

State and Local Tax Bulletin

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Alabama Edition



Department of Revenue Certifies Composite Return and QIP Regulations; Continues to Seek Comments for Possible Amendments

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Upcoming Seminars Involving Members Of Our SALT Practice Group

January 21-23, 2010

American Bar Association Tax Section Winter Meeting, Grand Hyatt Hotel, San Antonio, Texas. Bruce Ely and Will Thistle will be speakers in a panel presentation on "State Administrative Procedure Acts: Procedural Avenues to Attack Faulty Regulations and Assessments." For more information, please visit the ABA website: www.abanet.org/tax/meetings.

January 28-29, 2010

Council On State Taxation 2010 SALT Basics School, Georgia Tech Hotel & Conference Center, Atlanta, Georgia. Chris Grissom will be a co-panelist in a presentation on preparing internal research memoranda and the interplay with the attorney-client privilege and work product doctrine. For more information, please visit the COST website: www.statetax.org.

February 2, 2010

Bruce Ely and Jimmy Long will be speaking to the Birmingham Tax Forum on February 2 on the topic of "Recent Alabama Legislative Developments and Prognostications". The Forum is held at the Summit Club, atop the Regions-Harbert Building in downtown Birmingham.

On Monday afternoon, January 11, the Alabama Department of Revenue certified as final a revised set of three proposed regulations regarding composite income tax return payment requirements for Subchapter K entities with nonresident members/partners, the exemption for qualified investment partnerships (or "QIPs"), and the requirements for qualification as a QIP. The regulations were promulgated under Acts of Alabama 2009-144, which requires Subchapter K entities doing business in Alabama (except for QIPs, certain publicly-traded partnerships, and other categories of pass-through entities exempted by regulation or private letter ruling) to file annual composite returns and remit Alabama income tax on behalf of their nonresident members, for tax years beginning on or after January 1, 2009.

As readers may recall from our October 7, 2009 SALT Bulletin, the Department held two separate hearings during the month of October at which a number of concerned taxpayers and tax practitioners submitted comment letters or appeared and testified as to various aspects of the original set of proposed regulations. The authors and several other tax practitioners, as well as several investment funds and business and professional groups, filed lengthy comment letters with the Department pointing out several issues of concern to Subchapter K entities, especially those wishing to qualify as QIPs. The co-authors of the regulations took into consideration many of the comments they received during the formal notice and comment period and attempted to address many of those concerns in the revised proposed regulations that were certified on Monday.

Last Friday afternoon, the Department circulated a draft of the revised proposed regulations to a handful of tax practitioners (including the authors) for additional comment. Several tax practitioners spent much of their weekend reviewing the revised proposed regulations in order to provide the Department with hasty comments on Monday morning, some of which the Department incorporated into the new set of regulations that it certified later that day. The ad hoc working group requested additional time for comments and in order to circulate the new proposals more widely, but because of the Monday deadline for certification the Department elected to move forward with the process.

Despite the best efforts of this small group of tax practitioners and the Department, there remain several issues and questions surrounding the new proposed regulations that will affect many Subchapter K entities (particularly those wishing to qualify as QIPs) and their nonresident members. Although the revised set of proposed regulations

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has been certified, and they automatically become “final” on **February 15** (absent intervention by the 21 member Legislative Council), members of our firm, as well as a number of other tax practitioners and investment fund managers, are providing comments on and suggested revisions to the new regulations to their authors. Thankfully, the Department has offered to issue rule amendments to address at least some of those concerns.

Below is a non-exclusive list of some of the major issues that we hope will be addressed in the forthcoming rule amendments.

Transitional Relief

While the ad hoc working group is generally pleased with the Department’s effort to provide some transition relief, especially since the legislation mandating composite returns and payments was not passed until late March 2009 but was made retroactive to January 1, we believe the new provision needs further work. As currently drafted, the provision allows a Subchapter K entity to reduce the amount of its composite income tax payment for the 2009 tax year “to the extent the nonresident member made tax payments or estimated tax deposits to Alabama in regard to the nonresident member’s income from the pass-through entity.” The regulation requires that the Subchapter K entity include some form of documented proof of these tax payments with the filing of the composite return.

One concern is that many nonresident members of Subchapter K entities have Alabama-source income from multiple sources. Thus, their estimated tax payments would be based on income from numerous sources rather than solely from the Subchapter K entity filing the composite return. Additionally, some nonresident members with income from multiple Alabama sources may be reluctant to provide their personal tax information to the Subchapter K entity because of privacy or other concerns. Lastly, because of the retroactive nature of the Act, many nonresident members made both first and second quarter estimated tax payments to the Department, either unaware of the new legislation or relying on informal advice given by Department personnel that they could continue to follow that practice for 2009, based on their previously-filed Schedule NRAs, Nonresident Member Jurisdictional Consents.

The ad hoc working group suggested that, although a Subchapter K entity would have an Alabama composite filing requirement in 2009, to the extent it relied on filed Schedule NRAs in effect for its nonresident members or other assurances that the nonresident members timely made estimated Alabama income tax payments, no composite tax payment would be due for those nonresident members for the 2009 tax year. The Department has been made aware of this suggestion and has taken it under advisement.

Amount of Composite Income Tax Payment

In calculating the required composite tax payment, the revised proposed regulations provide that the composite payment is based on both separately-stated and nonseparately-

stated income, but not losses of the entity. This could create an unfair payment burden on Subchapter K entities with nonresident members. For example, an entity could have an ordinary loss and separately-stated guaranteed payments to certain members, along with I.R.C. § 179 expenses. As currently written, the regulation provides that in calculating the amount of the composite tax payment, the entity cannot take into account any loss from operations or its I.R.C. § 179 expense. The ad hoc working group pointed out that this provision differs from the composite return payment calculation for S corporations and their nonresident shareholders. It is our belief that the amended regulations should be similar to the current regulations applicable to S corporations, which provide for the netting of income and loss items (exclusive of separately-stated items that are subject to percentage limitation at the individual level).

The Department is aware of this concern and is considering other possible bases for calculating the composite tax payment.

50% or Greater Interest Held by One Corporation or Affiliated Group

Under the revised proposed regulations, there is a rebuttable presumption that an entity is disqualified as a QIP if “50 percent or more of the ownership interest or voting interest of an entity is owned or controlled, directly or indirectly, by a corporation, as defined in § 40-18-1, Code of Alabama 1975.” This provision troubles investment funds and their advisers because many of these funds are initially formed by a corporation, or an affiliated group of corporations, such that a large portion (possibly even 100%) of the fund’s ownership during its development stage is held by a corporation or an affiliated group, thereby triggering the presumption that the fund is not a QIP. The regulations do not address how to rebut this presumption; however, the Department has said it is open to suggestions for change and has indicated, on an informal basis, that it does not intend that official ruling requests on this matter will be necessary.

“Qualified Investment Securities”

The new proposed regulations define “qualified investment securities” (“QIS”) in the negative, *i.e.*, defining a QIS by specifying what is not a QIS. Notably, the proposed regulations now provide that certain “deposits with a financial institution or bank that is not regulated by the United States government, or by a political subdivision thereof” shall not be QISs. That is a marked improvement over the previous version, which required the deposit to be FDIC-insured. Concern remains, however, over whether cash balances deposited with certain non-bank financial institutions will qualify as QISs. In addition, while the new proposed regulations have a narrow definition of “loans” that will qualify as QISs, the ad hoc working group pointed out that many investment funds often make loans to businesses in which they have already invested (*e.g.*, as mezzanine funding or as bridge loans). Therefore, we believe it is reasonable to allow loans and certain other debt instruments to be QISs. The Department has been made aware of both these concerns and

is also taking them under advisement.

The issues addressed above are just a few of the concerns the ad hoc group of tax practitioners has already expressed to Department personnel since the revised proposed regulations were certified on Monday. Needless to say, as tax season approaches, and composite tax payments become due, the Department is aware that taxpayers and tax practitioners need clear guidance on how these rules will operate.

Thankfully, key Department officials have expressed their desire to continue working with tax practitioners and organizations and to issue rule amendments that hopefully will address many of these concerns. However, those rule amendments must be finalized by **Wednesday, January 20** in order for them

to be published in the January 29 edition of the *Alabama Administrative Monthly* as official proposed regulations. Therefore, we encourage our readers doing business through Subchapter K entities in Alabama, or who have clients that do so, to *promptly review the new regulations* (available at <http://www.babc.com/files/upload/Regulations.pdf>) and provide any comments to us. If you wish to contact the Department of Revenue directly, please send your comments to Curtis Stewart, the Director of Tax Policy and Research (Curtis.Stewart@revenue.alabama.gov).

Please contact either Bruce Ely or Will Thistle of our SALT Practice Group if you have any questions or comments regarding how the new regulations will affect your company or clients.

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