Checkpoint Contents
State & Local Tax Library
Journal of Multistate Taxation and Incentives (WG&L)
Journal of Multistate Taxation and Incentives
2010
Volume 19, Number 10, February 2010
Articles
State Taxation of Partnerships and LLCs and Their Members, Journal of Multistate Taxation and Incentives, Feb 2010

S CORPORATIONS, PARTNERSHIPS, AND LLCs

### State Taxation of Partnerships and LLCs and Their Members

The state tax treatment of these pass-through entities involves a variety of issues and complexities not found at the federal level, and careful planning is needed to avoid unanticipated results.

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State and local taxation (generally referred to herein simply as "state taxation") is a complex area that, at times, resembles the federal income tax but also can depart sharply from any resemblance to federal tax principles. In the context of pass-through entities, several fundamental and unique characteristics of state taxation introduce elements of tax planning—and tax pitfalls—that differ markedly from traditional federal income tax planning. With 50 states (plus the District of Columbia), and myriad local taxing jurisdictions, generalizations are impossible, if not dangerous. Nevertheless, some basic features of state taxation, in various permutations, frequently surface as relevant and significant in tax planning for partnerships and limited liability companies (LLCs).

# Pass-Through Status, Generally

Under the federal check-the-box regulations, entities not automatically treated as corporations may elect their federal tax classification. Such an entity with more than one owner can elect to be classified as either a corporation or a partnership. An entity with only one owner can elect to be classified as a corporation or disregarded as an entity separate from its owner (i.e., treated as a sole proprietorship, branch, or division). If the election is not affirmatively made, an entity will be treated as a partnership if it has more than one owner and disregarded if it has only a single owner. If a foreign eligible entity does not make an election, it will be treated as (1) a partnership if it has more than one owner and any owner does not have limited liability, (2) an association if all owners have limited liability, or (3) disregarded if it has a single owner that does not have limited liability.  $\frac{1}{2}$ 

For federal income tax purposes, an entity classified as a partnership pays no income tax itself; instead, its partners are allocated distributive shares of the partnership's income, expense, gain, loss, and credits. <sup>2</sup> The partners then report that income on their individual or corporate income tax returns, or, for partners that are themselves pass-through entities, pass the income through to their partners, and so on up the chain.

A threshold question in state taxation is whether a state or locality conforms to the federal tax classification of the entity as a nontaxpayer pass-through entity. Generally speaking, state income tax statutes largely conform to the federal tax classification of entities. Thus, for example, an LLC classified federally as a partnership will likewise be classified, for state income tax purposes, as a partnership <sup>3</sup> rather than as a corporation or some other form of entity.

That said, states add various bells and whistles to their basic conformity to federal classification. These may

#### include:

- Entity-level income taxes.
- · Entity-level fees.
- Non-income-type entity-level taxes.
- Withholding and estimated tax payment obligations.
- Partner consent conditions for pass-through classification.
- · Composite filing rules.

As a result, while one may fairly begin the state analysis with the assumption that an entity classified federally as a partnership will be similarly classified for state tax purposes, that generality is a long way from the end of the analysis.

### Diversions From Classic Pass-Through Treatment

While many states and localities treat partnerships as pass-throughs, some important exceptions exist where tax is directly imposed on the partnership as a full-blown taxpayer.

### Entity-level taxes.

Taxes may be imposed on partnerships and LLCs at the entity level on net income or some other tax base. For example, New Hampshire imposes its business profits tax directly on pass-through entities, <sup>4</sup> while Tennessee imposes its corporate excise and franchise taxes on LLCs and limited partnerships. <sup>5</sup> By way of illustration, two of the more significant entity-level taxes are described below.

## New York City unincorporated business tax (UBT).

New York City is no longer authorized to impose an income tax on nonresidents who earn their living working in the city. The city does, however, tax S corporations and also imposes a 4% tax on the net income derived from an unincorporated business operating in the city. <sup>6</sup> The classic form of entity that is subject to the UBT is a partnership whose partners and employees provide services out of offices maintained in the city.

The UBT is generally imposed on net income as determined under federal income tax principles, with certain modifications.  $^{7}$  One such modification, for example, is an addback to federal income for tax-exempt interest earned on non-New York municipal bonds.  $^{8}$ 

Significantly, the New York City UBT generally does not allow an entity to deduct payments made to partners for services rendered (except for a minimal amount, currently \$10,000) or for the use of capital. Specifically, the UBT law provides: "No deduction shall be allowed (except as provided in section 11-509 of this chapter) for amounts paid or incurred to a proprietor or partner for services or for the use of capital." This provision disallows deductions for guaranteed payments, as well as for payments made under stand-alone contracts (i.e., a management services agreement). One important exception to this disallowance is that to the extent a payment to a partner reasonably represents the value of services provided to the payor partnership by *employees* (but not officers or partners) of the payee partner, the payment is deductible. 10

Given this limitation on the deductibility of what can be, in many cases, substantial sums, there has been considerable controversy over the definition of "partner." 11 The details of the relationship a "contract" partner has to a partnership can be very important in determining

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whether or not payments to that individual are deductible in calculating the payor's 4% UBT. Along similar lines, because the federal income tax law holds that an individual cannot be both a partner and an employee, payments to such an individual are treated by the city as paid to a partner, and, thus, are not deductible.

Several other features of the New York City UBT merit note. In addition to excluding from the UBT the activity of trading for one's own account, the UBT maintains a bifurcated allocation system for business vs. investment income, much like the New York corporate tax scheme. Under this system, an unincorporated business apportions income earned from investments in corporate and governmental stocks and other securities based not on its own business activities but, rather, on the activities of the issuers of the securities. 12

For business income, the UBT has generally applied the traditional three-factor formulary apportionment. <sup>13</sup> In applying formulary apportionment, gross receipts from the performance of services are generally allocated to New York City if the services were performed by an employee (or partner) "chiefly situated at, connected by contract or otherwise with, or sent out from, offices of the unincorporated business ... situated within New York City." <sup>14</sup> There are, however, special rules for securities and commodities brokers, which may elect to allocate commissions by reference (in part) to the location where an order originated. <sup>15</sup>

A special sourcing rule applies also for receipts derived from management services provided to regulated investment companies (RICs). Under these provisions, receipts are allocated based on the locations of a RIC's shareholders, assuming the relevant information can be obtained from the RIC by the manager. 16

# The Texas margin tax.

For tax returns due after 2007, Texas imposes a so-called "margin" tax on all entities whose owners enjoy the privilege of limited liability. <sup>17</sup> Thus, the margin tax is directly imposed not only on corporations but also on LLCs, limited partnerships, limited liability partnerships (LLPs), professional associations, and business trusts. Neither sole proprietorships nor general partnerships that are owned solely by natural persons are subject to the new tax.

Under the former Texas tax scheme, the franchise tax was imposed at the greater of 0.25% of a taxable entity's capital (i.e., net

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worth) or 4.5% of the entity's "earned surplus" (i.e., net income plus officer compensation). These tax bases have now been replaced with "margin" base.

The margin base. Under the margin tax, the tax base is the lesser of (1) 70% of total revenue, or (2) total revenue minus, at the taxpayer's election, either (a) cost of goods sold (COGS) or (b) compensation. The election to deduct either COGS or compensation is made on the taxpayer's annual report and is effective for only that annual report; it may not be changed retroactively by filing an amended return after the due date of the annual report. <sup>18</sup> The margin base is then apportioned based solely on a sales factor: total receipts from business in Texas divided by total receipts everywhere. The applicable tax rate is 1%, except that taxpayers primarily engaged in the retail or wholesale trade are subject to a 0.5% rate. <sup>19</sup>

Alternatively, a taxpayer with no more than \$10 million in annualized total revenue may choose to calculate its tax liability using the "E-Z computation." Under the E-Z method, the taxpayer multiplies total revenue by an apportionment factor, and then applies a 0.575% tax rate to determine the tax due. No deduction is allowed for COGS or compensation when choosing the E-Z computation.

The margin tax employs a "privilege period" concept, under which a taxpayer pays for the privilege of doing business in Texas during the calendar year in which the tax is paid, but the tax liability is based on the business activity that occurred during the taxpayer's accounting period that ended in the *preceding* calendar year. For example, an entity whose accounting period ends on December 31 would pay tax on 5/15/12 for the privilege of doing business in Texas during calendar year 2012, but the tax due would be based on the entity's business activity during calendar year 2011. The initial margin tax was due on 5/15/08, and was calculated based on business activity during 2007.

Passive entities. The margin tax does not apply to certain "passive entities." To qualify as a "passive entity," the following criteria must be met:

- The entity must be a general or limited partnership or a nonbusiness trust.
- During the period on which its margin is based, at least 90% of the entity's federal gross income must be from certain specified "passive" sources (described below).
- The entity may not receive more than 10% of its federal gross income from the conduct of an active trade or business.

The following categories of income are the only ones that qualify for the 90% of gross income test:

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- Dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from an LLC.
- Distributive shares of partnership income, to the extent that the shares are greater than zero.

- Net capital gains from the sale of real property, net gains from the sale of commodities traded on a commodities exchange, and net gains from the sale of "securities."
- Royalties, bonuses, and delay rental income from mineral properties, and income from other nonoperating mineral interests. <sup>21</sup>

Significantly, rental income is not qualifying income for a passive entity for purposes of the margin tax. 22

A "security" is defined to include any of the following:

- An instrument defined by IRC Section 475(c)(2), where the holder of the instrument has a non-controlling interest in the issuer/investee.
- An instrument described in IRC Section 475(e)(2)(B), (C), or (D).
- An interest in a partnership where the investor has a non-controlling interest in the investee.
- An interest in an LLC where the investor has a non-controlling interest in the investee.
- A beneficial interest in a trust where the investor has a non-controlling interest in the investee.

For purposes of the 10% limit on a passive entity's gross income from the conduct of an "active trade or business," an entity conducts an active trade or business if (1) the activities being carried on include active operations that form a part of the process of earning income or profit, and (2) the entity performs active management and operational functions. Activities performed by the entity include activities performed by persons outside the entity, including independent contractors, to the extent that (1) those persons perform services on behalf of the entity and (2) those services constitute all or part of the entity's trade or business. Further, an entity conducts an active trade or business if assets (including royalties, patents, trademarks, and other intangible assets) held by the entity are used in the active trade or business of one or more related entities. <sup>24</sup>

Combined filing for margin tax. Following what seems to be a trend among states, Texas has adopted a combined reporting structure under the margin tax: all affiliated entities that are engaged in a unitary business must report on a combined basis. Accordingly, "taxable entity" includes a "combined group," which means taxable entities that are part of an affiliated group engaged in a unitary business and required to file a group report. "Affiliated group" is a group of one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member entities. 25

In determining ownership among members of an affiliated group, a "controlling interest" is:

- For a corporation: more than 50% direct or indirect ownership of either (1) the total combined voting power of all classes of stock of the corporation, or (2) the beneficial ownership interest in the voting stock of the corporation.
- For a partnership, association, trust, or other entity: more than 50% direct or indirect ownership of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.
- For an LLC: more than 50% direct or indirect ownership of either (1) the total membership interest of the LLC, or (2) the beneficial ownership interest in the membership interest of the LLC. 26

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Because the Texas margin tax requires combined reporting for generally all taxable entities that are part of an affiliated group engaged in a unitary business, Texas has the rather unique feature of requiring partnerships to file combined reports together with its affiliated entities, including corporations, other partnerships, S corporations, and LLCs taxed as partnerships under federal law or disregarded under federal law. A combined group is required to include all taxable entity members, without regard to whether the particular member has nexus with Texas. <sup>27</sup> The group files its margin tax reports on a combined basis as a single economic unit.

The following entities, however, may not be included in a combined group:

- · Insurance companies that pay gross premiums tax.
- · Exempt entities.
- Passive entities (but the pro rata share of net income from a passive entity is included in total revenue to the
  extent not generated by the margin of another taxable entity).
- Entities excluded under the "water's edge" rule (i.e., an entity that conducts business outside the U.S. and either (1) 80% or more of the entity's property and payroll are assigned to locations outside the U.S., or (2) the entity has no property or payroll and 80% or more of the entity's gross receipts are assigned to locations outside the U.S.). 28

### Entity-level fees.

In addition to income-based taxes, states have experimented, to varying degrees, with a variety of fees imposed on pass-through entities. Often, LLCs incur much higher fees than do limited partnerships. Fees have been structured based on, e.g., (1) a fixed dollar amount per member, (2) a percentage of income or assets, or (3) a simple annual fee for the privilege of doing business in the state. For example, Alabama, Kansas, West Virginia, and Wyoming impose net-worth-based franchise taxes on LLCs and certain types of partnerships. Some other states such as New York, Florida, Illinois, and Texas, impose per-partner or per-member annual filing fees on pass-throughs.

At the extreme, fees have been successfully challenged as not sufficiently coordinated with state activity to withstand constitutional scrutiny. For example, a California court of appeal held that the state's unapportioned annual fee on LLCs registered or doing business in California violated the U.S. Constitution's fair apportionment standards. <sup>29</sup> In other instances, the fees have come to be understood as not operating particularly rationally. While potentially only a nuisance, in some situations these fees can represent a real and significant cost—one to be planned for, particularly where tiers of entities with multistate sources of income are involved.

# Withholding and estimated tax obligations.

As discussed in more detail below, the pass-through nature of partnerships potentially separates the in-state business from out-of-state taxpayer-partners. Historically, compliance and collection problems arose as partners with relatively little contact with a remote state failed to pay income tax on their distributive shares of income allocated to those states. Many states have responded to this situation by enacting provisions that effectively require partnerships to pay their nonresident partners' taxes. Depending on the state and the situation, these rules either can be fairly easy to live with or can cause significant cash-flow disruptions for partnerships or for the partners whose income tax liabilities are being funded by their partnership. The following discussion illustrates the two basic types of payment regimes, and also looks at some of the practical issues these regimes create.

Withholding. A pure withholding regime requires a partnership to withhold state or local income tax from distributions made to targeted partners. In a classic, simple scenario involving a California

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partnership, the partnership is required to calculate its California-source income allocable to a nonresident partner, multiply that income by a specified tax rate, and withhold, out of the cash distributions made to the nonresident partner, the requisite tax due to California. 30 The partnership would then remit to California the aggregate tax due in respect of all of the partners for whom the withholding requirement applied. Those partners, in turn, when filing their nonresident income tax returns, would claim credit for the California tax withheld on their behalf.

A variation on withholding from actual distributions is to "withhold" on income allocated to the targeted partner without regard to whether there is an actual tax distribution to the partner. Such an approach is more akin to an estimated tax payment.

Estimated tax payments. Under an estimated tax payment regime, a partnership may be required to make, for example, quarterly payments of estimated tax in respect of target partners. 31 This system differs from a pure withholding regime in that the timing of the required tax payment is fixed by the state's rules, and the partnership is required to fund the targeted partners' taxes without regard to whether the partnership actually distributes cash to those partners on the appointed date.

Issues for partnerships and partners. The most obvious issue raised by these tax payment regimes is the obligation of a partnership to fund the partner's income taxes. If the payment obligations are coordinated with, and collectively no greater than, the partnership's intended cash distributions to the affected partners, then neither the business nor the other partners are particularly burdened by the obligation to pay some partners' taxes directly to the state. In other circumstances, however, these payment obligations can create real dislocations.

In New York, for example, the introduction of requirements to pay quarterly estimated taxes for nonresident individual and C corporation partners threatened to cause affected partnerships to be in default under certain debt obligations, such as federal Department of Housing and Urban Development loans, that restrict or prohibit distributions to partners. The state found a way to waive the estimated tax payment obligation of those partnerships, but the episode stands as evidence of one kind of unintended consequence.

Partnerships required to make estimated tax payments—or to "withhold" with respect to allocated rather than distributed income—also can face cash-flow issues in circumstances where a transaction generates income but no cash, or where a partnership has investments in multiple states, some of which have income while others have losses. Cancellation of debt income or gain on a foreclosure can create significant income but no cash. If the targeted partners' taxes are paid by the partnership in these circumstances, those partners effectively enjoy a

cash-flow benefit that the other partners (usually residents of the taxing state) do not. Similar problems can arise if the "distribution" triggering a withholding obligation is a "deemed distribution" resulting from a reduction of partnership liabilities. 32

The obligation to make payments with respect to certain partners creates business issues that ideally should be addressed in the partnership agreement. If tax payments exceed distributions that otherwise would be made, those payments should be treated as loans to the targeted partners to be repaid to the partnership with interest. If partners contemplate receiving periodic "tax distributions," those distributions obviously should be calculated by taking into account the taxes that might be required to be paid on behalf of

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targeted partners. Reference also should be made to any available "escape hatches" offered by states in which a partnership is, or anticipates it may be, doing business (see below), and partners should be required to execute consents (for example, that the partner will file required nonresident returns) as necessary to relieve the partnership of its payment obligations. In admitting new partners, or allowing transfers of interests, partnerships again should review their compliance obligations and plan, insofar as possible, to get out of the business of paying their partners' taxes.

One particularly sticky element of these requirements is identifying the partners to whom they apply. Classically, these obligations apply with regard to "nonresident" individuals. This requires a partnership to know the residency status of all of its individual partners. A state may provide some guidance on this. California, for example, allows partnerships to assume that having a California street address for a partner absolves the partnership of responsibility with respect to that partner (provided the address does not say "in care of"). 33

Some compliance regimes target entity partners as well, like C corporations or upper-tier partnerships. 34 Again, this requires a level of knowledge the partnership may not have. An LLC might be a disregarded entity wholly owned by a nonresident, in which case, as a tax matter, the partner really is a nonresident. On the other hand, for tax purposes, the LLC may be a partnership or it could have "checked the box" to classify itself as a C corporation.

Withholding and estimated tax obligations in respect of entities also create the potential for confusion when there are tiers of pass-throughs. If a California partnership is required to withhold from distributions to an upper-tier partnership, for example, the withholding will be calculated with respect to the entire distribution to the upper-tier entity, even though that entity might be partially, or even entirely, owned by California residents who, in their individual capacities, would not be considered targeted partners.

There also may be discriminatory features of these tax regimes that potentially rise to the level of a constitutional problem. Requiring partnerships to pay the taxes of nonresidents may, in some situations, make such an individual a less attractive business partner. Requiring partnerships to calculate the targeted partners' taxes at a specified rate—usually the state's highest—and without taking into account other losses, deductions, or credits that might actually be available to the partner, can effectively force nonresidents to pay estimated taxes on a less-favorable basis than a similarly situated resident would pay. In a particularly egregious case, an offended targeted partner might have a legitimate constitutional complaint.

These and other potential problems with partnership withholding and estimated tax regimes make the available "escape hatches" important. There are differing mechanisms through which states may "turn off" a partnership's obligations to make payments in respect of a particular partner. California's system for nonresident members of LLCs, for example, is triggered only with respect to members who have failed to provide, for filing with the LLC's tax return, a consent form indicating they will file individual returns in California. 35 New York has a somewhat similar system for nonresident individuals and C corporations. 36 California's more broadly applicable withholding regime permits partnerships to request waivers from the Franchise Tax Board—a somewhat more cumbersome process but potentially useful, especially where tiered entities are concerned. 37 California does not, however, provide any waiver of its IRC Section 1446-like obligation to "withhold" California tax from income allocated to foreign (i.e., non-U.S.) persons. 38

Whatever the mechanism, there obviously can be considerable advantage to securing the necessary paperwork to liberate a partnership from the financial and practical burdens associated with obligations to pay partners' taxes on their behalf.

Composite filings. At the other end of the spectrum lie state taxation provisions that enable partnerships to elect to make their partners' lives easier by effectively filing tax returns on their behalf. Numerous states have provisions under which eligible partners can satisfy their state tax filing obligations with respect to partnership income by being included in a composite return. Under this approach, the partnership files a tax return on behalf of the eligible partners and pays the related income tax. The liability usually is calculated at the highest tax rate, taking into

account only the partnership's income and without regard to any other items partners might, on their own, take into account in calculating their individual state tax liabilities. Although a composite return simplifies filing requirements, the resulting tax may be higher than the combined taxes that otherwise would have been imposed on the nonresident owners. Furthermore, some states do not permit the nonresident owner to claim any refund for taxes paid with a composite return.  $\frac{39}{2}$ 

Composite returns offer an efficient and effective way to deal with one of the biggest drags on the state tax treatment of investment partnerships—the obligations

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of every partner, all the way up the chain, to file tax returns in every state in which their partnerships, directly or through lower-tier entities, earn state or local taxable income. Particularly in situations where the tax to be paid can easily be funded by distributions that would otherwise be made to the partners, composite filing solves the problems of both taxpayers and tax collectors in a manner that achieves rough justice.

The problem, however, is that existing composite return rules are neither uniform nor particularly easy to work with. The rules frequently are limited to nonresidents whose sole source of in-state income is the filing partnership.  $\frac{40}{}$  An individual who invests in two partnerships may, therefore, be ineligible. Sometimes a spouse's investment in another partnership renders the nonresident ineligible. Some regimes restrict composite filings to individuals,  $\frac{41}{}$  leaving trusts, corporations, and upper-tier pass-throughs in the lurch. Furthermore, sometimes the paperwork required to file composite returns can be daunting.

Given that composite returns are generally elective and mainly serve to enable compliance with a minimum of friction, it would seem logical to make these regimes as user-friendly as possible. Particularly in the context of hedge funds, where it can be complex to follow state or local income up the chain to the ultimate taxpayer—and where the affected taxpayers might rationally (if not legally) conclude that the "ratio" of the tax owed as compared with the filing burdens involved does not merit compliance—a simple mechanism for making composite filings broadly available makes a great deal of sense. Unfortunately, that is not where we are currently.

#### Non-income taxes.

Obviously, while entities classified as pass-throughs for federal income tax purposes should at least start from the same premise in analyzing their state and local income tax situation, the state and local world employs many other tax schemes in which income tax classification is completely irrelevant. Sales and use taxes, property taxes (real, personal, and intangible), real property transfer taxes, stock transfer taxes, and myriad other approaches to raising state and local revenue appear frequently and can loom large. These tax schemes often treat as taxpayers entities that are disregarded for income tax purposes, essentially ignoring their tax-free classification under income tax principles.

For instance, the Alabama Department of Revenue stated that because a single-member LLC (SMLLC) is disregarded for federal income tax purposes, it is disregarded also for Alabama sales and use tax purposes.  $\frac{42}{2}$  In contrast, Minnesota treats a SMLLC as a separate legal entity for sales and use tax purposes.  $\frac{43}{2}$  Accordingly, outside the income tax context in particular, one cannot rely on any general assumptions with respect to the state tax treatment of pass-throughs, and each state's rules must be individually researched.

Similarly, the states vary widely with respect to the application of taxes on the transfer of real property to pass-throughs. In Florida, the state supreme court resolved a conflict between two lower courts, finding that a transfer from a parent partnership to a newly created LLC was not subject to the documentary stamp tax because the transfer lacked both "consideration" and a "purchaser." <sup>44</sup> In Pennsylvania, however, the Commonwealth Court held that a transfer from an individual to an entity owned entirely by the individual was subject to the real estate transfer tax. <sup>45</sup>

### Partners' Tax Status

At the federal level, partners are classified in ways that determine the federal income tax treatment of the ultimate taxpayers. For federal tax purposes, partners can be separated into a variety of categories, including:

- U.S. individuals.
- · Foreign individuals.
- U.S. trusts.
- · Foreign trusts.
- · Domestic corporations.

• Foreign corporations.

At the state level, the basic federal classifications of taxpayers are further subdivided, and include:

- Resident individuals.
- Nonresident individuals.
- · Resident trusts.
- Nonresident trusts.
- · Corporations carrying on business in the taxing state only.
- Corporations carrying on business in multiple states.
- Corporations whose activities are limited to investment.
- Corporations taxed under various divergent state or local tax regimes.
- Ranks
- General corporations.
- Utilities.
- S corporations (recognized or not at the state level).

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#### State taxation of individuals.

Forty-three states impose income taxes on individuals. 46 States can tax the worldwide income of individuals who are resident or domiciled in the state. 47 Therefore, if an individual partner resides in a state that imposes a personal income tax, that state generally will tax the partner's entire pro rata share of the flow-through entity's income, regardless of where the income is earned. In contrast, the state will tax nonresident partners on income derived only from in-state sources. 48 This, logically enough, leads to controversies in determining resident status and source of income.

If a portion of an individual partner's income is subject to tax in two states—one by virtue of the individual's residence and the other by virtue of the source of the flow-through entity's income—the state of residence, as a means of mitigating double taxation, usually allows the individual to claim a credit for income taxes paid to the source state. This general rule, however, may not avoid double taxation in the context of investment income since income from intangibles typically is sourced by reference to the domicile of the individual earning the income. 49 Thus, the residence stakes can be particularly high where investment income is concerned.

For instance, a taxpayer resident in Florida (which has no personal income tax) pays no state income tax on investment income. <sup>50</sup> A taxpayer resident in New York City pays state tax at a top rate of 8.97% plus city tax at maximum 3.648%. A taxpayer domiciled in Connecticut but meeting New York's (state and city) definition of a statutory resident can pay, on the same investment income, Connecticut income tax of 6.5% plus New York State income tax of 8.97% plus New York City income tax of 3.648%, all with no offsetting credits allowed. This result follows from dual resident status, which allows each state to tax the individual's worldwide income and to treat investment income from intangibles as sourced to each taxing state because of the individual's status as a resident of that state. In contrast, if that same dual resident had earned income from working in New York City, such income would be subject to tax by both states but Connecticut would allow the taxpayer a credit for the New York tax on the earned income, which is sourced to New York, resulting in the resident's paying tax just once, albeit at the higher New York rate.

The source of income can vary also depending on the nature of a transaction. An individual partner in a partnership earning income from operations in various states generally is required to file income tax returns in each of those states, reporting to each a pro rata share of the income derived from such state. If that same partner sells the partnership interest, however, the transaction generally is treated as the sale of an intangible, and thus the related income is sourced to, and taxable by, the individual's state of residence. <sup>51</sup> By contrast, if instead the partnership were to sell the underlying business, the individual partners generally would be subject to tax in all the jurisdictions in which the business was conducted, with any gain being allocated or apportioned among those jurisdictions (see discussion below). The partner's state of residence then usually will allow a credit for taxes paid to the source states.

The federal income tax treatment of any asset disposition may not differ markedly from the federal income tax treatment of the sale of a partnership interest. 52 Nevertheless, because of the differences between federal and state tax principles, and differences among state tax regimes, the states' tax treatment of individual partners could vary considerably depending on the jurisdictions in which the assets or businesses are located and the individuals reside, and the structure

of the relevant state tax regimes. (Also, in evaluating an asset sale versus an entity sale, there often are other state tax considerations, such as sales taxes, real estate transfer taxes, partnership-level taxes and fees, and a partnership's withholding or estimated tax obligations. As with state taxation generally, these analyses are highly fact-specific, and the devil is in the details.)

Additional issues arise if an individual's residence changes during the year. An individual's resident state income tax return generally must include all the income the individual recognized during the year. A part-year resident would include all income recognized during the period of residency, as well as income sourced to that state during the nonresident period. The state tax treatment of flow-through entity income for a part-year resident varies significantly and, in some situations, can result in taxation of less than 100% of the individual's share of the flow-through entity's income for a year. For example, in Maryland, whether and to what extent a part-year resident partner's share of income, gain, or loss, is taxable by Maryland depends on all of the following:

- (1) The closing date of the partnership's tax year.
- (2) Whether the partnership carried on business in Maryland.
- (3) The date the individual partner established or abandoned Maryland residence. 53

In California, a part-year resident must, in effect, divide his or her tax year into two distinct periods. All items of income and deduction are to be included in the individual's California taxable income for the California-resident portion of the year. Accordingly, for a part-year resident partner, any items of income and loss realized by the partnership during the partner's period of residency are included in the partner's California taxable income. For the nonresident period, only gross income and deductions realized from sources within California are included in the individual's taxable income. Therefore, all California-source items of income and loss realized by the partnership during a partner's period of California nonresidency are also included in the partner's California taxable income. The allocation of income between a part-year resident's period of residency and period of nonresidency must be made in a manner that reflects the actual date of realization. In the absence of such information, the taxpayer must allocate an annual amount on a proportional basis between the two periods, using a daily pro rata methodology. <sup>54</sup>

### State corporate taxation.

In order for a state to impose tax on a corporation, as with any potential state taxpayer, the state must establish the requisite "nexus" with the corporation. For this purpose, federal constitutional principles established under the Due Process  $\frac{55}{2}$  and Commerce Clauses  $\frac{56}{2}$  are the most relevant, along with state constitutional and statutory standards.  $\frac{57}{2}$ 

Nexus. Exactly what constitutes nexus is one of the most vexing problems in the field of state taxation. Clearly, the state of incorporation has the power to tax, as does a state where a corporation is physically present by means of property or employees. Whether "economic nexus"—that condition of seeking profits from in-state markets while having no physical presence in the state—suffices is a matter of ongoing controversy. Several state courts have upheld their states' assertions of income tax nexus with, e.g., out-of-state credit card companies and intangible holding companies, based on those entities' economic ties to the jurisdiction, but the U.S. Supreme Court has thus far declined to get involved. <sup>58</sup>

In many states, a corporation is subject to tax only if it is "doing business" or "transacting business" in the state. Other states impose income tax on corporations that "derive income" from sources in the state. A few states have adopted both an income-based franchise tax and a corporate income tax, by which they impose the franchise tax on corporations doing business in the state and impose the corporate income tax on out-of-state corporations that derive income from sources in the state. Therefore, for corporate owners of pass-through entities, the key question is: If the corporation's only connection with a state is its ownership of an interest in a flow-through entity that does business in the state, is the corporation subject to that state's income-based tax?

Nexus based on the ownership of a partnership interest is a particularly interesting area of state taxation. Historically, partnerships were thought of in terms of general partnerships, where an agency relationship existed between the partnership and its partners, and partnership assets were, under some state laws, considered "owned" by the partners as tenants-in-partnership. As the economy

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matured, limited partnerships took hold, but the basic concept that partners have a taxable nexus in the jurisdiction in which the partnership has nexus was not really challenged. Particularly given the pass-through tax treatment of partnerships, and the historic "agency" thinking around partnerships generally, the working assumption generally was that partners were subject to state tax in states in which the partnership has nexus.

Thus, for example, New York's tax regulations provide that a corporation will always be considered subject to tax in New York if it is a general partner in a partnership that does business in New York. <sup>59</sup> Corporate limited partners, however, may be excluded from taxable status if their New York contact is limited to an interest in a "portfolio investment partnership," which is defined as a limited partnership that meets the income tests applied to RICs under IRC Section 851(b)(2), with special rules for income from commodities, and excluding dealers in stocks or securities.

New York also generally excludes from its taxing jurisdiction out-of-state corporate limited partners that are not engaged, directly or indirectly, "in the participation in or the domination or control of all or any portion of the business activities or affairs of the partnership." The regulations provide a raft of presumptions under which corporate limited partners might be considered so engaged, notwithstanding the particular facts. 61

As illustrated by an Alabama court decision *Lanzi v. Alabama Department of Revenue*, <sup>62</sup> the assumption that limited partners cannot be taxed on investment income has not gone universally unchallenged. In *Lanzi*, Alabama sought to tax a Georgia resident on his distributive share of income earned as a limited partner in an Alabama limited partnership managed by his parents in Alabama. Aside from his ownership of the limited partnership interest, the nonresident taxpayer had no connection or contact whatsoever with the state of Alabama. The courts eventually agreed with the taxpayer that the ownership of a limited partnership interest, in and of itself, was not sufficient to subject the taxpayer to the taxing jurisdiction of the state in which the partnership conducted its activities.

Lanzi was decided on jurisdictional grounds, and it raises questions far beyond pure investment activities. Not insignificantly, it no doubt led to the rather stringent composite return rules Alabama now applies to partnerships with nonresident partners. In some other jurisdictions, however, favorable statutes exempt nonresident partners from tax on income derived from investment partnerships. These rules tend to impose both asset and income tests on the partnerships to qualify their nonresident partners for exemption from state tax. 63

Moreover, as LLCs came to the forefront it became even less clear that the "old" general partnership concepts had any relevance. For instance, LLC statutes provide that members have no ownership interest in LLC assets and own only an interest in the entity.  $\frac{64}{2}$  Further, LLC members frequently have no rights or status even approaching agency. The question of whether, under Due Process or Commerce Clause principles, a state can assert jurisdiction over a member of an LLC based solely on the activities of the LLC has, to date, not been fully tested.  $\frac{65}{2}$ 

Of course, if a pass-through entity is not itself subject to tax under a state's income-tax classification scheme, but the members of the entity also cannot be subjected to the state's taxing jurisdiction because, under Due Process or Commerce Clause principles, the members' contacts are not sufficient to create nexus, a large hole suddenly appears in state income taxation. This potential hole, as well as issues of collection and compliance, are pushing many states to adopt various forms of partnership-level taxes and withholding or estimated tax payment requirements, as discussed above.

Another issue that should be carefully analyzed is whether the protection from state taxation offered by P.L. 86-272 is lost

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as the result of the corporation's ownership of an interest in a partnership or an LLC doing business in the state. For instance, in determining nexus for Massachusetts income tax purposes, if a foreign corporate limited partner engages in a unitary business with its partnership, the activities of the partnership will be deemed to be activities of the limited partner for purposes of determining whether taxation of the limited partner is precluded by P.L. 86-272. 66

Allocation/apportionment. In order for a state tax to withstand constitutional scrutiny, in addition to requiring substantial nexus, the U.S. Supreme Court further requires that the tax:

- Be fairly apportioned.
- Not discriminate against interstate commerce.
- Be fairly related to the services provided by the state.

The requirement of fair apportionment means that states must adopt some methodology for determining what portion of a multistate taxpayer's income can fairly be said to be related to the taxpayers' activities in the state.

The apportionment regimes adopted by many states distinguish between "business" and "nonbusiness" income. 68 Business income is divided among the states in which a corporation conducts business activities, typically using a formula that compares the taxpayer's property, payroll, and sales in the taxing state with those same factors everywhere; the latest voque is to employ a formula emphasizing, or using only, sales. 69 Nonbusiness income may

be allocated entirely to the domicile of the taxpayer (for income from intangibles), or to the state in which tangible nonbusiness property is located.  $\frac{70}{100}$ 

If a corporate owner's distributive share of flow-through income is business income to the corporate owner, the two primary methods under which such corporation will determine its state tax base is either by separate accounting (i.e., apportionment at the flow-through entity level) or by aggregating the partnership income or loss with the corporation's other business income or loss. The resulting tax liability in the taxing state can vary significantly under these two methods.

In several states, the treatment of income from a flow-through entity depends on whether the owner and entity are engaged in a unitary business. Under the state tax concept of "unitary business," the various entities into which businesses may be divided are ignored; state taxes are computed instead by reference to the entire "unitary" business, rather than the separate companies conducting pieces of that business. If a corporate partner and its partnership are not engaged in a unitary business, the partnership income is apportioned at the flow-through entity level and the partner's share essentially is treated as allocable income. If the corporate partner and its partnership are engaged in a unitary business, the flow-though income is apportioned at the partner or member level (i.e., the corporate partner combines its distributive share of partnership income with its other apportionable income, and also combines its share of the partnership's property, payroll, and sales factors with the corporation's own apportionment factors). 71

Regardless of how the income is computed, income earned through a partnership generally retains its character as it passes up to the ultimate taxpayer. <sup>72</sup> Thus, the character of income as "business income" is generally determined by reference to the activities of the operating partnership—it is not a function of the "investment intent" of the partners. <sup>73</sup>

When dealing with corporate partners, many complex questions can arise. For example, the apportionment of business income commonly relies (in part or entirely) on comparisons of receipts in the taxing state with total receipts. In that regard, consider a partner that engages in transactions with its partnership: e.g., a corporate partner sells goods to its partnership, which then sells the goods to the partnership's customers. In determining the sales factor, New York, for example, provides for the elimination of receipts derived by the corporation on a sale to its partnership, to the extent of the corporation's percentage interest. <sup>74</sup> In some other states, however, the treatment of such intercompany receipts

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is not always clear. Variations abound, and while the regulations of many states require such eliminations between a partner and its partnership, many of these rules have not been explicitly expanded to cover LLCs.

In many states, the application of the sales throwback rule in situations involving flow-through entities also is unclear. For example, is a partnership deemed subject to tax in every state in which its unitary corporate partner is taxable, or does the partnership determine its taxable presence in other states on a stand-alone basis?

As another example, some states apply differing tax regimes to different types of corporations, depending on the nature of the corporation's predominant activities. Where a corporation carries on one line of business, while owning an interest in a partnership that conducts a different line of business, questions may arise as to which tax regime the corporation belongs.  $\frac{75}{100}$ 

Because of the complexities and inconsistencies of state tax treatment of partnerships and LLCs, tax-exempt entities and, sometimes, foreign persons are well advised to invest in U.S. pass-throughs via blocker corporations. By capturing income from U.S. business activities in a taxable C corporation, the ultimate investors bear one level of corporate tax but also insulate themselves from any taint (e.g., unrelated business taxable income, FIRPTA (the "Foreign Investment in Real Property Tax Act")) that might otherwise flow to them by reason of the investments or activities of the lower-tier pass-through entities. The use of a blocker corporation also eliminates the potential administrative disaster of potentially having to issue state K-1s to every member of the lower-tier, as well as upper-tier, partnership.

### Series LLCs.

One of the more interesting aspects of state taxation in the context of pass-through entities is the treatment of the "series LLC." The concept behind the series LLC is similar to that of a series trust, which is made up of a series of sub-trusts with their own assets and streams of income. A series LLC is a state law vehicle in which different series of investments can be identified, with the LLC members having varying shares (or perhaps no share) in different series, and the assets of each series being walled off and protected from the liabilities of the other series. <sup>76</sup>

Several states have issued pronouncements discussing the treatment of a series LLC. For California purposes, a series (division) within the series LLC will be considered a separate business entity if (1) the holders of interests in that series (a) are limited, on redemption, liquidation, or termination, to the assets of that series, and (b) may share in the income of only that series, and (2) under state law, payment of the expenses, charges, and liabilities of that series is limited to assets of that series. Each series that is a separate business entity and registered or doing business in California must file its own California tax return and pay the annual tax, and may be subject to a fee based on total annual income. The Massachusetts Department of Revenue has ruled that each series of a Delaware series LLC would be classified as a separate entity for Massachusetts income and corporate excise tax purposes.

By contrast, the Florida Department of Revenue, on considering a single member series LLC that was classified as a disregarded entity for federal tax purposes, stated that the state tax status of a Delaware series LLC will be governed by the federal income tax treatment of the LLC, "unless that treatment conflicts with the Florida Statutes." Additionally, the Department ruled that transfers of interests or assets between series would trigger income recognition for Florida tax purposes if income were recognized for federal tax purposes. 79

Federal income tax experts have debated at length about the proper characterization of these kinds of vehicles. 80 There also are state taxation questions that are not purely income tax issues, such as:

- Is a transfer from series A to series B potentially subject to transfer tax? Sales tax?
- Do the in-state activities in series A create nexus for the (different?) participants in series B?
- Can a series LLC be used to wall off income from certain jurisdictions and insulate partners who prefer not to incur state filing obligations?
- Are states really bound by the firewall concept, or can they collect unpaid taxes (e.g., a Texas margin tax) in respect of series A activities out of series B assets?

Without knowing the answers to some of the very basic federal questions, there should be no reason to assume we can divine the answer to these (and other) state tax questions.

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# Special Allocations of State-Specific Income

An investment in a lower-tier pass-through entity can generate in-state-source income that is taxable to nonresidents. Similarly, the in-state presence of a lower-tier pass-through entity can generate factors that render an out-of-state upper-tier entity subject to the state's tax. Depending on the circumstances, these results could prove to be more trouble than the situation is worth, whether by triggering state tax filing requirements for myriad partners, each of whom has only a small share of the in-state income, or by creating a taxable status that taints other income or activities. These problems lead to the question of whether income derived from certain state tax-sensitive investments or operations could be specially allocated to certain partners, and away from others, so as to achieve the result of restricting the state income and related tax filing obligations to some partners, while absolving others

There are at least two different angles to this question. For example, an allocation might seek to channel state income to partner A, and away from partner B, simply to locate all of the in-state income and filing responsibilities in A, who will fully pay all the tax imposed by all affected jurisdictions on that particular income stream. This effort is not directed by a desire to reduce state taxes, only by a desire to contain them within a limited population.

Alternatively, one might seek a special allocation of state or local taxable income for more proactive planning reasons, such as a desire to direct income from state or local bonds to those individuals whose home states will exempt that income. This kind of special allocation does not seek to simplify compliance; rather, it uses allocations to reduce the partners' overall state tax burden. Whether such allocations "work" is an interesting question. As a general matter, assuming a state's income tax computation starts with federal income, one needs to design an allocation regime that, at a minimum, passes muster under federal income tax principles. 81

A question then arises as to whether the states might layer on their own rules to constrain special allocations of state-specific income. New York, for example, has promulgated regulations, under both the corporate tax and the personal income tax, describing situations in which allocations may not be respected by the state. The corporate regulation states that an allocation will not be respected if it has as a principal purpose the evasion or avoidance of any tax imposed by the state or any of its political subdivisions on the corporation or the combined group of which it is a member. But under the personal income tax regulations, an allocation will not be respected if it has as a principal purpose the avoidance or evasion of the state's personal income tax or if it does not have substantial economic effect in accordance with IRC Section 704(b). But a promotion of the state's personal income tax or if it does not have substantial economic

### State Taxation and Investment Activities

While states that impose income taxes generally seek to tax persons earning income from in-state activities, there are certain respects in which in-state investment activities can be kept below the threshold for imposing tax.

#### Individuals.

As noted, investment income from intangibles generally is sourced to, and subject to tax by, an individual's state of domicile (assuming, of course that state imposes an income tax). Moreover, while as a federal matter the activity of trading for one's own account can depart from pure investment and rise to the level of a trade or business, states may not go so far as to tax nonresidents engaging in such in-state activities. New York, for example, provides that a nonresident (other than a dealer holding property primarily for sale to customers) will not be considered engaged in business in New York solely by reason of the purchase or sale of property, or the purchase, sale, or writing of stock option contracts, or both, for his or her own account. 84

### Partnerships.

Jurisdictions that impose tax on business activities may carve out investment activities from the scope of the tax. New York City, for example, provides that an individual or unincorporated entity (other than a dealer) is not engaged in an unincorporated business—and thus not subject to the unincorporated business tax—solely by reason of (1) the purchase, holding, or sale of property, or the entry into or assignment or other termination of a position in property, for the individual's or entity's own account, or (2) the acquisition, holding, or disposition, other than in the ordinary course of a trade or business, of interests in unincorporated entities engaged solely in such self-trading activities. 85

The Texas margin tax has a somewhat similar rule, for "passive" entities. As discussed in "The Texas margin tax," above, that exemption requires that 90% of income be from, e.g., dividends, interest, and similar "passive income."

# Corporations.

The bias in the taxation of corporations is an assumption that their activities constitute "business," and thus are taxable. In New York, for instance, there is authority holding that a corporation whose activities are limited to monitoring and administering various investments is nonetheless "doing business," and, therefore, subject to tax. 86

Special rules, however, may apply to investment income. As noted above, UDITPA divides income between business and nonbusiness classifications, and generally removes nonbusiness income from intangibles from the tax base of all but the corporation's state of commercial domicile. 87 Whether it is possible, in a UDITPA state, for a corporation to have only nonbusiness income is an interesting question, with no clear answer.

To encourage its attractiveness as a headquarters state, New York apportions investment income by reference to the factors of the investees, not the investor. While this approach has been questioned, <sup>88</sup> it has, in the past, withstood challenge. <sup>89</sup> In addition, New York provides a special rule for corporations investing in "portfolio investment partnerships." <sup>90</sup>

Finally, foreign corporations may find relief under state parallels to IRC Section 864 (regarding exclusions from the definition of "trade or business within the U.S."). New York, for example, provides by statute that a non-U.S. corporation will not be treated as taxable based solely on its activities of "investing or trading" in securities or commodities for its own account. 91 Note that the New York provision includes not only trading, as specified in IRC Section 864, but also investing, which activity by itself could otherwise be sufficient to invoke state tax.

#### Conclusion

In sum, the state tax treatment of partnerships and LLCs—and their members—involves a variety of issues and complexities not found at the federal level. Careful planning is needed to avoid unanticipated results. 92

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See Treas. Regs. §§301.7701-2 and -3. For background on the "check-the-box" regulations, see Peabody, "States Generally Endorse Check-the-Box but Key Issues Remain," 7 JMT 206 (Nov/Dec 1997).

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See, e.g., N.Y. Tax Law §§2.5, 2.6, and 658(c).
 N.H. Rev. Stat. Ann. §77-A:1.
 Tenn. Code Ann. §67-4-2001 et seq.
 N.Y.C. Admin. Code §11-501 et seq. (City Unincorporated Business Income Tax). A similar New York State UBT was
repealed some years ago. As discussed in the text below, the city UBT does not apply to certain investment
companies.
 N.Y.C. Admin. Code §§11-503, 11-506, and 11-507.
 Most states that impose an income tax employ a similar practice with regard to municipal bond interest, i.e.,
exempting interest from bonds issued by the taxing state and its political subdivisions but not interest from bonds
issued by other states and their political subdivisions. In Dept. of Revenue of Kentucky v. Davis 128 S.Ct. 1801, 170
L Ed 2d 685 (2008), rev'g Davis v. Kentucky Dept. of Revenue, 197 SW3d 557 (Ky. Ct. App., 2006), rev. den. Ky.
S.Ct., No. 2006-SC-105-D, 8/17/06, the U.S. Supreme Court held that such a tax scheme did not violate the
Commerce Clause of the U.S. Constitution. This case was discussed in U.S. Supreme Court Update, 18 JMT 42
(August 2008).
 N.Y.C. Admin. Code §11-507(3). Section 11-509(a) generally allows a deduction for up to $10,000 per proprietor or
active partner for services rendered.
 19 Rules of the City of New York (RCNY) Reg. §28-06(d)(1)(ii)(D).
<u>11</u>
 See, e.g., Matter of Proskauer Rose LLP, N.Y.C. Tax App. Trib., TAT(E)01-19(UB), 11/5/07, aff'd Proskauer Rose,
LLP v. Tax Appeals Tribunal of City of New York, 57 App Div 3d 287, 868 NYS2d 206, 2008 WL 5170644 (1st Dept.,
2008).
<u>12</u>
 N.Y.C. Admin. Code §§11-501(h) and 11-508(f).
<u>13</u>
 N.Y.C. Admin. Code §11-508(c). The former allowance of a "books and records" method of apportionment no longer
applies, nor does the requirement that a taxpayer maintain a regular place of business outside the city in order to
allocate income. 19 RCNY Reg. §28-07. Beginning with tax periods that start in 2009, New York City is phasing in,
over a period of ten years, single-factor apportionment, in an effort to conform with New York State. N.Y.C. Admin.
Code §11-508(i).
<u>14</u>
 19 RCNY Reg. §28-07(d)(1)(iii).
<u>15</u>
 19 RCNY Reg. §28-07(h).
 N.Y.C. Admin. Code §11-508(e-2).
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IRC §701.

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the State's New Margin Tax," 16 JMT 8 (October 2006).
 Tex. Tax Code Ann. §171.101; 34 Tex. Admin. Code §3.584(d)(1).
 Tex. Tax Code Ann. §§171.106, 171.002; 34 Tex. Admin. Code §3.584(d)(3).
 Tex. Tax Code Ann. §§171.0002(b)(3), 171.0003; 34 Tex. Admin. Code §3.582.
 Tex. Tax Code Ann. §171.0003(a)(2); 34 Tex. Admin. Code §3.582(c)(2).
 Tex. Tax Code Ann. §171.0003(b)(1); 34 Tex. Admin. Code §3.582(d)(1).
 34 Tex. Admin. Code §3.582(b)(10). For purposes of passive entity determination only, a "non-controlling interest"
is an interest of not more than 50% that is held by an investor, either directly or indirectly, in an investee. Id.,
§3.582(b)(9).
 Tex. Tax Code Ann. §171.0004; 34 Tex. Admin. Code §3.582(b)(1).
 Tex. Tax Code Ann. §§171.1014, 171.0001(1) and (7), and 171.0002(a).
 Tex. Tax Code Ann. §171.0001(8); 34 Tex. Admin. Code §3.590(b)(4).
 34 Tex. Admin. Code §§3.590(b)(2)(C) and (D).
 Tex. Tax Code Ann. §171.052; 34 Tex. Admin. Code §3.590(b)(2).
 See Ventas Finance I, LLC v. California Franchise Tax Bd., 165 Cal App 4th 1207, 81 Cal Rptr 3d 823, 2008 WL
3272046 (1st Dist., 2009), rev. den. Cal. S.Ct., No. S166870, 11/12/08, cert. den. U.S. S.Ct., Docket No. 08-1022,
4/6/09. The California LLC fee at issue in Ventas Finance was discussed in detail in Pace, Moll and Ely, "Wrestling
With Taxes in the Golden State—California's Unconstitutional LLC Fee," 16 JMT 24 (July 2006), in connection with
similar litigation in Northwest Energetic Services, LLC v. California Franchise Tax Bd., Cal. Super. Ct. San Francisco
County, Docket No. CGC-05-437721, 4/12/06, aff'd 159 Cal App 4th 841, 71 Cal Rptr 3d 642, 2008 WL 257230 (1st
Dist., 2008), rev. den. Cal. S.Ct., No. S162627, 6/11/08. Subsequent to the 2006 decision, the California legislature
amended the LLC fee statute, effective for tax years beginning after 2006, to provide for apportionment.
 Cal. Rev. & Tax. Code §18662. Cf. IRC §1446 (withholding tax on foreign partners).
 See, e.g., N.Y. Tax Law §658(c)(4).
 See IRC §752 (treatment of certain liabilities).
 See California FTB Informational Publication No. 1017 (6/1/09) ("Cal. Pub. 1017"), Q&A 33.
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Tex. Tax Code Ann. §171.0001 et seq. See Jackson and Wellington, "Major Tax Reform in Texas: An Overview of

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See, e.g., N.Y. Tax Law §658(c)(4); Cal. Pub. 1017, supra note 33, Q&A 19.
 Cal. Rev. & Tax. Code §18633.5(e).
36
 New York estimated tax payments are not required for any partner that files with the partnership Form IT-2658-E
or CT-2658E (certificate of exemption from estimated tax paid on behalf of nonresident partners) certifying that the
partner will comply in the partner's own capacity with the state's estimated tax and tax return filing requirements.
The partnership need not submit copies of the exemption forms to the state tax department but must maintain
copies of the forms in its records.
<u>37</u>
 Cal. Pub. 1017, supra note 33, Q&As 38 and 58 through 67.
 Cal. Pub. 1017, supra note 33, Q&A 110, referencing Cal. Rev. & Tax. Code §18666 and IRC §1446.
 See, e.g., Cobb v. Dept. of Revenue, Ore. Tax Ct. Magistrate Div., No. TC-MD 031021A, 3/11/04, 2004 WL
540704 .
<u>40</u>
 See, e.g., Ga. Code Ann. §48-7-129(b); Ga. Comp. R. & Regs. §560-7-8-.34(3)(d).
 See, e.g., Cal. Rev. & Tax. Code §18535.
 Ala. Rev. Rul. 02-003, 10/29/02.
 Minn. Rev. Notice 02-10, 7/8/02.
 Crescent Miami Center LLC v. Florida Dept. of Revenue, 903 So 2d 913 (Fla., 2005). This decision was limited by
subsequent legislation.
45
 Penn Towers Associates, LP v. Commonwealth, 866 A2d 1205 (Pa. Commw. Ct., 2005). This case was reviewed in
Shop Talk, "Pennsylvania Realty Transfer Tax Applied Despite No Change in Beneficial Ownership," 15 JMT 37
(September 2005).
 The exceptions are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire and
Tennessee tax only certain types of income, e.g., business profits, interest, dividends.
 See, e.g., N.Y. Tax Law §611 et seq. An individual is deemed a resident of New York if the individual is (1)
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See, e.g., N.Y. Tax Law §611 *et seq*. An individual is deemed a resident of New York if the individual is (1) domiciled in New York (with certain carve-outs), or (2) maintains a permanent place of abode in New York and, during the tax year, spends more than 183 days in the state. N.Y. Tax Law §605(b)(1). New York City applies similar tests. "Domicile" generally is the place that an individual intends to be his or her permanent home, i.e., the place to which the individual intends to return whenever he or she may be absent. See N.Y. Codes, Rules & Regs. §105.20

(d). <u>48</u>

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See, e.g., N.Y. Tax Law §631.
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This assumes the intangibles have not acquired a "business situs" in the state (for example, securities held for sale to customers by a broker-dealer, or investments held as working capital for an in-state business). See, e.g., N.Y. Tax Law §631(b)(2) ("[i]ncome from intangible personal property ... shall constitute income derived from New York

sources only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in this state....").

See Fla. Const. Art. VII, §5(a), generally prohibiting the imposition of a state personal income tax.

A different rule, however, may apply in New York. As part of New York's 2009-2010 budget legislation (A.B. 157, 4/7/09; Laws of 2009, ch. 57), the state enacted N.Y. Tax Law §631(b)(1)(A)(1) (Laws of 2009, ch. 57, Part F-1, §1). This new provision expands the definition of income, gain, loss, and deduction derived from New York sources to include certain gains and losses from the sale or exchange of an interest in certain entities that own real property in New York. Such entities include partnerships, LLCs, S corporations, and non-publicly traded C corporations with no more than 100 shareholders, that own realty located in New York with a fair market value equal to at least 50% of the value of all the assets the entity has owned for at least two years as of the date of the sale or exchange. This provision is effective 4/7/09 and applies to sales or exchanges of entity interests that occur after 5/6/09.

Compare, however, potential differences in holding periods and character. See, e.g., IRC  $\S$ 1221, 1223, 1231, 741, and 751.

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Md. Income Tax Administrative Release No. 8, 9/1/08.

Cal. FTB Legal Rul. 03-1, 4/7/03.

U.S. Const., Amend. XIV, §1.

U.S. Const., Art. I, §8, cl. 3.
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In New York, for example, a corporation is subject to tax if it is "doing business, ... employing capital, ... owning or leasing property ..., or ... maintaining an office" in the state. N.Y. Tax Law §209.1. State standards for nexus are limited by the federal Constitution but may, of course, be more narrow.

See, e.g., Capital One Bank (USA), N.A. v. Comm'r of Revenue of Mass., 453 Mass. 1, 899 N.E.2d 76 (2009), cert. den. U.S.S.Ct., 6/22/09; West Virginia Tax Comm'r v. MBNA America Bank, N.A., 640 SE2d 226 (W.Va., 2006), cert. den. sub nom. FIA Card Services, N.A. v. Tax Comm'r of the State of West Virginia, U.S.S.Ct., Docket No. 06-1228, 6/18/07, and Lanco, Inc. v. Director, Division of Tax'n, 908 A2d 176 (N.J., 2006), cert. den. U.S.S.Ct., Docket No. 06-1236, 6/18/07. Cf. Quill Corp. v. North Dakota, 504 US 298, 119 L Ed 2d 91 (1992) (Supreme Court held that, under the Commerce Clause, an in-state physical presence is a necessary prerequisite to the imposition of an obligation to collect and remit sales and use taxes on sales made to customers in the taxing state). For a bit more on Capital One, see U.S. Supreme Court Update, 19 JMT 41 (August 2009). Both the West Virginia and the New Jersey decisions were analyzed in greater detail in Weiss, "MBNA America Bank: A New Standard for Nexus in Income and Franchise Taxation?," 17 JMT 8 (Mar/Apr 2007); also see Sollie and Gutowski, "New Jersey: What Now for Intangible Holding Companies in the Wake of Lanco?," 15 JMT 18 (January 2006). For more background on Quill, see Eule and Richman, "Out-of-State Mail-Order Vendors Need Not Collect Use Taxes—Yet!," 2 JMT 163 (Sep/Oct 1992). See also Nolan, "Crossing the Bright Line: Evaluating Physical Presence in Quill's Shadow," 7 JMT 244 (Jan/Feb 1998).

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20 N.Y. Codes, Rules & Regs. §1-3.2(a)(5). It appears that New York has taken the nexus issue to a whole new level. A recent administrative law judge decision held that Delaware corporations were subject to tax in New York merely because they held membership interests in a corporate general partner of a New York partnership. Matter of Shell Gas Gathering Corp. #2 and Shell Gas Pipeline Corp. #2, N.Y. Division of Tax App., ALJ Determination, DTA Nos. 821569 and 821570, 6/11/09. ALJ decisions are not binding precedent in New York, however, and the matter is currently pending on appeal with the New York State Tax Tribunal.

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20 N.Y. Codes, Rules & Regs. §§1-3.2(a)(6)(i) and (ii).
  968 So 2d 18 (Ala. Ct. Civ. App., 2006), rev'q Ala. Cir. Ct., No. CV-2003-2705, 11/17/04, cert. den. Ala. S.Ct.,
No. 1051475, 4/13/07. This case was discussed in greater detail in Ely and Houser, "Alabama: No Income Tax Nexus
for Nonresident Limited Partner in Investment Partnership," 17 JMT 38 (August 2007).
 See, e.g., 35 ILCS §5/1501(a)(11.5); Ky. Rev. Stat. Ann. §141.206(12); N.J. Admin. Code §18:7-1.21 (defining
"qualified investment partnership"). Also see, generally, Gotlinger and Mahon, "State Tax Exemptions for Investment
Partnerships and Their Nonresident Partners," 17 JMT 22 (February 2008).
 See, e.g., Del. Code Ann. tit. 6, §18-701 (part of the state's LLC Act).
 On a possibly related note, see Wisconsin v. J.C. Penney Co., 311 US 435, 85 L Ed 267 (1940), and International
Harvester Co. v. Wisc. Dept. of Tax'n, 322 US 435, 88 L Ed 1373 (1944) (upholding state income tax on dividends
paid to shareholders by corporations with in-state business activities). See also Revenue Cabinet v. Ashworth Corp.,
Ky. Ct. App., Nos. 2007-CA-002549-MR, 2008-CA-000023-MR, 11/20/09, 2009 WL 3877518; BIS LP, Inc. v. Director,
Division of Tax'n, 25 N.J. Tax 88 (2009); Matter of Shell Gas Gathering Corp. #2 and Shell Gas Pipeline Corp. #2,
supra note 59.
 830 Code Mass. Regs. §63.39.1(8)(f). See also Arizona Dept. of Revenue v. Central Newspapers, Inc., 222 Ariz.
626, 218 P.3d 10831 (Ct. App. Div. 1, 2009); Virginia Pub. Doc. Rul. No. 99-34, 3/24/99. P.L. 86-272 (15 USC
§§381-384, the "Interstate Commerce Tax Act") limits a state's ability to assert income tax jurisdiction over a
business whose only activity in the state is the solicitation of orders for sales of tangible personal property, provided
the orders are sent out of the state for approval and are filled by shipment from outside the state. P.L. 86-272 does
not protect other types of activities in a state and does not apply to non-income taxes (e.g., sales or use taxes) or
to the sale of intangibles.
 See Complete Auto Transit, Inc. v. Brady, 430 US 274, 51 L Ed 2d 326 (1977).
 See generally the Uniform Division of Income for Tax Purposes Act (UDITPA).
 See, e.g., N.Y. Tax Law §210.3(a) (§210.3(a)(10)(A)(ii) provides for single sales factor apportionment, effective
for tax years beginning after 2006).
 See UDITPA §§1(e) (defining "nonbusiness income") and 4 (allocation of "nonbusiness income").
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 See, e.g., 18 Cal. Code Regs. §25137-1.
 See, e.g., N.Y. Codes, Rules & Regs. §3-13.3(a)(1).
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 But see, e.g., New York's carve out for certain corporate limited partners, discussed in the text below.
 N.Y. Codes, Rules & Regs. §4-6.5(a)(2)(ii).
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See, e.g, GTE Spacenet Corp. v. N.Y.S. Dept. of Tax'n and Finance, 224 App Div 2d 283, 638 NYS2d 29, 1996 WL 73794 (1st Dept., 1996), aff'q N.Y.S. Sup. Ct., 10/13/94, app. den. N.Y. Ct. App., 10/10/96, 673 NE2d 1242, 1996

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WL 750020 .
 See, e.g, Del. Code Ann. tit. 6, §18-215 (the progenitor for several other state series LLC statutes; it provides
that "any such series [of the LLC] may have a separate business purpose or investment objective"). Also see,
generally, McLoughlin and Ely, "The Series LLC Raises Serious State Tax Questions but Few Answers Are Yet
Available," 16 JMT 6 (January 2007).
 See California FTB Informational Publication No. 689 (2/1/07).
 Mass. Dept. of Revenue Ltr. Rul. 08-2, 2/15/08.
 Fla. Tech. Assist. Adv. (TAA) No. 02(M)-009, 11/27/02.
 For a thoughtful discussion of similar issues, see Tax Letter 1154: "Notice 2008-19 and Protected Cell Companies
Outside of the Insurance Arena" (5/2/08), from the New York State Bar Association to then-IRS Comm'r Shulman and
Dept. of Treasury Ass't Secretary (Tax Policy) Solomon (available on the Association's website at www.nysba.org (Select "Sections/Committees," "Tax Section," "Tax Section Reports—2008")). (Notice 2008-19 may be found at
2008-5 IRB 366.)
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 In particular, the federal rules requiring that partnership allocations have "substantial economic effect" must be
addressed. See Treas. Reg. §1.704-1(b)(1)(i).
 N.Y. Codes, Rules & Regs. §3-13.3(a)(3).
 N.Y. Codes, Rules & Regs. §117.5.
 N.Y. Tax Law §631(d).
 N.Y.C. Admin. Code §11-502(c)(2). Also, see Gotlinger and Mahon, supra note 63.
 See, e.g., Guaranty Trust Co. of New York v. Lynch, 265 N.Y. 593, 193 N.E. 335 (1934); City Bank Farmers Trust
Co. v. Graves, 272 N.Y. 1, 3 N.E.2d 612 (1936).
87
 See, e.g., Allied-Signal, Inc. v. Director, Division of Tax'n, 504 US 768, 119 L Ed 2d 533 (1992); MeadWestvaco
Corp. v. Illinois Dept. of Revenue, 128 S.Ct. 1498, 170 L Ed 2d 404 (2008). These cases are analyzed in,
respectively, Dyk and Bilich, "Allied-Signal and the Unitary Business Principle: Little Guidance, Many Questions," 2 JMT
154 (Sep/Oct 1992); and Goodman, "Illinois: U.S. Supreme Court Rejects Application of Operational Function Test in
the Sale of a Division," 18 JMT 46 (September 2008).
88
 See MeadWestvaco Corp., supra note 87.
 See Allied-Signal, Inc. v. Comm'r of Finance, 79 N.Y.2d 73, 580 N.Y.S.2d 696, 588 NE2d 731 (1991).
 See note 60, supra, and accompanying text.
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N.Y. Tax Law §209.2-a. 92

For more details on all the states' tax treatments of LLCs and LLPs (including entity-level taxes, state conformity with the federal entity classification rules, and potential entity-level withholding requirements, as well as certain nontax elements, such as restrictions on the availability of entity forms for certain professionals), see Ely, Grissom, and Thistle, "State Tax Treatment of LLCs and LLPs: Update for 2009," 19 JMT 20 (Mar/Apr 2009). A 2010 update will be published in an upcoming issue of this Journal.

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