the licensee uses the property to produce income.

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[147] NYTL § 612(a)

[148] NYTL § 612(b)(18)

[149] New York Advisory Opinion TSB-A-11(a)I, 02/11/2011

[150] Owners sometimes elect S status intending to minimize employment taxes by limiting their salaries and receiving the remainder of the S corporation's income in the form of distributions not subject to FICA. However, for a nonresident stockholder, wages are sourced where the individual's services are performed, while the distributive share of income is sourced by apportionment at the corporate level. A stockholder residing in a no- or low-tax state, who performs most or all of his or her services in the state of residence, may benefit from maximizing the salary if a significant portion of the S corporation's income is apportioned to a relatively high-tax state.

Also, if a nonresident buys or sells intangible property in the state or places orders with brokers in the state so regularly, systematically, and continuously as to constitute doing business, the income may have a source in the state regardless of the situs of the property.[151] Nevertheless, some states specify that income from investment partnerships has its source at the partner's residence.[152]

"Combined reporting" for nonresident individuals

If a nonresident individual owns interests in two or more sole proprietorships or FTEs, one or more of which is doing business in **California**, and the proprietorships or FTEs are engaged together in a unitary business, a California regulation requires a combined apportionment calculation to determine the amount of California source income arising from the unitary business and subject to tax.[153]

The combination rule does not apply to FTEs in which the taxpayer owns less than 20% of the interest. Family attribution rules apply to determine whether a taxpayer's interest in the activity meets the 20% test.

For less than 20% interests, a combined computation may be required at the FTB's discretion, but only if California source income is not clearly reflected after applying the comparable uncontrolled price method prescribed by the IRC § 482 regulations and Cal. Rev. & Tax. Code § 23801(d)(1).

California appears to be the only state that has taken this approach to determining source income of a nonresident individual from flowthrough entities or sole proprietorships. However, the **Michigan** Supreme Court has ruled that for purposes of determining the out-of-state business income of a resident taxpayer, which is excludable under the Michigan law, a taxpayer may combine and apportion the income of two wholly-owned S corporations that are engaged together in a unitary business.[154]

[151] *E.g.* Cal. Rev. & Tax. Code § 17952

[152] *E.g.* Cal. Rev. & Tax. Code § 17955; Mass. G.L. Ch. 62, §17(b)

[153] 18 Cal. Code of Regs. § 17951-4, eff. January 23, 2002. The current FTB project to revise Reg. § 25137-1 includes a proposed revision of Reg. § 17951-4 to clarify that the apportionment of income from the unitary business is governed by the UDITPA rules (CRTC §§ 25120-25139) and not by CRTC § 17952. This amendment is meant to address the issue created by the State Board of Equalization's nonprecedential decision in the *Appeal of Venture Communications, Inc., et al.,* Cal. St. Bd. of Equal., Feb. 5, 2003, in which the Board applied CRTC § 17952 to source income from the sale of a partnership interest (an intangible) by an S corporation to the residence of the Nevada resident stockholder.

[154] *Malpass, et al. v. Department of Treasury*, Mich. S. Ct., Dkt. Nos. 144430-144432, 145367-145370, 06/24/2013. See also *Winget v.Dept. of Treasury,* Mich. Ct. pf App. No. 302190, 03/11/2014, clarifying that the S corporations must be unitary.

Part-year resident issues

For part-year residents, the issue is how to allocate non-source FTE income to the period of residence.

Most states prorate non-source FTE income by the months or weeks of residence and nonresidence. An actual cutoff as of the date of residence change may be allowed.

California and **New York** have changed their positions on this matter over the years. Before 2003, **California** held that partnership income becomes taxable at the end of the partnership's year, and includes 100% of the non-California source income or loss if the partner is a resident at that date.[155] The same principle was administratively applied to S corporation stockholders.

However, after the repeal of the accrual rule of former CRTC § 17554,[156] the FTB staff reconsidered its approach to the inclusion and sourcing of flowthrough income for part-year residents. For years beginning on or after January 1, 2002, the FTB applies a proration rule.

If information is available to determine the actual date of realization of an item of income (e.g., the date of sale of an asset by the partnership), that information will be used to assign the income to one period or the other. In the absence of such information, income will be prorated by the days or months of residence and nonresidence.[157]

Many states follow the proration rule. This approach is generally taken by states that require a part-year resident to file two tax returns, a nonresident return for the nonresident period (if there is source income to report) and a resident return for the period of residence. **Massachusetts** is an example.[158]

New York has been through a similar series of changes, taking the proration approach before 1987, then switching by regulation to the end-of-entity's year approach until that was found invalid by the Tax Appeals Tribunal in 1999. The TAT allowed the taxpayer to prorate by the months.[159]

[155] *Appeal of Kimbrough*, Cal. St. Bd. of Equal., 1982; *Appeal of Lacey*, Cal. St. Bd. of Equal., 1984.
[156] AB 1115, Ch. 920, Laws 2001
[157] California FTB Legal Ruling 03-1, 4/7/03
[158] *See* 830 CMR 62.17A.1(6)
[159] *Petition of Robert T. and Susan M. Greig,* DTA No. 815529, 9/16/99

Whether a taxpayer could use an actual cutoff method in lieu of proration by the months was a matter of controversy until 2004, when the New York statute was amended to provide for proration by the days or the use (by the taxpayer) or requirement (by the Department) of an accrual method division of the actual income, deductions, etc. of the FTE.[160] The current rules apply to years beginning on or after January 1, 2004.

Source of gain or loss on sale of FTE interest by nonresident owner

If a nonresident owner sells his or her interest in an FTE, what is the source of the gain or loss? States generally consider a partnership interest or a share of corporate stock to be an intangible asset, and the gain or loss to be sourced at the residence of the owner. As discussed above, gain on the sale of S corporation stock is sourced to the owner's residence. The treatment of partnership or LLC interests is not as clear.

Some states differentiate between the sale of a limited partner interest and a general partner interest. While a limited partner is considered a passive investor, and the limited interest analogous to a share of stock, a general partner interest may be considered to have a business situs where the partnership's business is carried on. The same approach might be applied to an interest in a member-managed LLC.

- In *Appeal of Amyas and Evelyn P. Ames* the taxpayers were nonresident limited partners in a partnership that did business in **California**.[161] The FTB argued that because the partnership operated in California, the partnership interest had a business situs here. The SBE concluded that the gain was not the result of California business operations, but rather the disposition of an intangible asset. As a result, the *mobilia* doctrine applied. The decision does not suggest that a different result would have been obtained if the taxpayer's interest had been general rather than limited.

[160] L. 2004, S7561 (c. 712), eff. 11/18/2004

[161] Cal. St. Bd. of Equal., June 17, 1987

The holding in *Ames* was foreshadowed by the *Appeal of Holiday Inns Corporation*.[162] In 1988, Cal. Rev. & Tax. Code Sec. 25125 was amended to overturn *Holiday Inns* by allocating nonbusiness gain or loss on the sale of a partnership interest in the ratio of the original cost of partnership property (just before the sale) in California to the total everywhere. This rule applies only to corporate partners; individual partners are still subject to the *Ames* rule.

- **Maine** has adopted a rule similar to California's CRTC Sec. 25125 to apportion gain or loss from the sale of a partnership interest, applicable to sales occurring on or after July 1, 2005.[163] This provision appears to apply to both individual and corporate partners.

- **Ohio** has a statute that requires a nonresident owner of a 20% or greater interest in an FTE doing business in the state to pay individual income tax on an apportioned share of the gain (or loss) on the sale of an interest in the LLC. The statute, as applied to a passive investor in the LLC, was struck down by the Ohio Supreme Court on due process grounds because there was no unitary relationship between the taxpayer and the LLC. The decision suggests that if the owner had been more active in the business, the gain might have been apportionable under due process.[164]

- What if the partnership interest is sold by an intermediate partnership in a tiered structure?

[162] Cal. St. Bd. of Equal., 1986.

[163] Laws 2005, H 343, eff. 6/29/2005.

[164] *Corrigan v. Testa,* No. 2014-1836, slip op. 2016-Ohio-2805 (May 4, 2016)

■ **Example**

A closely-held **California** corporation, C, was a real estate developer. C was a general partner in P1, which in turn was a general partner in P2. P2 was formed to do condominium conversions in **Maryland**. Everyone agreed that P1 and P2 were not engaged in a unitary business with C, and it appears that C had no other business activities outside California, so that UDITPA (and CRTC Sec. 25125) did not come into play. P1 sold its interest in P2 at a gain. The FTB argued that the gain was California source income because C's commercial domicile was in California. The SBE held that the gain should be sourced to the commercial domicile of P1, because it was the entity that sold the intangible. The taxpayer did not meet its burden of proof that P1's commercial domicile was outside California. This is an unpublished SBE decision and therefore is not precedential, but it does raise some interesting planning possibilities. If the taxpayer had set up P1 to have a clear commercial domicile in Maryland, where P2's project was located, presumably the taxpayer would have won.[165] ■

- A nonresident partner's gain on the sale of an interest in a partnership that owned **New York** real property was not taxable by New York.[166] Similarly, a nonresident was not allowed to deduct a loss on the dissolution of a partnership that had owned an office building in New York. The partnership sold the building at a loss. The nonresident partner was allowed to deduct the loss passed through from the partnership (the difference between his distributive share of the sale price and his inside basis in the property). However, his outside basis in the partnership was larger than his inside basis, and he was not allowed to deduct the difference between his outside and inside basis because the partnership interest was an intangible, sourced to his state of residence.[167]

[165] *Appeal of Carousel Complex, Inc.,* Cal. St. Bd. of Equal., Jan. 31, 1992 (summary decision).

[166] *Petition of Loehr,* Division of Tax Appeals, ALJ, February 27, 1992

[167] *Petition of Olsheim*, NYS Tax Appeals Tribunal, 824218, 04/10/2014.

- Gains realized by Florida residents on the sale of interests in three **Massachusetts** partnerships did not constitute Massachusetts source income. The partnerships owned income-producing real property in Massachusetts. Each of the Florida residents was a general partner in one or more of three family partnerships organized in Massachusetts, and each sold his or her interest back to the partnership. The Appellate Tax Board considered the income to be from the sale of the partnership interests, an intangible, and not from the sale of an interest in the underlying Massachusetts real estate.[168]

- A Mississippi resident stockholder in an **Alabama**-based S corporation was assessed Alabama tax on his distributive share of gain recognized at the S corporation level on the deemed sale of its Alabama assets pursuant to an election under IRC § 338. The taxpayer argued that the transaction was, in reality, a sale of his stock in the S corporation, and the gain was sourced at his residence. The Alabama Court of Civil Appeals agreed with the Department of Revenue that the character and source of the gain were determined by the § 338 election.[169]

- The **Oregon** Tax Court differentiated between limited and general partner interests in holding that the sale of a limited partner interest did not generate Oregon source income to a nonresident. The court observed that a general partner interest in the same partnership would have had a situs in Oregon "because, by definition, it was intangible personal property used in a trade or business in Oregon." The fact that the taxpayer's general partner interest was converted to a limited partner interest and sold in the same document on the same day did not change the result. The taxpayer had first tried to sell the general partner interest but was unable to get the other general partner's consent. In converting the interest to a limited partner interest, the seller (and the buyer) gave up significant rights.[170]

- **Idaho** law provides that gain or loss from the sale of a partnership interest or the stock of an S corporation is Idaho source income to a nonresident individual owner, to the extent of the entity's Idaho apportionment percentage in the year immediately preceding the year of sale.[171] This rule is in effect for years beginning on or after January 1, 2005 and was expected to increase annual revenue by $1 million.

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[168] *Cohen, et al. v. Comm.,* Appellate Tax Board, August 30, 1995.

[169] *James E. Prince, Jr. v. State Department of Revenue*, 2080634, 05/07/2010

[170] *Bishop v. Dept. of Revenue,* 13 OTR 472, April 24, 1996

[171] Idaho Code § 63-3026A as amended by HB 25, Ch. 21, Laws 2005, effective 1/1/05

State tax withholding programs for nonresident owners

Reasons for implementation

Filing enforcement and revenue enhancement

Based on a study matching K-1s to individual income tax returns, the **California** Franchise Tax Board estimated a $31 million annual "tax gap" due to noncompliance by nonresident partners in the mid-1980's.[172] According to FTB sources, approximately $20 million was collected in the first 10 months of its nonresident partner withholding program, despite the fact that FTB was lenient in granting delays and waivers of withholding in the early months.[173]

New Mexico expected to collect an additional $18 million annually from its newly instituted nonresident withholding program. HB 487 (1999) requires partnerships, LLPs, LLCs, and S corporations to withhold taxes from nonresident owners.

Acceleration of tax collection

Withholding can result in early collection of tax by the state, especially from taxpayers who would not otherwise file or pay without filing enforcement contact from the state. Some states require withholding to be calculated and paid quarterly by the FTE. **Maine, Massachusetts, New York** and **Vermont** are examples.

Many taxpayers may choose to leave small amounts of tax withheld "on the table" rather than go to the trouble and expense of filing a return to claim a full or partial refund.

Base for withholding

Distributive share

Most states with nonresident owner withholding programs require withholding on the distributive share of income from sources within the state, generally at the time it is credited or paid to the owner. As a result, most withholding is payable at the end of the FTE's taxable year or at the date of distribution, whichever is earlier.

[172] $31 million in 1985 would be more than $61 million in 2008, according to a popular Internet inflation calculator.

[173] According to an internet inflation calculator, $20 million in 1991 would be more than $474 million in 2015 dollars.

Distribution of cash or property

California withholding is required on all distributions of cash or property to a nonresident partner or S corporation stockholder to the extent the distribution represents California source income of the current or a prior year. However, the FTB is proposing to change its regulation to require withholding on the distributive share.[174]

Withholding issues

If withholding is required on the distributive share, or if a distribution consists of property other than cash and no cash is distributed or available for distribution, the partnership may be unable to withhold. Some states forbid the distribution of property unless cash is available to pay the withholding.

These are the same kinds of problems that arise under IRC Sec. 1446 withholding on the distributive share allocable to non-U.S. partners. As a result of these problems, some investment partnership interests are no longer marketed to foreigners.

A state may withhold only on income over which it has jurisdiction, e.g., income from sources within the state.

Tiered structures present difficult problems for withholding, especially on distributive shares as opposed to actual cash or property distributions. Partnership returns and individual income tax returns are due at the same time, and although the partnership may be required to distribute K-1s by January 31, many partnerships fail to meet that deadline. If withholding is required on partnership income distributable to a partner that is itself an FTE, and the lower tier partnership does not report the withholding until near or after the due date of the returns of the upper tier partnership and the partners, the result is confusion and delayed reporting, sometimes resulting in penalties for late filing or late payment.

[174] Proposed Reg. §18662-7. An interested parties meeting on this proposal was held on December 12, 2014. https://www.ftb.ca.gov/law/regs/18662-7/12122014_Summary_0f_Interested_Parties_Meetings.pdf.

Rev 05/2017

Composite nonresident returns

Introduction

Many states have adopted statutory or regulatory provisions allowing an FTE to file a composite return (CR) on behalf of its nonresident individual owners, subject to certain conditions or approvals. Some states extend the composite return procedure to nonresident individual beneficiaries of trusts and estates as well.

Composite nonresident returns discharge the participating nonresident owners' individual return filing responsibilities. Additionally, CR programs often offer an alternative to mandatory nonresident withholding.

Composite filing has the advantage of administrative simplicity for the individual owner, particularly if the FTE is doing business in a number of states where the owner has no other source income. Disadvantages may include the loss of personal exemptions, deductions or credits and the benefits of graduated tax rates.

Conditions for filing composite returns

Elective CR programs generally require the taxpayers who wish to be included to agree to some or all of the following conditions:

- Permission to file a composite return must be granted in advance.

- The FTE must file a return with the state.

- Only individual owners may be included.

- Only owners who agreed to be included, and who have no other income from sources within the state (or whose only other source income is from FTEs that also file CRs) are eligible for inclusion in the CR.

- The FTE must notify the owners of the election to participate in the program. An election to participate is final and irrevocable upon filing of the return. Some states require each owner to attach a signed election to the return. Others require the FTE to obtain a power of attorney from each owner included in the CR.

- The owners and the FTE must agree that the FTE will accept and pay any assessments of additional tax on the CR. The FTE must agree to represent the individual owners in protest, claim for refund, or appeal proceedings, or in court proceedings relating to the CR.

- The FTE must make estimated tax payments on behalf of the nonresident owners included in the CR.

- The FTE must agree to act as withholding agent in the event that any owner (not just one included in the CR) has a final assessment of tax.

- No deductions are allowed other than those necessary to determine each owner's distributive share of FTE income.

- No credits are allowed other than those attributable to FTE activity.

- Tax for each owner included in the return must be paid at the highest marginal rate.[175]

Mandatory composite returns

Several states now impose mandatory composite return filing on behalf of all nonresident individual partners, whether or not they have other income from sources in the state. **Illinois** and **Indiana** are examples; in **Vermont,** beginning in 2012, the Commissioner of Taxes may require a composite return of a flowthrough entity with more than 50 owners.

Reverse credit states

Most states allow their residents credit for taxes paid to another state on income also taxed by the residence state. In effect, the residence state cedes the tax to the state where the income arises. However, a handful of states stand in a reverse relationship, whereby the source state cedes the tax to the state of residence. A resident of one of those states who has income with a source in another is allowed a credit on his or her nonresident return for the tax paid to the state of residence.

States involved in these reverse credit relationships are **California, Arizona, Indiana, Oregon,** and **Virginia**. **Arizona, Indiana**, and **Virginia** also allow credit to residents of the **District of Columbia**, which does not subject nonresidents to its individual income tax. **California** also allows credit to residents of **Guam**.

All states that allow nonresident credits and also permit the filing of composite returns on behalf of nonresident owners of FTEs deny the nonresident credit for tax paid to the state of residence on the income included in the composite return. A composite return of nonresident owners does not provide enough information on an individual basis to compute the credit. Therefore, the owner who elects to be included in a composite return gives up his or her right to the nonresident credit.

[175] Before 2009, nonresident owners subject to the Mental Health Services Tax (i.e, those with more than $1 million of California source income) could not be included in a California composite return. These taxpayers are subject to an additional 1% tax. Beginning in 2009, such individuals may be included in a composite return, and the additional 1% tax must be withheld or paid with the return.

- The **Arizona** Board of Tax Appeals held that a resident partner could not claim credit for taxes paid on such composite returns filed with other states. The Arizona resident could have claimed credit from the states of Virginia and Indiana, but was bound by an agreement with his firm (KPMG Peat Marwick) to be included in a composite return. The BTA said that because the taxpayer voluntarily gave up his right to a credit that would otherwise be allowed by the other state, he was not entitled to a credit from Arizona.[176], [177]

- The **California** State Board of Equalization reached the opposite conclusion. Interpreting statutory language very similar to Arizona's, the Board held that the other state had not "allowed" the credit, even though the taxpayer had voluntarily given up his right to it by his inclusion in the composite return. Since the nonresident state allowed no credit, California law required the allowance of a credit to a resident. The appellant in this case was the head of Ernst & Young's Los Angeles tax practice.[178] The FTB recently confirmed this result in a Technical Advice Memorandum issued in January 2017.[179]

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[176] *Daniel J. and Mary B. Vine v. Arizona Department of Revenue,* Arizona BTA, December 19, 1996.

[177] Effective for years beginning in 2008, **Indiana** now requires partnerships to file a composite return on behalf of all nonresident individual partners, whether or not they have other Indiana source income. Ind. Code § 6-3-4-12(h) and (i). Since the nonresident taxpayer now has no right to file his own separate Indiana return to report partnership income, **Arizona** may now be willing to allow credit to a resident partner for the tax paid on the **Indiana** composite. However, nothing in the Arizona form instructions or regulations indicates that the credit would be allowed.

[178] *Appeal of Gregory J. Soukup and Mary Jo Carr,* Cal. St. Bd. of Equal., December 13, 1994 (released March 1995).

[179] FTB TAM 2017-01, 03/01/2017