

# State Taxation of Flowthrough Entities

Kathryn M. Jaques  
Summer Tax Institute  
June 2017

## Types of FTEs

- ▶ General partnership
- ▶ Limited partnership
- ▶ Limited liability partnership (LLP)
- ▶ Limited liability company (LLC)
  - Multiple member LLC
  - Single member LLC (SMLLC)
- ▶ Subchapter S corporation
- ▶ Qualifying Subchapter S subsidiary (QSSS)
- ▶ Quasi-FTEs

## Trends in state taxation of FTEs

- ▶ Increased withholding & composite return requirements
- ▶ State imposition of entity-level taxes on FTEs
- ▶ Simplified merger and conversion statutes
- ▶ Ways of limiting liability
  - Multiple LLCs
  - Series LLCs
- ▶ State reactions to new federal partnership audit procedures

## State tax issues

- ▶ Does state recognize flowthrough status, or tax at entity level, or both?
- ▶ How is flowthrough income taxed to
  - Resident individual owners
  - Nonresident individual owners
  - Corporate owners
- ▶ Where is the entity required to file returns?
- ▶ Is the entity required to withhold on nonresident owners?
- ▶ Are composite nonresident individual returns available or required?

## Conformity to federal flowthrough status

- ▶ Conformity to Subchapter K
- ▶ Conformity to check-the-box
- ▶ Conformity to Subchapter S
  - Requirements for state recognition of S status
  - Election out of S status
    - California before 2002
    - Pennsylvania
- ▶ No state-only S status

## State jurisdiction over FTEs and owners

- ▶ Jurisdiction over the FTE
  - Due process/commerce clause nexus standards apply
  - P.L. 86-272 can protect from net income taxes
    - Does it protect owners as well as the FTE?
  - FTE may have to file an information return where
    - It is organized
    - It does business
    - It derives income
    - It has at least one resident owner

## State jurisdiction over FTEs and owners

- ▶ Jurisdiction over the FTE (cont.)
  - Penalties for failure to file information returns
  - State elections on partnership returns
  - Filing requirements for LLCs
  - Filing requirements for S corporations

## State jurisdiction over FTEs and owners

- ▶ Jurisdiction over the owners
  - Resident individual owner
  - Nonresident individual owner
    - General partner
    - Limited partner
    - LLC member – manager or nonmanager
    - S corporation stockholder

## State jurisdiction over nonresident owners

- ▶ Calculating source income taxable to nonresident individual owners
  - Some states use UDITPA rules
  - General rules for individuals
    - Real & TPP: Location
    - Personal services: Where performed
    - Business: Where conducted
    - Intangibles: Residence or business situs

## State jurisdiction over nonresident owners

- ▶ Corporate owners of limited interests with no other connection to the state
  - Generally held to have nexus
  - Some exceptions
  - Tiered entities

## Entity-level taxes on FTEs

- ▶ Partnerships and LLCs
  - California – \$800 min, LLC fee
  - Ohio CAT
  - Texas margin tax
  - Kentucky LLE tax
  - Illinois “replacement tax”
  - Michigan Business Tax
    - Repealed effective 1/1/12
  - New Hampshire BPT/BET

## Entity-level taxes on FTEs

- ▶ Partnerships & LLCs (cont.)
  - New York City UBT
  - Tennessee excise (income) tax
  - District of Columbia UBT
  - Minnesota “factors tax”
  - New Jersey per partner fee

## Entity-level taxes on FTEs

### ▶ S corporations

- California – \$800 min, 1.5% CFT/CIT tax
- Massachusetts
- Michigan Business Tax
- Illinois replacement tax
- New York \$25 to \$4,500 minimum tax
- Connecticut \$250 BET every other year
- New Jersey \$375 to \$1,500 minimum tax

## Entity-level taxes on FTEs

### ▶ S corporations (cont.)

- Taxes on BIG and NPIL
  - Most states tax BIG and NPIL attributable to the state at C corp rates
  - States that do not include NY, VA, IN, IL
  - Conformity to shortened recovery periods for BIG dispositions in 2009 thru 2014
    - Yes – AZ (09–13 only), MA, UT (all years)
    - No – AL, CA

## Entity-level taxes on FTEs

- ▶ Allocation and apportionment
  - Generally follow UDITPA or other corporate rules
- ▶ Consolidated or unitary combined returns
- ▶ Net worth/capital stock taxes

## Taxation of corporate owners

- ▶ State issues for corporate owners
  - Corporate partners
  - Corporate LLC members
    - Taxed as partnerships
    - Taxed as C corps
  - Nexus issues
    - Nexus only through FTE
    - Nexus from own operations but not FTE
    - Nexus from both FTE & own operations
    - Does PL 86-272 apply at FTE level, partner level, or both?

## Taxation of corporate owners

- ▶ Flowthrough to corporate owner
  - Generally applies
  - Exceptions (examples)
    - Michigan before 2012
    - New Hampshire
    - DC

## Taxation of corporate owners

- ▶ Allocation & apportionment of FTE income
  - At partnership level
  - At partner level with factor relief
  - At partner level without factor relief

## Apportionment of partnership income

### ► Facts

	Corp C	P Total	20% P
In-state sales	500	200	40
Everywhere sales	1000	5000	1000
Net income	200	500	100

## Apportionment of partnership income

### ► Apportion at partnership level

	Corp C	20% P	Total
In-state sales	500	40	
Everywhere sales	1000	1000	
Apportionment %	0.5	0.04	
Net income	200	100	
Apportioned income	100	4	104

## Apportionment of partnership income

- ▶ Apportion at partner level w/factor relief

	Corp C	20% P	Total
In-state sales	500	40	540
Everywhere sales	1000	1000	2000
Apportionment %			0.27
Net Income	200	100	300
Apportioned income			81

## Apportionment of partnership income

- ▶ Apportion at partner level w/o factors

	Corp C	20% P	Total
In-state sales	500		500
Everywhere sales	1000		1000
Apportionment %			0.5
Net income	200	100	300
Apportioned income			150

## Apportionment of partnership income

- ▶ Unitary business determination
  - Same result as factor relief if unitary
  - No factor relief if not unitary but business income?
    - California
    - Illinois
    - Idaho
    - Indiana
    - New Jersey

## Is corporate partner “doing business”?

- ▶ California minimum tax
  - Changes due to “economic nexus” statute effective 1/1/2011 – defines “doing business”
  - Is an LLC/P member with no other CA connection “doing business”?
    - Ct of Appeal says no – *Swart v. FTB*
    - Narrow interpretation – FTB Notice 2017-01
- ▶ Massachusetts

## Combination issues

- ▶ Can limited partner interest be unitary?
- ▶ Combining corporation with noncorporate stockholders?

## Taxation of individual owners

- ▶ Resident individual owners
  - Income generally flows through
  - All income regardless of source (some exceptions)
  - No state income tax if both
    - No individual income tax and
    - No entity-level tax on FTE
    - FL, WY, SD, WA, NV

## Taxation of individual owners

- ▶ Credits for taxes paid to other states
  - Residents generally allowed credit for tax on FT income
  - May be allowed credit for entity-level tax
- ▶ Payment of tax on behalf of S corp stockholder
- ▶ S corporation distributions
- ▶ Gain/loss on sale of S corp stock
  - Source of income
  - Basis differences

## Taxation of individual owners

- ▶ Nonresident individual owners
  - Source of income
    - Salary vs. distributive share
  - “Combined reporting” for nonresident individuals (Calif. Reg. 17951-4)
    - Note MI Supreme Ct *Malpass* case
  - Part-year residents
  - Source of gain/loss on sale of interest/stock by NR owner
    - Effect of IRC Sec. 338 election
    - Due process issue? *Corrigan* Ohio Supreme Court

## Withholding

- ▶ Reasons for withholding
  - Filing enforcement
  - Revenue enhancement
  - Acceleration of tax collection
  - Sidesteps possible nexus issues
- ▶ Base for withholding
  - Distributive share (cf. IRC Sec. 1446)
  - Distribution of cash or property
    - CA considering change from distribution to distributive share

## Composite returns

- ▶ Administrative convenience
- ▶ General requirements
  - FTE files return, assumes responsibility
  - Only individuals (no corps)
  - No other source income
  - Tax at highest marginal rate
  - No deductions or credits except related to FTE
- ▶ Mandatory composite returns
  - IL, IN, VT, AL
- ▶ Reverse credit states
  - CA, AZ, IN, VA