CHAPTER 1

State Taxation of Subchapter K Entities and Their Owners*

BRUCE P. ELY
CHRISTOPHER R. GRISSOM
WILLIAM T. THISTLE

Messrs. Ely and Grissom are partners with Bradley Arant Boult Cummings LLP (www.babc.com), resident in its Birmingham, Alabama office. Mr. Ely chairs the firm's SALT Practice Group and is a member of the Institute's Advisory Board. **Mr. Thistle** is an associate in that office and is the principal author of this article.

SYNOPSIS

* IRS Circular 230 Notice: Any U.S. federal tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding U.S. federal tax penalties or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

(Rel.12–6/2010 Pub.1125)

§ 1.01 SUMMARY OF STATE TAXATION OF SUBCHAPTER K ENTITIES AND THEIR OWNERS

[1] Introduction

In recent years, the use of pass-through entities, particularly Subchapter K entities, has evolved into one of the most significant state tax planning opportunities available for multistate corporations. Not only may state corporate income tax savings be realized, but if properly structured, significant franchise tax and sales/use tax savings may be achieved. In addition, a growing number of states have adopted straightforward legal entity conversion provisions, thereby providing businesses with an easier means by which to change the legal and tax classification of a subsidiary into a pass-through entity.

Not all states are as favorable in their treatment of pass-through entities. Indeed, during the past several years, a number of states, such as Alabama, Georgia, Kentucky, New Jersey, North Carolina, and Pennsylvania, have attempted to close certain pass-through entity planning ideas. However, these attempts have merely reduced (not eliminated) the list of planning opportunities.

[2] In General

The ownership of an interest in a pass-through entity raises a number of state and local tax issues including: (a) whether the mere ownership of the interest in the pass-through entity creates nexus for the owner; (b) how the corporate owner's distributive share of the pass-through entity's income or loss will be treated for state tax purposes; (c) whether the pass-through entity impacts the composition of the corporate owner's apportionment factors; and (d) whether the availability of tax credits is affected. As is generally the case in the state taxation arena, the state laws and policies governing these issues vary significantly among the states. Accordingly, with appropriate planning these issues provide a multitude of planning techniques that allow a multistate corporation to legally reduce its overall state tax liability. Conversely, these non-uniform laws or interpretations can become a trap for the unwary.

[3] Scope of Chapter

This chapter provides an overview of the state taxation of Subchapter K entities and their owners, with particular emphasis on classification conformity issues, nexus, nonresident withholding provisions, allocation/apportionment issues, significant recent developments, and some planning strategies.

[4] Terminology

Throughout this chapter, we will refer to "pass-through" entities, but that term only includes those entities taxed under Subchapter K of Title 26 of the United States Code (hereinafter referred to as the "Internal Revenue Code" or "I.R.C."), rather than all pass-through entities, and thus excludes S corporations. Furthermore, we frequently use the terms "partnerships" and "partners," but those terms include limited liability companies ("LLCs") classified as partnerships for federal and state income tax purposes and their members. In addition, the following terms will be abbreviated as follows: single member limited liability company ("SMLLC"); limited partnership ("LP"); limited liability partnership ("LLP"); and limited liability limited partnership ("LLLP").

§ 1.02 CLASSIFICATION RULES APPLICABLE TO SUBCHAPTER K ENTITIES

[1] Summary of Federal Income Tax Rules Applicable to Subchapter K Entities

A partnership is not ordinarily subject to federal income tax, unless it is, for example, publicly-traded. The partners are taxed on the partnership's items of income, gain, loss, and deduction.[1] These items are computed at the partnership level and then allocated or "passed through" to the partners, generally at the end of the partnership's tax year.[2]

Partners, like shareholders in an S corporation, are taxed on their shares of the items that are allocated to them, regardless of whether those items are actually distributed to them.[3] Generally, the character of these items is determined at the partnership level.[4] A partner's allocable share of income, gain, loss, and deduction is determined by the partnership agreement.[5] Special allocations of income, gain, loss, and deduction are generally permitted as long as they have substantial economic effect.[6] Partners are taxed on their allocable share of income at individual rates, so, depending on the character of the income and the individual's tax situation, the rates may range from the special 10% capital gains rate to the highest ordinary income rate of 39.6%.[7] As will be discussed below, the states generally conform to the federal income tax rules, but not uniformly.

The ability to be taxed as a partnership is not available to all entities. Any business entity classified as a per se corporation may not be taxed as a partnership. Any business entity that is not a per se corporation is an "eligible entity" that may elect its tax classification.[8] The default tax classification for any domestic entity with two or members is a partnership.[9] Thus, partnership tax classification for federal income tax purposes does not have to be affirmatively elected by multi-member pass-through entities, such as general partnerships, LLCs, LPs, LLPs, LLLPs. The federal entity classification rules, and the state law conformity or non-conformity to them, are discussed in detail below in the next three sections.

As with C and S corporations, the formation of a partnership is usually a non-taxable event for federal income tax purposes.[10] Partners receive an adjusted basis in their partnership interest equal to the amount of money and the adjusted basis of property contributed to the partnership.[11] The partnership takes a transferred basis in contributed property equal to that of the contributing partner.[12] Items of income and gain allocated to the partners increase the partners' respective outside bases in their

[1] 26 U.S.C. §§ 701, 703.

[2] 26 U.S.C. §§ 702, 703, 704, 706.

[3] 26 U.S.C. §§ 702, 703, 704, 706.

[4] 26 U.S.C. § 702(b).

[5] 26 U.S.C. § 704(a).

[6] Treas. Reg. § 1.704-1(b).

[7] 26 U.S.C. § 1(a), (h).

[8] Treas. Reg. § 301.7701-3(a).

[9] Treas. Reg. § 301.7701-3(b)(1).

[10] 26 U.S.C. § 721(a); *but see* 26 U.S.C. §§ 721(b), 707.

[11] 26 U.S.C. § 722.

[12] 26 U.S.C. § 723.

partnership interests.[13] Losses allocated to a partner reduce that partner's outside basis.[14] Generally, a partner cannot deduct losses in excess of its basis in its partnership interest.[15] Losses that exceed the partner's outside basis do not pass through; rather they are suspended for the benefit of that particular partner and may be taken in subsequent taxable years when the partner has sufficient outside basis.[16] Distributions from the partnership to the partner are not generally taxable to the extent of the partner's outside basis, but reduce the partner's basis accordingly.[17]

Sales of partnership interests are taxable to the extent the amount realized exceeds the partner's outside basis in the partnership interest.[18] Assuming the holding period is met and the shareholder is not considered a dealer in partnership interests, the sale of the partnership typically generates long-term capital gain for the partner.[19] However, in contrast to the sale of stock in a corporation, ordinary income will realized on the sale of a partnership interest to the extent it holds inventory or unrealized receivables (this category of assets is broad and includes, among other things, assets with built-in depreciation recapture).[20]

[2] Federal Check-the-Box Regulations

The first state tax question for unincorporated entities is often whether the entity will qualify for partnership (pass-through) taxation or whether it will be taxed in the same manner as a corporation. Before reviewing the state rules, it is helpful to review the federal classification rules, as most states generally follow them.

The U.S. Treasury Department released its so-called "check-the-box" regulations on December 17, 1996. These landmark regulations, which became effective for tax years beginning on or after January 1, 1997, replaced the old *Morrissey* corporate characteristics test and streamlined the classification of pass-through entities for federal income tax purposes.[21]

Pursuant to the check-the-box regulations, a domestic (U.S.) unincorporated entity

---

[13] 26 U.S.C. § 705(a).

[14] 26 U.S.C. § 705(a).

[15] 26 U.S.C. § 704(d).

[16] 26 U.S.C. § 704(d).

[17] 26 U.S.C. §§ 705, 731(a); *but see*, 26 U.S.C. §§ 731(c), 704(c), 751(b).

[18] 26 U.S.C. §§ 741, 1001(a).

[19] 26 U.S.C. §§ 741, 1221, 1223(1).

[20] 26 U.S.C. § 751(a) and (c).

[21] *See* Treas. Reg. §§ 301.7701-1 through -3. In Littriello v. United States, 484 F.3d 372 (6th Cir. 2007), *cert. denied*, 128 S. Ct. 1290 (2008), the Sixth Circuit Court of Appeals held that the check-the-box regulations were a reasonable and valid exercise of the IRS' authority to fill in statutory gaps. Specifically, the court stated "[t]he Treasury Regulations at the heart of this litigation . . . were issued in 1996 to clarify the rules for determining the classification of certain business entities for federal tax purposes." The court noted that the regulations were an attempt to replace the so-called "Kintner regulations." The court also noted that the regulations were "particularly helpful with regard to the tax status of the new [entity] hybrids, because the hybrid entities were not, and still are not, explicitly covered by the definitions set out in § 7701."

may elect its tax status for federal income tax purposes. If it does not affirmatively elect to be treated as an association taxable as a corporation, an eligible entity with more than one owner will automatically be classified as a partnership, and an eligible entity with only one owner will be "disregarded" as an entity separate from its owner and therefore treated as a sole proprietorship, branch, or division, depending on the tax classification of the owner.[22]

The entity can make an "Entity Classification Election" by filing Form 8832. The effective date of the election cannot be more than 75 days prior to the date of filing the Form 8832 or more than 12 months after the date of filing. Once an election is made, an entity is prohibited from changing its classification by filing another election for a period of 60 months following the effective date of the election. If an entity fails to make an election, the default provisions apply. Before making an election, however, taxpayers and tax practitioners alike should be aware that the economic substance and step transaction doctrines, as well as all other relevant provisions of the Code and general principles of tax law, apply in determining the tax treatment of a change in the classification of an entity.[23]

While the check-the-box regulations have made selecting corporate or partnership taxation relatively easy, the state and local tax consequences of such an election can become very complex for multistate taxpayers and, to a lesser extent, pass-through entities with owners in multiple states.[24]

[3] State Conformity to the Check-the-Box Regulations

States are free to establish their own rules as to the types of entities that may be formed in their jurisdiction and may establish their own formation requirements. Nevertheless, following the Treasury Department's adoption of the check-the-box regulations, most state legislatures acted quickly to apply the federal regime for state income tax purposes. During the first three quarters of 1997, more than twenty-five states enacted laws relevant to check-the-box, and twenty states repealed a prior injunction against domestically-formed SMLLCs. Today, the vast majority of states generally follow the federal check-the-box regulations for state income tax purposes. As with any general rule, however, there are exceptions, as discussed in § 1.01[4] below.

Although the determination of whether a particular state conforms to the federal entity classification regulations appears to be relatively straightforward, the manner in which states have conformed leaves some questions unanswered. Following the adoption of the check-the-box regulations, many state departments of revenue issued bulletins indicating that the state would follow the federal scheme. Other states enacted statutory provisions to that effect. Rather than simply providing that the state would follow the federal classification for state income tax purposes for all covered entities,

---

[22] Treas. Reg. § 301.7701-3(b).

[23] Treas. Reg. §§ 301.7701-3(g)(2), and 1.1361-4(a); *see also*, ILM 200840040.

[24] *See generally*, B. Ely, "Selected Pitfalls in the Use of Hybrid Entities—Part I," 4 *Business Entities J.* 28 (Sept./Oct. 2002).

however, many states only addressed application of the check-the-box rules to LLCs. Maine is a typical example:

> For purposes of taxation under Title 36, Part 8, a limited liability company formed under this chapter or qualified to do business in this State as a foreign limited liability company is classified as a partnership, unless classified otherwise for federal income tax purposes, in which case the limited liability company is classified in the same manner as it is classified for federal income tax purposes.[25]

Presumably, if a state follows an LLC's federal tax classification as a corporation, it would respect a partnership's federal election to be taxed as a corporation. Many states provide so indirectly by defining the term "corporation" in their income tax statute to include entities taxable as corporations for federal income tax purposes. Some states, however, do not directly address the treatment of partnerships and make no reference to federal tax classification in their definition of "corporation."

Another gray area involves the tax treatment of disregarded entities, such as SMLLCs. Under the federal check-the-box regulations, a SMLLC is treated as a division of its corporate member-owner for federal income tax purposes. Although most states provide that a SMLLC disregarded for federal income tax purposes will likewise be disregarded for state income tax purposes, they fail to address whether a partnership that is disregarded for federal income tax purposes will be similarly disregarded for state income tax purposes.

To illustrate, assume that a corporation is the sole owner of two LLCs that are disregarded for federal income tax purposes and are therefore considered divisions of their corporate owner. The two LLCs, in turn, collectively own a limited partnership. Because the two SMLLCs are disregarded for federal income tax purposes, the limited partnership will be treated as a division of the corporation because, for federal income tax purposes, it does not have two partners. It is unclear, however, how the limited partnership would be treated in states that only address the tax treatment of disregarded SMLLCs.

Another wrinkle with state conformity to the check-the-box regulations involves the imposition of entity-level taxes. In theory, if a state broadly applies the federal check-the-box regulations for state tax purposes, the state would not impose any of its various taxes on an entity that is disregarded or taxed as a partnership for federal income tax purposes. As any experienced practitioner will confess, however, theory and practice do not always coincide.

Because the federal check-the-box regulations were formulated for federal *income* tax purposes, one might reasonably assume that state adoption of federal entity classification would be limited in effect to a state's income tax. However, a minority of states have applied federal check-the-box concepts to non-income taxes, such as sales and use taxes or franchise (net worth) taxes. For example, a minority of states imposing a net worth tax have defined "corporation" with respect to an entity's federal

---

[25] Me. Rev. Stat. Ann. tit. 31, § 761.

income tax classification, thereby employing the federal income tax check-the-box concepts to determine whether an entity is subject to the state's net worth tax.

[4] State Nonconformity or Partial Conformity to the Check-the-Box Regulations

[a] In General

While most states will treat most entities in the same manner as they are treated for federal income tax purposes, not all states uniformly conform to the check-the-box rules. Taxpayers that are contemplating electing out of the default rules should be especially careful in ensuring the proper classification for state tax purposes. Some of the more notable exceptions to the general rule of conformity are noted below.

[b] Examples of Nonconformity or Partial Conformity

[i] Alabama

In 2007, the Administrative Law Division ruled that a SMLLC should be disregarded for purposes of Alabama's annual state/county business license tax and the tax should be assessed against the single member of the disregarded entity.[26] Chief Judge Thompson's decision confirmed that the Alabama Department of Revenue (the "ADOR") follows the federal entity classification rules regarding SMLLCs for purposes of *all* taxes levied under Alabama's Revenue Code, Title 40 (except the business privilege tax), and not just for state income tax purposes.[27]

Act 2009-621 enacts the Alabama Law Institute's Alabama Uniform Limited Partnership Act of 2010, which includes language (inserted at the ADOR's request) limiting state tax conformity with the IRS's check-the-box entity classification regulations to only income taxes regarding limited partnerships, thereby leaving the issue of federal conformity uncertain with respect to sales, use, rental, lodging, excise, and property taxes.

[ii] District of Columbia

Despite following the federal check-the-box regime in determining a partnership's or an LLC's classification as a corporation, partnership, or disregarded entity,[28] the District of Columbia nevertheless imposes an unincorporated business franchise tax on partnerships and LLCs, other than those taxable as corporations for federal income tax purposes—the latter being subject to the state's tax on corporations.[29]

[iii] Florida

Florida follows the federal check-the-box regime for an LLC's classification as a corporation, partnership, or disregarded entity for income tax purposes (only).

---

[26] First American Holding, LLC v. State Dep't of Rev., Admin. Law Div., Dkt. No. MISC. 07-773 (Dec. 20, 2007).

[27] *See* Ala. Code § 10-12-8(b); Ala. Rev. Proc. 98-001 (Mar. 16, 1998).

[28] DC Code Ann. §§ 29-1074, 47-1808.01, 47-1801.04(16).

[29] DC Code Ann. § 47-1801.04(16).

However, Florida appears to diverge from the federal check-the-box regime with respect to partnerships because it excludes "partnerships of any type" from its definition of "corporation," for purposes of the state's corporate income tax. Also, the definition of "partnership" does not reference the entity's classification for federal income tax purposes.[30]

[iv] Illinois

An Illinois appellate court upheld an administrative law judge's ruling that an airplane owned by a SMLLC was not exempt from use tax because the exemption applies only to individuals, and an LLC does not satisfy the plain and ordinary meaning of an "individual."[31] The trial court found for the taxpayer by applying a substance over form analysis, reasoning that the LLC should be exempt because its single member was an individual and was the substantive owner of the airplane. The appellate court disagreed, however, noting that the Use Tax Act used the terms "individual" and "LLC" separately and distinctly and that the legislature therefore did not intend for the exemption to apply to LLCs.

[v] Kentucky

For taxable years beginning on or after January 1, 2007, the state conforms to the federal check-the-box regime in determining a partnership's or an LLC's classification as a corporation or partnership for state income tax purposes. Nevertheless, certain limited liability entities exceeding a gross receipts threshold—including those treated as partnerships for federal income tax purposes—are required to pay the greater of an annual limited liability entity gross receipts tax or $175.

[vi] Louisiana

Louisiana follows the federal check-the-box regime in determining a partnership's or an LLC's classification as a corporation, partnership, or disregarded entity with respect to its corporate income tax.[32] However, in Revenue Ruling 01-013 (Oct. 1, 2001), a ruling concentrating on those entities that elect to be taxed as corporations for federal tax purposes, the Louisiana Department of Revenue concluded that the check-the-box regulations will *not* govern the classification of LLCs for Louisiana *franchise* tax purposes.

[vii] Michigan

The taxpayer, KMPS, LLC, was a Michigan LLC, wholly-owned by its single corporate member, Kmart Corporation ("Kmart"). KMPS was a disregarded entity for federal income tax purposes. However, KMPS filed its own Michigan Single Business Tax ("SBT") return for the fiscal year ending January 28, 1998. The Michigan Department of Treasury determined that KMPS should not have filed a separate SBT

---

[30] Fla. Stat. § 220.03(1)(e).

[31] JB4 Air LLC v. Dep't of Rev., 388 Ill. App. 3d 970, 905 N.E.2d 310 (2009).

[32] La. Rev. Stat. Ann. §§ 12:1368, 47:287.11(A); La. Admin. Code § 61:I.1401; La. Rev. Rul. 03-006 (Dec. 8, 2003); La. Rev. Info. Bull. No. 04-003 (Jan. 7, 2004).

return; rather it should have been disregarded and its tax information included on Kmart's SBT return. The Department, relying on a 1999 Revenue Administration Bulletin ("RAB"), argued that an entity must use the same entity status it chose for federal income tax purposes. The Court of Appeals disagreed, however, concluding that the RAB was not legally binding and that nothing in the SBT or the check-the-box regulations required an entity to be consistent in its self-classification with respect to its state and federal tax filings for a given year. Therefore, KMPS properly filed a separate SBT return.[33]

[viii] Pennsylvania

In Pennsylvania, LPs are exempt from the state's capital stock/franchise tax, but LLCs are taxable.[34]

[ix] Tennessee

For purposes of the Tennessee franchise and excise tax, a business entity is generally classified as a corporation, partnership, or other type of business entity consistent with the way the entity is classified for federal income tax purposes.[35] However, only SMLLCs that are disregarded for federal income tax purposes *and* that have a corporation or a business trust as their sole member are disregarded for Tennessee excise tax purposes.[36] Moreover, despite the state's purported general conformity to the federal check-the-box rules, LPs and LLCs, other than SMLLCs with a corporate owner, are subject to state franchise/excise tax.

[x] Texas

For Texas franchise tax reports due before January 1, 2008, all LLCs (but *not* LPs, LLPs, or LLLPs)—including SMLLCs—are treated as corporations.[37] However, effective for reports due on or after January 1, 2008, the franchise tax has been replaced by the so-called "margin tax." Under the expanded margin tax, most pass-through entities are subject to tax, except general partnerships owned entirely by natural persons, certain passive investment partnerships, and certain family limited partnerships.

[xi] Wisconsin

As provided in the recent budget bill, L. 2009, AB 75 (Act 28), single-owner entities disregarded as separate entities for Wisconsin income tax purposes are disregarded as separate entities for Wisconsin sales and use tax purposes effective July 1, 2009. Formerly, Wisconsin treated these entities as separate entities for sales and use tax

---

[33] Kmart Michigan Property Services, LLC v. Dep't of Treas., 283 Mich. App. 647, 770 N.W.2d 915 (May 12, 2009).

[34] Pa. Stat. Ann. 72 § 7601(a).

[35] Tenn. Code Ann. §§ 48-211-101, 67-4-2004(28), 67-4-2007(1)(d).

[36] Tenn. Code Ann. § 67-4-2007(1)(d); Tenn. Ltr. Rul. 04-01 (Jan. 1, 2004); Tenn. Ltr. Rul. 08-14 (Feb. 22, 2008).

[37] Tex. Admin. Code § 3.562.

purposes except for reporting purposes. Owners of disregarded entities must include information from the disregarded entities on the owners' sales and use tax returns for any such returns filed prior to September 1, 2009. Effective for returns filed after that date, owners have the option to include disregarded-entity information on their own returns or file separate electronic returns for the disregarded entities. Any owner of more than one disregarded entity that chooses to file a separate return for one of the disregarded entities must do so for all of them.

Disregarded entities will be treated as entities separate from their owners with respect to purchases and leases of tangible personal property made prior to July 1, 2009, which will protect the owners of the entities from facing use tax liability solely on account of this legislation.

[5] Classification of Series LLCs

[a] In General

Since 1996, Delaware law has permitted LLCs to form and register separate series within the LLC (collectively, a "series LLC").[38] Seven other states also now officially authorize their formation,[39] while at least two others recognize series LLCs formed in other states.[40] This allows LLCs to establish separate series of management and economic rights for specific assets or obligations and permits each series to shield its assets from liabilities incurred in or against any other series in the LLC. Among other potential planning opportunities, series LLCs could separate large corporate enterprises without triggering the consolidated return regulations, potentially reduce state taxes, avoid triggering the disguised sale rules, and possibly defer recognition of gain on sales of assets or entire businesses.

On September 16, 2002, the Delaware Department of Finance issued an informal ruling to the authors' law firm confirming that the status of a series LLC for Delaware state tax purposes would be governed by the federal check-the-box regulations. The entity under consideration in the ruling was a SMLLC that did not elect to be classified as a corporation for federal tax purposes, so the SMLLC was disregarded for Delaware tax purposes as well, as was each series.

[b] California

The California Franchise Tax Board has indicated that each series in a Delaware series LLC that is registered or is doing business in California should be considered a

---

[38] Del. Code Ann. tit. 6, § 18-215.

[39] ILCS ch. 805 180/37-40; Iowa Code § 489.1201 effective Jan. 1, 2009 (formerly § 404.305A); Nev. Rev. Stat. § 86.161; Okla. Stat. tit. 18, § 2005; Tenn. Code Ann. § 48-249-309; Texas (Tex. Bus. Org. Code § 101.601 et seq., effective Sept. 1, 2009) and Utah Code § 40-2c-606. Several more states authorize classes and series of interests but do not have the "internal shields" that are the essence of a Delaware-type series LLC. *See, e.g.*, Minn. Stat. § 322B.03(44). *See generally*, M. McLoughlin and B. Ely, "The Series LLC Raises Serious State Tax Questions but Few Answers Are Yet Available," 16 *Journal of Multistate Taxation and Incentives* 6 (Jan. 2007).

[40] *See* Cal. FTB Informational Publication 3556 (July 1, 2008); and Fla. Technical Assistance Advisement No. 02(M)-009 (Nov. 27, 2002).

separate LLC for purposes of the LLC franchise and gross receipts-based fees. Therefore, each series must file its own Form 568, Limited Liability Company Return of Income, and pay its own separate LLC annual tax and fee.[41]

[c] Florida

The Florida Department of Revenue has indicated that it will follow the federal income tax treatment of each series in an LLC, unless that treatment conflicts with Florida law (whatever that means).[42]

[d] Massachusetts

The Massachusetts Department of Revenue has ruled that a Delaware series LLC that will be a successor entity to a trust will be classified as a separate entity for Massachusetts income and corporate excise tax purposes.[43] The Department further ruled that each LLC series and any additional series established by the LLC in the future will be classified for Massachusetts income and corporate excise tax purposes in accordance with its federal classification. Since the Department concluded that the Massachusetts rules for classifying an LLC extend to a series LLC established and governed pursuant to the Delaware LLC statutes, it was unnecessary to rule that each series of the LLC is itself a separate LLC.

[e] Possible Treatment of Series LLCs

Until recently, Congress, the courts, and the IRS had all failed to provide any specific guidance on the federal tax classification of a series LLC.[44] The threshold question to determine the tax classification of a series LLC is whether each series is treated as a separate entity. Prior to PLR 200803004, it appeared that series LLCs could be classified in different ways, including treating each series of a series LLC as (1) a separate entity or (2) as a parent company that is the sole owner of each of its series that is taxed as a disregarded entity, in which case the series LLC and all of its series could be treated in the aggregate as a single entity. Assuming that each series could be taxed separately, there was further uncertainty before PLR 200803004 as to whether all of the series must have the same tax classification.

PLR 200803004 is the first published ruling on the taxation of a series LLC. The IRS issued the private letter ruling to a group of insurance company taxpayers that were reorganizing their mutual fund operations as a Delaware series LLC. The IRS implicitly ruled that each series of the series LLC is a *separate entity* for federal income tax purposes and each series is therefore entitled to choose its own entity

---

[41] California 2008 Limited Liability Company Tax Booklet, p. 6, Section F; FTB Pub. 3356 p. 4 (Rev. 7-2008).

[42] *See* Fla. Technical Assistance Advisement No. 02(M)-009 (Nov. 27, 2002).

[43] Massachusetts Dept. of Rev. Letter Ruling 08-2 (Feb. 15, 2008).

[44] The IRS did issue PLR 9435015 (June 3, 1994), which involved the taxation of a Delaware series business trust—not a series LLC. The IRS treated each series of the business trust as a separate entity for federal income tax purposes, thereby suggesting that each series in a series LLC may also be treated as a separate entity for federal tax purposes.

classification independent of the classification of other series. Although the facts of the letter ruling involved a particular type of taxpayer (i.e., mutual funds used to fund variable annuity and life insurance contracts), its analysis and holdings should be broadly applicable to series LLCs conducting other types of activities. The Massachusetts Department of Revenue ruling discussed above appears to be the parallel state tax ruling.

§ 1.03 NEXUS

[1] In General

The initial nexus question that arises with respect to the state taxation of pass-through entities and their owners is whether merely holding an interest in a pass-through entity creates nexus with the state in which the entity does business. Until recent statutory and regulatory changes, a number of states varied the treatment of corporate partners depending on the type of ownership interest—thus taxing corporate general partners but not taxing limited partners. A few states still apparently make this distinction.

Some states subject a corporation to tax only if it is “doing business” or “transacting business” in the state, while other states impose income tax on corporations that “derive income” from sources within the state. A few states (e.g., Alabama) have combined both approaches by levying a net worth-based franchise tax and a corporate income tax; the franchise tax is imposed on corporations doing business in the state, while the corporate income tax is imposed on corporations that are either doing business in the state or deriving income from sources within the state. In states that subject a corporation to tax only if the corporation is doing or transacting business in the state, the nexus question becomes whether an owner of a pass-through entity is considered to be doing or transacting business in the state merely because it owns an interest in a pass-through entity that does business in that state.

In reaching the conclusion that a partnership’s nexus with a particular state flows through to the corporate partner, several states have applied the age-old aggregate or conduit theory of partnership law. This theory treats the corporate owner as having a ratable share of the partnership’s tax items, and as such, the corporate partner would have nexus in those states where the partnership engages in activities that result in taxable nexus for the partnership.[45]

An argument can be made that the more modern entity theory (where the entity is treated as separate from its owners and the owners are not deemed to own a ratable share thereof) applies to LLCs but not to partnerships, even though an LLC may be taxed like a partnership. Although it is unlikely many states will easily accept such a position, a corporation should not automatically presume that it is subject to state tax if its only connection with the state is its interest in an LLC doing business there.[46]

---

[45] *See, e.g.*, Borden Chemicals and Plastics, L.P. v. Zehnder, 312 Ill. App. 3d 35, 726 N.E.2d 73 (2000).

[46] For a thoughtful treatment of this issue involving a nonresident limited partner of a limited

If an LLC is treated as a partnership for state tax purposes, it could be argued that corporate members of LLCs should be treated in the same manner as would a corporate partner. If a state varies the treatment of a corporate partner depending on whether the corporation is a limited or general partner, it may be argued that all LLC members should be taxed in the same manner as limited partners because all members of an LLC have limited liability. However, states may determine that members participating in managing the LLC should be treated similarly to general partners, despite their limited liability.[47]

Most states have considered the nexus question of whether a corporate partner is subject to tax in a state as a result of the partnership's activities there. As noted above, sometimes the conclusion reached by the states differs depending on whether the corporation is a limited or general partner. Below are several examples of the conclusions rendered in several states that have considered this issue.

[2] Alabama

The Alabama Supreme Court denied *certiorari* in 2007 in *Lanzi v. State Dep't of Revenue*,[48] thus letting stand the Court of Civil Appeals' landmark ruling that the mere ownership of a limited partnership interest does *not* provide sufficient minimum contacts with the state for the state to exercise jurisdiction, and therefore the Due Process Clause prohibits the State of Alabama from taxing a nonresident limited partner's income from the partnership. The years in question, however, pre-dated the nonresident partner/member income tax composite return/consent statute enacted by the Alabama Legislature in 2001.

[3] Arizona

Public Law 86-272 does not preclude the State of Arizona from including an out-of-state partnership's revenues in the numerator of the apportionment formula of an Arizona consolidated return. The taxpayer, a newspaper company that elected to file a consolidated return in Arizona with its affiliates, owned a partnership interest in a Washington general partnership that solicited sales of newsprint in Arizona, but otherwise conducted no business in the state. The court concluded that a partner that is independently subject to tax in the state must include the income from the partnership because the limitations of Public Law 86-272 do not apply to that company.[49]

---

partnership, *see* Lanzi v. State of Ala. Dep't of Revenue, Dkt. No. Inc. 02-721 (Ala. Admin. L. Div. 2003), *aff'd*, 968 So.2d. 18 (Ala. Civ. App. 2006), *cert. denied*, Ala. S. Ct. 1051475 (April 13, 2007) (holding that the nonresident limited partner did not have nexus with the state, on Due Process Clause grounds); *see also*, J. Hellerstein & W. Hellerstein, State Taxation ¶ 20.08[2][a][ii] (2006).

[47] *See* Garnett v. Comm'r, 132 T.C. 19 (2009) (concluding that ownership interests in LLCs and LLPs should not be considered presumptively passive for purposes of the passive loss limitation rules of I.R.C. § 469(h) because, unlike limited partners in limited partnerships, these partners are not prohibited by state law from materially participating in the entity's business).

[48] Lanzi v. State of Ala. Dep't of Revenue, Dkt. No. Inc. 02-721 (Ala. Admin. L. Div. 2003), *aff'd*, 968 So.2d. 18 (Ala. Civ. App. 2006), *cert. denied*, Ala. S. Ct. 1051475 (April 13, 2007).

[49] Arizona Dep't of Rev. v. Central Newspapers, 218 P.3d 1083 (Ariz. Ct. App., Div. 1, Nov. 3, 2009).

[4] California

Effective January 1, 2007, a foreign corporation will not be considered to be transacting intrastate business just because it is a limited partner in a domestic or foreign LP or member or manager of a domestic or foreign LLC.[50]

[5] Connecticut

Effective for years beginning on or after January 1, 2010, Connecticut has adopted "economic nexus" as the basis for determining whether an out-of-state business is subject to the Connecticut corporate tax if it is a C corporation, or whether nonresident partners or members of a partnership/LLC or S corporation are subject to income tax on income from the business.[51]

[6] Idaho

A corporation is considered to be transacting business in Idaho if it is a partner in a partnership that transacts business in the state "even though the corporation has no other contact with Idaho."[52]

[7] Kentucky

In 2006, the Kentucky Legislature expanded the definition of "doing business" in Kentucky to include deriving income (directly or indirectly) from a SMLLC that is doing business in the state and that is disregarded as a separate entity for federal income tax purposes. Subsequent 2006 legislation, H.B. 1, expanded the "doing business" statute to include: (1) maintaining an interest in a pass-through entity doing business in the state; and (2) deriving income directly or indirectly from a SMLLC doing business in Kentucky that is a disregarded entity for federal income tax purposes.[53]

In *Asworth Corporation v. Revenue Cabinet*,[54] the Kentucky Board of Tax Appeals held that corporate partners, whose sole connection to the state was their respective interests in resident LPs, were not taxable on their share of distributive income under Kentucky law, because the partners themselves did not own or lease property or have employees in the state. That ruling was reversed, however, by a Kentucky circuit court in July 2007, was amended in November of that year as a result of the taxpayers' motion to alter, amend or vacate, and was appealed by the taxpayer. The Kentucky Court of Appeals recently affirmed the circuit court's order to the extent that it held that the taxpayers, the out-of-state-corporations, have nexus with Kentucky.[55] Interestingly,

---

[50] Cal. Corp. Code § 17001(ap)(1).

[51] L. 2009 09-3, June Sp. Sess. § 90.

[52] Idaho Admin. Rule 35.01.01.620(02).

[53] Ky. Rev. Stat. Ann. § 141.010(25); *see also*, Ky. Admin. Regs. 103 § 16:240 (Section 4), for a list of factors that establish "doing business" in Kentucky.

[54] Asworth Corp. v. Revenue Cabinet, Ky. Bd. Tax App., Order No. K-19449 (Jan. 27, 2006).

[55] Revenue Cabinet v. Asworth Corp., Ky. Ct. App., Dkt. Nos. 2007-CA-002549-MR, 2008-CA-000023-MR (Nov. 20, 2009).

the Court of Appeals found physical presence nexus through the taxpayer's ownership in LPs, but did not allow the property and payroll of those entities to flow through for apportionment purposes. The authors anticipate that the taxpayer will appeal the Court of Appeals' decision.

[8] Massachusetts

The activities of a partnership are generally attributed to all partners, including limited partners, for purposes of determining whether a corporate partner is "doing business" in Massachusetts. There is a de minimis exception for corporate partners that own less than a 5% interest when the Massachusetts property, payroll, or sales (multiplied by the partner's share) do not exceed $10,000. Attribution rules and look-through rules deter avoidance or manipulation of the de minimis rule.[56]

[9] New Jersey

The New Jersey Tax Court held that a corporate taxpayer holding a 99% limited partnership interest in a limited partnership doing business in New Jersey was entitled to a refund of corporation business tax because its LP interest was a passive interest, it was not in the same line of business as the LP, and did not otherwise do business in the state. The taxpayer's sole activity in New Jersey was holding its interest in the partnership. Although the taxpayer received 100% of its income from its limited partnership interest, it was not a general partner and did not have control of the business, nor was it unitary with the partnership. Consequently, the Tax Court concluded that the taxpayer's business activities in New Jersey were not sufficient to give the state jurisdiction to impose its income tax.[57]

[10] New York

The New York Division of Tax Appeals has held that two Delaware holding companies that were members of an LLC that held a general partnership interest in a firm doing business in New York were subject to New York's franchise tax.[58] The Division's decision was largely based on its finding that New York had given something for which it could impose a tax, namely it had accorded privileges and immunities that led to the firm's capital appreciation, which inured to the benefit of its owners, including the holding companies. The taxpayer has appealed this decision to the full New York Tax Tribunal.

[11] North Carolina

The North Carolina Assistant Secretary of Revenue ruled that a corporate limited partner, which otherwise has no activities in the state, is subject to corporate franchise and income taxes by virtue of its ownership interest in a partnership that in turn owns a limited interest in a partnership "doing business" in North Carolina (i.e., a tiered

---

[56] Mass. Reg. 830 CMR 63.39.1(8).

[57] BIS LP, Inc. v. Director, Division of Taxation, 25 NJ Tax 88 (Jul. 30, 2009).

[58] *In re* Shell Gas Gathering Corp. #2, Nos. 821569 and 821570 (June 11, 2009).

partnership).[59]

[12] Oregon

Even though mere ownership of a partnership interest may not rise to the level of "doing business" in Oregon, an out-of-state corporation is subject to Oregon tax solely as a result of owning a limited partnership interest in a partnership doing business in Oregon because it is realizing income from Oregon activities.[60]

[13] Tennessee

In Revenue Ruling #02-06, the Tennessee Department of Revenue addressed the application of Tennessee's franchise and excise tax law to an out-of-state LP treated as a disregarded entity for federal income tax purposes that is registered to do business in Tennessee when the LP is owned by two single-member LLCs that are, in turn, owned by an S corporation having no Tennessee nexus. According to the Department, since LPs are themselves among the types of entities subject to Tennessee franchise and excise tax, a foreign entity's ownership of an LP, without more, will not create sufficient nexus to subject the foreign entity to Tennessee franchise and excise taxation. This is true even if the LP is disregarded for federal income tax purposes, because the LP is not disregarded for Tennessee tax purposes. Rather, the LP will be subject to Tennessee's minimum franchise tax because it is registered to do business in Tennessee and will also be subject to franchise and excise tax if it has nexus and does business within Tennessee.

[14] Virginia

In *DiBelardino v. Virginia Dep't of Taxation*[61] and *Dutton v. Virginia Dep't of Taxation*,[62] a Virginia circuit court ruled that income passed-through to a nonresident member from an LLC doing business in the state was not subject to Virginia individual income tax if the taxpayer did not (himself) have the requisite minimum contacts with the state under the Due Process Clause. In both cases the taxpayer-members were found to be passive owners, but in DiBelardino's case, they were found to have nexus because they also owned two bed-and-breakfast inns in Norfolk. In Mr. Dutton's case, the circuit court agreed with the Virginia Department of Taxation that the income in question was Virginia source income, but nevertheless ruled for Mr. Dutton because nothing in the record indicated that he had any contact with Virginia other than the ownership of his LLC membership interest. Though appealed to the Virginia Supreme Court, both cases were dismissed for procedural reasons.

Much like the State of Alabama did after the *Lanzi* decision, the Virginia legislature responded by enacting a nonresident partner/member withholding statute, effective

---

[59] N.C. Final Decision No. 97-548.

[60] CRIV Investments, Inc. v. DOR, No. 4046 (Ore. Tax Ct. April 23, 1997).

[61] DiBelardino v. Virginia Dep't of Taxation, Case No. CL06-5696 (June 22, 2007).

[62] Dutton v. Virginia Dep't of Taxation, Case No. CL06-6291 (June 22, 2007).

July 1, 2007.[63]

§ 1.04 ENTITY LEVEL TAX APPLICABLE TO SUBCHAPTER K ENTITIES

[1] In General

Although the majority of states do not impose entity-level taxes on partnerships or LLCs treated as partnerships for federal tax purposes, there are important exceptions to this general rule. The exceptions range from minor differences in filing requirements to full entity-level taxes that require pro-forma calculation of income at the entity level when the entity is disregarded for federal tax purposes. Partnerships and LLCs are also generally subject to state net worth or non-income-based franchise taxes in the states that levy these taxes. Some states may impose a small annual fee labeled as a tax.[64]

The discussion in the next two subsections generally does not include withholding-like taxes that technically may be imposed on the entity but are measured by the distributive shares of nonresident members. States may have alternative taxation schemes for particular industries, such as financial institutions or insurance companies; these also are not considered below. However, some of the more significant entity-level taxes are noted below.[65]

[2] Income or Receipts-Based Taxes

For federal income tax purposes, multi-owner entities that qualify for, and acquiesce to, default partnership classification under the check-the-box regulations "pass through" profit or loss to their partners or members rather than pay tax on profit themselves. As noted above, entities that qualify to be disregarded for federal income tax purposes are, by default, treated as divisions of their owner rather than as separate entities. States generally mirror this federal treatment when administering their own net income-based taxes. However, some states diverge from the federal scheme and impose a net income tax directly on such entities. Currently, approximately fifteen states tax pass-through entities with a direct net income tax, franchise tax based on net income, or net earnings tax.

[a] California

California's unapportioned LLC annual fee imposed on an out-of-state LLC with business activity outside the state has been held to violate the fair apportionment requirement of the Due Process Clause and Commerce Clause in two separate cases, *Northwest Energetic Services, LLC v. Franchise Tax Board* ("NES")[66] and *Ventas*

---

[63] *See* Va. Code Ann. § 58.1-486.2.

[64] *See, e.g.*, Ark. Code Ann. § 26-54-104(8) (annual $150 "franchise tax").

[65] *See generally* B. Ely, "Selected Pitfalls in the Use of Hybrid Entities—Part I," 4 *Business Entities J.* 28 (Sept./Oct. 2002).

[66] Northwest Energetic Services, LLC v. Franch. Tax Bd., No. CGC-05-437712 (Cal. Super. Ct., Jan. 23, 2006).

Finance I, LLC v. Franchise Tax Board.[67] The statute at issue was amended in 2007 in an attempt to cure the unconstitutional defects found to be present.

The first appellate court ruling on the issue came down in favor of the taxpayer in *NES*.[68] Specifically, the California Court of Appeals held that the unapportioned LLC fee violated the Commerce Clause and that the taxpayer was entitled to a refund of the entire amount paid. Because it found that the fee violated the Commerce Clause *as applied to the taxpayer* in the years at issue, the court held that it need not decide whether the fee was unconstitutional on its face or whether it violated the Due Process Clause.

The *Ventas* appeal, however, involved substantially different facts from *NES*. In *Ventas*, the taxpayer had some income from California, whereas in *NES* the taxpayer had no California income. Adopting the logic of the appellate court in *NES*, the state appellate court concluded that, as applied to *Ventas*, the LLC fee violated the Commerce Clause to the extent that it failed to provide a method of fair apportionment. However, the court also held that neither federal Due Process nor any principle of California law required the Franchise Tax Board to refund the entire amount the taxpayer paid, just the amount the taxpayer paid for the years in issue that exceeded the amount that would have been assessed, without violating the Commerce Clause, using a method of fair apportionment.[69] Although the taxpayer in *Ventas* filed a petition for *certiorari* with the U.S. Supreme Court, that petition was denied in April 2009.

In the wake of the U.S. Supreme Court's denial of the taxpayer's petition for *certiorari* in *Ventas*,[70] the California Franchise Tax Board set August 20, 2009 as the deadline for LLCs to choose the method for computing their LLC "fee" refunds.[71] FTB Notice 2009-04 set out two alternative methods for computing the amount of the LLC fee "using a method of fair apportionment"—(1) a default method, which computes the refund using the LLC's Schedule R; and (2) an alternative method, which requires an LLC to submit the LLC Income Worksheet from the 2008 LLC Tax Booklet (Form 568 Booklet). If the alternative method is not selected, the Franchise Tax Board will compute the revised LLC fee and the refund amount, if any, using the default method. Taxpayers and practitioners should be aware that the possibility for a full refund continues to exist, pending the ultimate outcome of *Bakersfield Mall LLC v. Franchise Tax Board*,[72] which is currently pending in the trial court and involves an

[67] Ventas Finance I, LLC v. Franch. Tax Bd., No. CGC-05-44000I (Cal. Super. Ct., Nov. 7, 2006).

[68] Northwest Energetic Services, LLC v. Franch. Tax Bd.71 Cal Rptr 3d 642 (Cal. Ct. App., 1st Dist., 2008).

[69] Ventas Finance I, LLC v. California Franch. Tax Bd., Cal. Ct. App. (2008) 81 Cal Rptr 3d 823, Dkt. Nos. A116277; A117751, Aug. 11, 2008, *cert. denied* S. Ct. Dkt. No. 08-1022 (April 6, 2009).

[70] Ventas Finance I, LLC v. Franch. Tax Bd., 81 Cal Rptr 3d 823 (1st Dist., 2008), *rev. denied* Cal. S. Ct., No. S166870 (Cal. 2008), *cert. denied* U.S. S. Ct. Dkt. No. 08-1022 (Apr. 6, 2009).

[71] Cal. Franchise Tax Board Notice 2009-04 (May 22, 2009).

[72] Cal. Super. Ct., No. CGC-07-462728.

LLC that derived its income *solely* from within California.

[b] District of Columbia

D.C. imposes a 9.975% franchise (income) tax on unincorporated businesses with gross receipts in excess of $12,000. Certain service-based partnerships may be exempt.[73] In addition, entities with gross receipts in D.C. of $5 million or greater are required to pay a "ballpark fee," ranging from $5,500 to $16,500, to help fund the construction of the stadium for the Washington Nationals.[74]

[c] Illinois

Pass-through entities, such as partnerships and multi-member LLCs, are subject to the 1.5% personal property replacement tax, which is based on net income. Certain investment partnerships may be exempt from this tax.[75] C corporations are taxed at a rate of 2.5%. While a multiple member LLC would only pay the tax on 1.5% of its net income, a corporate member would also be subject to the tax at the 2.5% rate; however, the corporation would receive a credit for the amount of the tax paid by the LLC.

[3] Net Worth or Other Taxes

[a] In General

Because pass-through tax treatment is an income tax concept, a net worth tax generally is not passed through to an entity's owners. Thus, a much larger number of states impose a net worth tax on pass-through entities than impose income tax on those entities. Currently, approximately ten states impose a net worth tax on partnerships and/or LLCs. Currently, seven states impose a net worth tax on SMLLCs, regardless of their federal entity classification. The tax base for net worth taxes varies, but generally includes the value of paid-in capital, stock, surplus, and undivided profits. Rates vary by state, but typically range from 0.1 percent to 0.3 percent. Finally, like state income tax, state tax administrators generally administer their net worth tax. However, certain net worth taxes are administered by state secretaries of state (e.g., Delaware and Illinois). Below are several examples of states with entity-level taxes measured by net worth.

[b] Alabama

Since 2000, Alabama has imposed a net worth-based business privilege tax ("BPT") on all corporations and limited liability entities. A minimum tax of $100 is due from each of these entities annually, and the tax is generally capped at $15,000. For "family limited liability entities," the maximum tax is $500. Even if a SMLLC is disregarded for federal income tax purposes, and therefore Alabama income tax purposes, the SMLLC is nonetheless required to file an annual BPT return. If the SMLLC's owner is subject to Alabama's BPT, and the SMLLC is disregarded, its net worth "shall be

---

[73] D.C. Code §§ 47-1805.02, 1805.08.

[74] D.C. Code Ann. § 47-2762.

[75] 35 ILCS 5/205(b).

. . . taken into account in determining the net worth of its owner, and the net worth of the disregarded entity shall be zero."[76] Thus, even though the net worth of the SMLLC is zero, it must file a return and pay the annual minimum $100 BPT.

[c] Connecticut

Connecticut does not require partnerships, LLCs taxable as partnerships, or disregarded SMLLCs to pay a general net worth tax or a tax based on net income. However, Connecticut requires LPs, LLCs taxable as partnerships, and disregarded SMLLCs, both domestic and foreign (regardless of whether actually registered), to pay the state Department of Revenue an annual $250 business entity tax.[77]

[d] Kansas

Kansas subjects LPs, LLPs, and LLCs (including SMLLCs disregarded for federal income tax purposes) with net capital accounts located or used in Kansas at the end of the preceding taxable year of $1,000,000 or more to an annual franchise tax at the rate of 0.0625 percent of the net capital accounts located or used in Kansas. The maximum tax is $20,000.[78] This tax is set to be phased out by 2011.

[e] Kentucky

For tax years beginning on or after January 1, 2007, LPs, LLPs, and LLCs that are not treated as corporations for federal income tax purposes are no longer subject to the state's corporation income tax, while a limited liability entity tax ("LLE tax") is imposed on all limited liability pass-through entities doing business in Kentucky (except those that are specifically exempt).[79]

A "limited liability pass-through entity" is defined as any pass-through entity that affords any of its partners, members, shareholders, or owners, through function of the laws of Kentucky or laws recognized by Kentucky, protection from general liability for actions of the entity.[80] The LLE tax is calculated as the greater of: (1) the lesser of a tax on the limited liability pass-through entity's Kentucky gross receipts or a tax on the limited liability pass-through entity's Kentucky gross profits, or (2) $175.[81] But for a limited liability pass-through entity with gross receipts and gross profits in excess of $6 million (or one that would be part of an affiliated group with combined gross receipts and gross profits in excess of $6 million if the limited liability pass-through entity had been organized as a corporation), the tax is computed as the lesser of: (1) 0.095 percent of Kentucky gross receipts, or (2) 0.75 percent of Kentucky gross profits.[82] Entities (or their affiliated groups) with gross receipts and/or gross profits less

---

76 Ala. Code §§ 40-14A-22(a)-(d); and -23(b) & (c).

77 Conn. Gen. Stat. § 12-284b(b).

78 Kan. Stat. Ann. § 79-5401(a)(2).

79 Ky. Rev. Stat. Ann. §§ 141.010(24)(a), 141.040(1), 141.0401(2)(a).

80 Ky. Rev. Stat. Ann. § 141.010(28).

81 Ky. Rev. Stat. Ann. § 141.0401(2)(a).

82 Ky. Rev. Stat. Ann. §§ 141.0401(1)(c), 141.0401(2)(b), 141.0401(2)(b)(1)(c), 141.0401(2)(b)(2)(c).

than $6 million are subject to a reduced tax computation (including no tax being computed on an entity/affiliated group with gross receipts or gross profits of $3 million or less).[83]

Each taxpayer subject to the LLE tax must file a return and pay the tax on or before the fifteenth day of the fourth month following the close of the entity's taxable year.[84] Limited liability pass-through entities and corporations that own an interest in a limited liability pass-through entity are allowed a credit against their LLE tax liability for their proportionate share of the LLE tax paid by the lower-tier entity, after reduction for a $175 minimum tax.[85] A credit against the individual and corporation income tax also is allowed for limited liability pass-through entity owners.[86] The credit is limited to the income tax associated with income from the pass-through entity.[87]

[f] Michigan

On July 12, 2007, Michigan adopted a controversial new Michigan Business Tax (the "MBT"). The MBT replaces the older Michigan Single Business Tax and became effective January 1, 2008.[88] The MBT incorporates several trends in state corporate taxation, including: (1) a gross margin tax element; (2) single factor sales-based apportionment; (3) market-based sourcing for apportionment of service revenue; (4) an abundance of credits; and (5) unitary combined reporting. Essentially, there are two tax components to the MBT—a business income tax component and a modified gross receipts tax component.

The MBT requires all unitary business groups to file a combined return. The return must include each "U.S. person" in the unitary business group. For purposes of the MBT, a unitary group is a group of U.S. persons, one of which owns or controls more than 50 percent of the ownership interest and that has activities or operations resulting in a flow of value through the unitary group. For this purpose, "person" broadly includes individuals, firms, banks, financial institutions, insurance companies, LPs, LLPs, partnerships, joint ventures, associations, corporations, S corporations, and LLCs, receivers, estates, trusts, and other organizational groups acting together.

[g] New York

New York imposes an annual filing fee (ranging from $25 to $4,500) on LLPs and LLCs that are taxed as partnerships for federal income tax purposes if the entity has any income derived from New York sources.[89] However, a partnership whose sole commercial activity is trading on its own account is not deemed to be carrying on a

---

[83] Ky. Rev. Stat. Ann. §§ 141.0401(2)(b)(1)(a); 141.0401(2)(b)(1)(b), 141.0401(2)(b)(2)(a), 141.0401(2)(b)(2)(b).

[84] Ky. Rev. Stat. Ann. § 141.0401(4).

[85] Ky. Rev. Stat. Ann. § 141.0401(2)(c).

[86] Ky. Rev. Stat. Ann. §§ 141.0401(3)(a), 141.0401(3)(b).

[87] Ky. Rev. Stat. Ann. §§ 141.0401(3)(a), 141.0401(3)(b).

[88] *See* S.B. 94, Laws 2007, codified at Mich. Comp. Laws Ann. § 200 *et seq.*

[89] N.Y. Tax Law § 658(c)(3).

business, trade, profession, or occupation in New York, and any dividends, interest, or capital gains received by the partnership are not characterized as New York source income. Thus, an LLC taxed as a partnership for federal income tax purposes and whose sole business activity was trading on its own account was exempt from the annual filing fee because its trading activities did not constitute New York source income.[90]

[h] Tennessee

Since 1999, Tennessee's excise and franchise taxes have applied to LLCs, LLPs and LPs, though general partnerships and sole proprietorships are not taxed. The excise tax is levied at a rate of 6.5 percent of net earnings, while the franchise tax is levied at a rate of $0.25 per $100 of net worth. Exemptions are available for qualifying venture capital funds, family-owned LLEs involved in farming or holding personal residences and certain closely-held entities whose business is acquiring items like notes or accounts receivable.

[i] Texas

H.B. 3 (2006) substantially modified the Texas franchise tax and, as modified, applies to all franchise tax reports due on or after January 1, 2008. The so-called "margin tax" is levied on taxable entities, including partnerships and LLCs, doing business in Texas or those entities chartered or organized in Texas. The tax is calculated on gross receipts less certain deductions such as cost of goods sold or compensation.[91]

[4] Taxes Measured by Business Activity

A recent state trend is to impose an annual tax on pass-through entities based on the entity's activity in the jurisdiction, as opposed to its net income. From a state's perspective, there are several advantages to this approach. First and foremost, unlike net income taxes, these activity-based taxes typically are not subject to Public Law 86-272, a federal statute that generally restricts a state's power to tax out-of-state sellers of tangible personal property by providing that the temporary presence of employees or independent contractors who engage in the regular and systematic solicitation of orders in the state does not establish nexus. Second, activity-based taxes eliminate the tax benefit associated with certain intercompany transactions that generate an interest or intangible expense deduction, because such deductions are eliminated from the tax base. This recent state approach is arguably a logical extension of the concurrent state legislative trends of switching from three-factor apportionment to single-factor sales apportionment and disallowing otherwise deductible royalty, interest and sometimes other expenses that arise as a result of designated related-party transactions.

---

[90] *In re*: Spencer Barback, New York Advisory Opinion TSB-A-07(7)I (Nov. 15, 2007).

[91] *See* Tex. Tax Code Ann. § 171.0001 *et seq.*

[5] Taxes on Single Member LLCs

[a] In General

In many states, being disregarded as a separate entity for federal *income* tax purposes does not relieve disregarded entities from liability for registration filings and fees and many non-income taxes, such as privilege taxes, sales and use, gross receipts, and other transaction and excise taxes; employment taxes; property taxes; and transfer taxes. Sometimes a SMLLC with a corporate member is not subject to a tax, while an LLC with a single individual member is subject to the tax.[92]

Because a SMLLC is a separate legal entity, most states require it to file separate sales and use tax reports, even though its owner also is required to file such reports with the state. Thus, while intercompany transactions between a disregarded entity and its owner are ignored for *income* tax purposes, such transactions could result in state sales and use taxes, excise taxes, real estate transfer taxes, and other transaction taxes. In addition, if the sale of a disregarded entity is treated as a sale of assets, rather than as a sale of an ownership interest in the entity itself, the sale may be subject to various state transaction and transfer-related taxes.

Also, consider whether the states follow the IRS pronouncements and new regulations on whether a SMLLC is required to, permitted to, or prohibited from, obtaining its own TIN and withholding account number separate from its "parent." There are a variety of answers here.[93]

Below are examples of states where a transaction between a disregarded entity and its owner could result in non-income tax obligations.

[b] Alabama

For ad valorem property tax purposes, real property may properly be assessed in the occupier's name, as the equitable owner, even though the property's title owner is actually a SMLLC, if the occupier of the residential property is the purchaser to an executory sales contract.[94]

[c] Florida

A SMLLC that is disregarded as an entity separate from its owner for federal income tax purposes is treated as a separate legal entity for all non-income tax purposes under Florida law. Further, Florida law considers the single member to be separate from the LLC that it owns. Thus, when the taxpayer transfers a vehicle owned by its SMLLC into its personal name, the taxpayer must pay Florida sales tax when the vehicle is registered in Florida.[95]

[d] New Hampshire

Effective for tax years beginning on or after January 1, 2009, all distributions made

---

[92] *See, e.g.*, Tenn. Code Ann. § 67-4-2106(c).

[93] *See, e.g.*, Ala. Dep't of Rev. Rul. 01-007 (Aug. 1, 2001).

[94] Opinion of the Alabama Attorney General No. 2008-049 (Jan. 31, 2008).

[95] Fla. Technical Assistance Advisement 07A-047 (Dec. 28, 2007).

by partnerships, associations, and LLCs during the year are subject to the Interest and Dividends Tax based on the calculation of earnings and profits.[96] The tax will apply to such distributions to the same extent that distributions to corporate shareholders are taxable as dividends (e.g., a distribution that is a return of capital is not subject to taxation). Liquidating distributions are not subject to this tax.

[e] Washington

The Department of Revenue's Appeals Division ruled that two partnerships that contributed their assets and liabilities, including the ownership of apartment buildings, to another partnership in return for limited partnership interests in the latter LP ("OP"), are entitled to have the transaction exempt from real estate excise tax.[97] Washington exempts from the definition of "sale" a transfer that, for federal income tax purposes, does not involve the recognition of gain or loss for purposes of entity formation, liquidation, dissolution, or reorganization, including the non-recognition of gain or loss because of the application of I.R.C. § 721. In the case at issue, the partnerships that owned the apartment buildings contributed their controlling interests in those assets, merged with OP, and were thereafter considered terminated, with the non-recognition of gain or loss on the contribution of the controlling interests in the apartment buildings occurring pursuant to I.R.C. § 721.

§ 1.05 APPORTIONMENT OF INCOME

[1] In General

A key issue is whether the business/non-business income determination is made at the partnership level or at the partner level. Only a handful of states offer any published guidance on this point but the answer can lead to dramatically different results. States generally follow one of two approaches in attributing an owner's distributive share of income from partnerships—apportionment at the partner level, or apportionment at the partnership level.

[2] Apportionment at the Partner Level

The first approach is to require apportionment *at the partner level*, which requires that the partners combine their share of pass-through entity apportionment factors with their other apportionment factors. Many practitioners refer to this method as "flow-through" or "flow-up" apportionment. In this chapter, we refer to this method as "partner-level" apportionment. Under this method, for example, if a corporation has a 60 percent interest in a partnership, the corporate partner would calculate its own apportionment factor by including 60 percent of the partnership's sales, property, and payroll (assuming that the state uses a three-factor apportionment formula).

[a] California

For purposes of calculating corporate income tax, partnership apportionment factors flow through to the corporate partners if the partnership and partners are unitary. When

---

[96] New Hampshire Technical Information Release 2009-008 (Jul. 16, 2009).

[97] Washington Dep't. of Rev., Appeals Division, Determination No. 06-0289 (2006).

the partnership and the partners are *not* unitary, however, factors do not flow through and income is apportioned at the partnership level and allocated to the state by the partners. However, if the partners and partnership are not unitary but the income is considered business income to the partnership, the partners must apportion the income from the partnership separately from their other business income. Thus, the income *and* apportionment factors from the partnership will flow up to the partner, but the partner will not include the partnership income and apportionment factors with its other income and factors and will instead apportion the partnership income separately.[98]

[b] Florida

For purposes of calculating corporate income tax, partnership factors flow through to the corporate partners and apportionment occurs at the partner level.[99] In 2003, the Florida Department of Revenue ruled that including a corporate partner's share of proceeds from a commercial rental partnership's occasional sale of real property in the partner's sales factor did not qualify for the distortion exception for an occasional sale, since inclusion of the proceeds was not shown to arbitrarily distort the apportionment factor or tax extraterritorial values.[100]

[3] Apportionment at the Partnership Level

The second approach is to require apportionment *at the partnership level*. Under this approach, the pass-through entity's income is apportioned to the state using only the entity's apportionment factors. The owners then allocate their distributive share of post-apportionment income to the appropriate state. For example, assume that a corporate partner has a 60 percent interest in a partnership and the partnership earns $100 of income. If apportionment is calculated at the partnership level and the partnership computes a 50 percent apportionment factor in a state, the partner would include $30 of partnership income in its tax base in that state, which is 60 percent of the partnership's income in the state after apportionment (i.e., $100 × 50% = $50, and $50 × 60% = $30).

[a] Massachusetts

For purposes of calculating corporate income tax, partnership factors flow through to the corporate partners if the partnership and partners are engaged in "related business activities." If not engaged in related business activities, the corporate partners separately account for partnership income and apportion it using only the partnership's factors. Subject to rebuttal, if a non-Massachusetts corporation's only connection to the state is its limited partnership interest in a partnership that conducts business in the state and the corporation owns less than 50 percent of the partnership, the corporation is presumed *not* to be doing business in the state and apportionment at the partnership level is required. Either the Commissioner or the taxpayer may rebut this presumption by showing that the corporate partners and the partnership have a unitary relationship.

---

[98] *See* Cal. Code Regs. tit. 18, § 25137-1.

[99] Fla. Admin. Code Ann. r. 12C-1.015(10).

[100] Fla. TAA #03C1-007-#03C1-013.

Transactions between the partnership and the corporate partners are eliminated from the apportionment factor. If apportionment occurs at the partnership level, an evenly weighted three-factor formula is used.[101]

In *Sasol North America, Inc. v. Commissioner of Revenue*,[102] the Massachusetts Appellate Tax Board held that the distributive share of income received from a Massachusetts LP by a corporate limited partner was subject to apportionment in Massachusetts rather than 100 percent allocation to the state. The Board's rationale for the ruling was based primarily on the investment serving an "operational function" for the corporate limited partner as opposed to a "passive investment function." The Massachusetts Department of Revenue did not appeal this decision.

[b] New Jersey

For purposes of calculating corporate income tax, partnership factors flow through to the corporate partners if the partnership and partners are unitary. New Jersey does not, however, look to the traditional tests of unity in determining if the partners and partnership are unitary. Instead, New Jersey has set forth its own rules of unity for corporate partners and partnerships. If not unitary, the corporate partners apportion partnership income at the partnership level and report their distributive share of apportioned taxable income without regard to their separate apportionment factors.[103]

[c] Oklahoma

For purposes of calculating Oklahoma corporate income tax, partnership factors do *not* flow through to the corporate partners. Instead, income is apportioned at the partnership level and allocated to the state by the corporate partners.[104]

[d] Virginia

A nonresident individual taxpayer received income from a Virginia LLC and a Virginia S corporation during the taxable years at issue. Both entities operated in Virginia and had Virginia-source income. Upon audit, the Virginia Department of Taxation determined that the taxpayer was liable for additional tax because he had Virginia-source income. The Virginia Tax Commissioner concluded that the taxpayer was required to file Virginia nonresident income tax returns and pay tax on his distributive share of the income of the two pass-through entities because the income retained its classification as Virginia-source when it passed through to the taxpayer, even though he was not a Virginia resident.[105]

---

[101] *See* Mass. Regs. Code tit. 830, § 63.38.1.

[102] Sasol North America, Inc. v. Commissioner of Revenue, Mass. Appellate Tax Board, No. C273084 (Sept. 5, 2007).

[103] NJ Rev. Stat. § 54:10A-15.7(a); NJ Admin. Code tit. 18, § 18:7-7.6(g). However, *see* Chiron Corp. v. Director Div. of Taxation, 21 NJ Tax 528 (2004), in which the New Jersey Division of Taxation took the unique position that there is a presumption that a corporate partner is *not* unitary with the partnership for purposes of apportionment factor flow-through.

[104] Okla. Admin. Code § 710:50-17-51(15)(A).

[105] Rulings of the Tax Commissioner, Document No. 09-103 (Jun. 24, 2009).

[4] Transactions Between Partners and Partnerships

[a] In General

States vary as to whether transactions between the owner and the partnership are required to be eliminated. Furthermore, even in states that have promulgated regulations requiring transactions between a partner and a partnership to be eliminated, some regulations have not yet been expanded to specifically cover LLCs.

[b] California

California Reg. § 25137-1(f)(3) provides that intercompany transactions are eliminated, even if the partner and partnership are non-unitary.

[c] Florida

Effective July 1, 2009, a new Florida law imposes a documentary stamp tax on real property conveyed to a conduit entity. The transfer tax applies when all or a portion of the grantor's interest in the conduit entity is subsequently transferred for consideration within 3 years of the conveyance. If an ownership interest is transferred in a conduit entity that owns assets other than the real property conveyed to the conduit, the tax is prorated based on the percentage the value of such real property represents to the total value of all assets owned by the conduit entity.[106] This bill is the Florida legislature's attempt to reverse the state supreme court's ruling in Crescent Miami Center, LLC v. Florida Dep't of Rev.,[107] which held that a transfer of property between a grantor and its wholly-owned grantee, absent any exchange of value, is without consideration or a purchaser and thus not subject to the documentary stamp tax under Fla. Stat. Ann. § 201.02(1).

[d] Illinois

Corporations filing combined unitary returns with their wholly-owned subsidiaries can eliminate intercompany sales with a unitary partnership, where all partners in the partnership were also included in the corporation's same unitary business group.[108]

[e] Minnesota

Partnership income is included in a corporate partner's Minnesota income in one of two ways. If a corporation and a partnership are engaged in a unitary business, the corporation must include its partnership income in its apportionable business income. The corporation must also include its pro-rata share of the partnership's property, payroll, and sales within and outside Minnesota in the corporation's apportionment factors. On the other hand, if the corporation and partnership are not engaged in a unitary business, the corporation must report its partnership income or loss as separately stated income or loss. In such cases, if the partnership conducts its business

[106] Fla. Laws 2009, Ch. 131 (S.B. 2430), signed by the Governor on June 10, 2009, available at http://laws.flrules.org/files/Ch_2009-131.pdf.

[107] 903 So. 2d 913 (Fla. 2005).

[108] Ill. Private Letter Ruling No. IT 08-0001-PLR (May 19, 2008).

both within and without Minnesota, the corporate partner's share of partnership income or loss is assigned to Minnesota based on the partnership's apportionment factors.[109]

[f] Oregon

Oregon has revised its apportionment rules in order to clarify their application to LLCs and their members. In computing its Oregon apportionment factor, a corporate member of an LLC taxed as a partnership shall include its distributive share of the LLC's property, payroll, and receipts. Furthermore, to the extent of the corporation's percentage interest in the LLC, transactions between the corporate member and the LLC are required to be eliminated.[110]

§ 1.06 NONRESIDENT PARTNER WITHHOLDING

[1] In General

A growing number of states have recognized a problem of nonresident owners of pass-through entities failing to file individual income tax returns in that state. Absent such filings, a state would thus not receive income tax on income earned by the pass-through entity attributable to that state when neither the nonresident owner nor the entity itself (as a nontaxable pass-through entity) pays the tax. In addition to the question of whether the state has the power to tax a nonresident member with no other connection to the state, administrative and practical concerns often prevent state taxing authorities from auditing and obtaining tax from all nonresident individuals located outside the state.

In response to the concerns mentioned above, most states (approximately 37) have now enacted one or more mechanisms that require the entity, in one form or another, to remit income tax to the state on behalf of the nonresident partners.

[2] Compliance and Enforcement Mechanisms

Generally, withholding at the source is triggered when a pass-through entity with a nonresident owner either fails to file a composite income tax return that includes that owner or, alternatively, fails to maintain or submit to the state a written agreement from the nonresident owner consenting to the state's jurisdiction for purposes of collecting income tax, including penalties and interest, and agreeing to pay tax on that owner's distributive share of pass-through entity income. Approximately 20 states fall into the latter category.

When withholding is required, the entity must generally pay tax on behalf of the nonresident owner at the highest rate applicable to individuals (if the owner is an individual) or corporations (if the owner is a corporation) multiplied by that owner's distributive share of income attributable to the state. A handful of states require withholding only in connection with the state's allocable share of a distribution to a nonresident owner. In addition, the type of owner for which withholding is required

[109] Revenue Notice No. 08-03 (Feb. 19, 2008).

[110] Or. Admin. Rule 150-314.650.

varies and occasionally does not include corporate owners (e.g., Missouri[111]).

There are generally four types of nonresident withholding provisions among the states:

1. Nonresident withholding is required unless the partnership files a composite return and/or the nonresident partner consents to income tax jurisdiction. A growing number of states have enacted what can be termed this conditional entity-level tax.
2. Nonresident withholding is required in many states. However, some states, like Alabama, merely authorize withholding, even though they require that the partnership file a composite return and remit tax, subject to certain exceptions.
3. Estimated tax payments are only required in three states.
4. The partnership is contingently liable for the taxes of its nonresident members or partners if the nonresidents fail to pay their taxes when due.

[3] Types of Withholding

[a] Mandatory Withholding

[i] California

A pass-through entity may be required by state law to withhold upon a nonresident owner's distributive share of income.[112] This requirement also may apply to a SMLLC that is treated as a disregarded entity. If a pass-through entity fails to timely file a nonresident income tax agreement with the state, it must pay an amount of tax on behalf of the applicable nonresident member at the highest applicable tax rate multiplied by the member's distributive share of California source income. Amounts to be paid are due at the same time the pass-through entity's tax return is required to be filed (ignoring extensions). Amounts paid by the pass-through entity are considered to be paid by the applicable nonresident partner on account of income tax imposed by California on the partner for that taxable year.[113]

[ii] Colorado

A partnership, including an LLC filing as a partnership, is required to ensure that its nonresident owners file a Colorado income tax return to report their share of Colorado source income earned by the partnership or LLC. This is accomplished in one of three ways: (1) file a composite return on behalf of the nonresident owner; (2) file an agreement to file and pay tax for each owner; or (3) withhold for each nonresident partner or member.[114]

---

[111] *See* Mo. Rev. Stat. § 143.411(5); Mo. Code Regs. 12 § 10-2.190(4)(B).

[112] Cal. Rev. & Tax Code § 18662.

[113] *See* Cal. Rev. & Tax. Code § 18633.5.

[114] Colo. Rev. Stat. § 39-22-601; Colorado FYI Tax Publication Income 54, Aug. 1, 2009.

[iii] Georgia

Georgia generally requires that a partnership or LLC that is not treated as a corporation and does not file a composite return on behalf of a nonresident owner withhold income tax at the rate of 4 percent on any distributions paid to that owner or otherwise credited to that owner in lieu of an actual distribution. "Distribution paid or credited" is defined to mean a recognition or assignment of interest in proceeds or property of a partnership, S corporation, or limited liability company, including a net *distributive share* of income which is passed through to members and which may be subject to Georgia income tax. This has been interpreted to include a nonresident owner's distributive share of the entity's Georgia-source income. In addition, under the revised rule, withholding may be required on guaranteed payments.[115]

[iv] Illinois

Illinois imposes a withholding requirement on partnerships operating in the state. For taxable years ending on or after December 31, 2008, every partnership must withhold from each nonresident partner in an amount equal to the distributive share (whether or not distributed) of the business income of the partnership apportionable to Illinois of that taxpayer multiplied by the applicable rates of tax for that partner. Such withholding is required regardless of whether the distribution is actually paid out. However, withholding is not required if the nonresident partner is included on a composite return filed by the entity.[116]

[v] Kentucky

Effective for taxable years beginning on or after January 1, 2007, limited liability entities such as partnerships, including LLCs taxable as partnerships for federal income tax purposes, are required to withhold Kentucky income tax on the distributive share of income, whether distributed or not, apportioned to the state for each (a) nonresident individual owner, or (b) corporate owner that is doing business in Kentucky only through its ownership interest in the entity. The withholding amount is to be computed using the highest tax rate applicable to that owner.[117] Withholding is not required for a nonresident individual owner who elects to participate in a composite return filed by the entity.[118]

[vi] Louisiana

A partner in a partnership that is a partnership itself is not included in a composite return. Such partners must separately file all applicable Louisiana tax returns and report all Louisiana source income, including income from the partnership, in their separate returns.[119]

---

[115] Ga. Code Ann. § 48-7-129; Ga. Comp. R. & Regs. r. 560-7-8-.34.

[116] 35 Ill. Comp. Stat. 5/709.5(a); Illinois Dept. of Rev. Info. Bulletin FY 2009-02, Oct. 1, 2008; Ill. Admin. Code tit. 86 § 100.7035(a); Ill. Admin. Code tit. 86 § 100.7035(g).

[117] Ky. Stat. Ann. § 141.206(4)(b).

[118] 103 Ky. Admin. Regs. § 18:160 (Section 2(4)(d)).

[119] La. Admin. Code § 61.I.1401.

[vii] Massachusetts

Effective for tax years beginning on or after January 1, 2009, a partnership, including an LLC treated as a partnership, that maintains an office or engages in business in Massachusetts must withhold and remit tax on a nonresident owner's pro rata share of Massachusetts-source income unless a composite return is filed by the entity.[120] The withholding requirement generally is applicable for all nonresident owners, defined to include: (1) an individual, estate, or trust that is not a resident or domiciliary of Massachusetts; (2) a pass-through entity without a usual place of business in Massachusetts; or (3) a corporation that does not file an income tax return in Massachusetts.[121]The amount required to be withheld is equal to the Massachusetts taxable amount of a nonresident owner's distributive share multiplied by the general individual income tax rate (for owners that are individuals, estates, trusts, or pass-through entities) or the applicable corporate income tax rate (for owners that are corporations).[122]

[viii] Missouri

A partnership, including an LLC treated as a partnership, is required to withhold income tax on behalf of a nonresident individual owner only if the entity fails to timely file a nonresident owner agreement with the state on behalf of that owner.[123]

[ix] South Carolina

Pass-through entities pay a 5 percent withholding tax on their nonresident corporate partners' or members' distributive shares of South Carolina-source income unless the nonresidents file a consent to pay the tax or a composite return is filed.[124]

[x] West Virginia

Effective January 1, 2008, the income tax must be withheld at a rate of 6.5 percent, whether the income is actually (or deemed) distributed to the nonresident partner, shareholder, or beneficiary. However, withholding is not required for tax-exempt entities, nonresidents with distributee tax payment agreements, or upon a showing of undue hardship.[125]

[b] Mandatory Withholding Unless Partner Consents to Jurisdiction

[i] Alabama

Act 2009-144, effective January 1, 2009, provides that partnerships or LLCs, other than qualified investment partnerships (discussed below), are required to file an annual composite tax return and remit Alabama income tax on the distributive share of their

[120] Mass. Gen. Laws. ch. 62B, § 2; Mass. Regs. Code tit. 830, § 62B.2.2(3).

[121] Mass. Regs. Code tit. 830, §§ 62B.2.2(2), 62B.2.2(3)(c).

[122] Mass. Regs. Code tit. 830, § 62B.2.2(4)(c).

[123] Mo. Rev. Stat. § 143.411(5).

[124] S.C. Code § 12-8-590.

[125] West Virginia Taxpayer Services Division Publication TSD-390 & TSD-391, Dec. 12, 2007.

nonresident owners (including corporate owners) at the highest marginal tax rate applicable to those nonresident owners.[126]

[ii] California

Partnerships, including LLCs treated as partnerships, are required to withhold income tax at the rate of 7 percent on *distributions* of California-source income to a domestic (U.S.) nonresident owner if the total distributions to the owner are greater than $1,500 for the calendar year.[127] Withholding is not required if (1) the owner is a California resident; (2) the owner is an entity qualified to do business or has a permanent place of business in California; (3) the owner or entity receives a withholding waiver from the Franchise Tax Board; (4) the owner is a tax-exempt entity under either California or federal law; (5) the distribution is exempt income; (6) the distribution is California source income previously reported on the owner's California tax return; (7) the distribution is a return of capital; or (8) the entity is a qualifying investment partnership.[128] With respect to foreign (non-U.S.) owners, tax is required to be withheld on any income that (1) is subject to withholding under I.R.C. § 1446 and (2) is from California sources.[129]

[iii] Connecticut

Effective for taxable years beginning on or after January 1, 2006, a partnership, including an LLC treated as a partnership, is required to pay income tax at the highest marginal rate on each nonresident partner's distributive share of Connecticut-source income from the partnership, if the distributive share of income is $1,000 or more.[130] Connecticut no longer permits the filing of group income tax returns on behalf of qualifying nonresident owners.

[iv] Pennsylvania

The pass-through entity pays withholding tax on the nonresident corporate partner's or member's distributive share of Pennsylvania-source income at the applicable tax rate.[131] There are generally no exceptions.

[v] Utah

Effective for taxable years beginning on or after January 1, 2009, Utah enacted the

---

[126] Ala. Code § 40-18-24.2(b)(1). However, a nonresident partner that has been included in a composite income tax return can file its own Alabama income tax return and claim credit for Alabama income tax paid on the partner's behalf by the partnership. Ala. Code § 40-18-24.2(b)(1).

[127] Cal. Rev. & Tax. Code §§ 18662; Cal. Code Regs. tit. 18, §§ 18662-1, 18662-2, 18662-11, 18662-12; FTB Pub. 1017, Cal. Fran. Tax Bd. (July, 1, 1996).

[128] Cal. Code Regs. tit. 18, §§ 18662-1, 18662-2, 18662-3(b), 18662-11, 18662-12; FTB Pub. 1017, Cal. Fran. Tax Bd. (July, 1, 1996).

[129] Cal. Rev. & Tax. Code § 18666(a).

[130] Conn. Gen. Stat. § 12-719(b) and (c); Connecticut Informational Publication 2006(22), Dec. 20, 2006.

[131] Pa. Stat. § 7324.

Pass-Through Entities and Pass-Through Entities Taxpayers Act,[132] which requires pass-through entities to pay or withhold tax on the business income of the pass-through entity and the non-business income of the pass-through entity derived from or connected with Utah sources on behalf of a nonresident pass-through entity taxpayer.[133] Pass-through entities are not required to pay or withhold tax on behalf of pass-through entity taxpayers who are resident individuals, pass-through entity taxpayers that are organizations exempt from corporate income tax, or pass-through entity taxpayers that are publicly-traded partnerships, classified as partnerships for federal income tax purposes that file an annual information return with the Commission that includes the partner's name, address, taxpayer identification number, and other information required by the Commission for each partner of the publicly-traded partnership with income derived from, or connected with, Utah sources in excess of $500 in a taxable year.[134]

[vi] Virginia

Pass-through entities doing business in Virginia and having taxable income derived from Virginia sources are required to pay a withholding tax equal to 5 percent of their nonresident owners' shares of taxable income from Virginia sources.[135] It should be noted, however, that the Virginia tax commissioner has ruled that a SMLLC, disregarded for federal tax purposes, is not subject to the pass-through entity withholding tax.[136]

[vii] Wisconsin

Effective for taxable years beginning on or after January 1, 2005, a partnership, including an LLC treated as a partnership, having Wisconsin income allocable to a nonresident owner is required to pay a withholding tax. A nonresident owner includes: (1) an individual who is not domiciled in the state; (2) a partnership, LLC, or corporation with a commercial domicile outside the state; and (3) a nonresident estate or a trust. The tax to be withheld for each nonresident owner is equal to the highest income tax rate for a single individual (for an individual, estate or trust) or the highest corporation income/franchise tax rate (for a partnership, LLC or corporation) multiplied by the nonresident owner's share of income attributable to Wisconsin. A pass-through entity, such as a partnership, that is an owner of another pass-through entity is required to withhold and remit tax on the distributable share of income of each of the entity's nonresident owners. An entity is not required to withhold tax on behalf of its nonresident owners if: (1) the owner is exempt from taxation in Wisconsin; (2) the owner's distributable share of the entity's Wisconsin income is less than $1,000 and the owner has no other Wisconsin source income; (3) the entity is a joint venture

---

[132] L. 2009, S23, eff. May 12, 2009 and operative retroactive to taxable years beginning on or after Jan. 1, 2009.

[133] Utah Code Ann. § 59-10-1403.2(1)(a).

[134] Utah Code Ann. § 59-10-1403.2(1)(b).

[135] Va. Code Ann. 58.1-486.2(B)(1).

[136] Va. Public Document Ruling No. 09-20 (Feb. 4, 2009).

that has elected not to be treated as a partnership for federal income tax purposes; or (4) the entity is a publicly-traded partnership that files an annual information return. A nonresident owner may claim the withheld tax as a credit on its own Wisconsin income tax return.[137]

[c] Requirement of Estimated Tax Payments

[i] New Jersey

A recent Division of Taxation regulation requires quarterly estimates.[138]

[ii] New York

Pass-through entities are required to make quarterly estimated tax payments on behalf of nonresident corporate members or partners. Estimated tax payments are not required for: (1) any owner whose estimated tax required to be paid for the tax year by the entity is $300 or less; (2) any nonresident individual owner who elects to be included in a group (composite) return that the entity has been authorized to file; or (3) any owner that provides the entity with an exemption certificate certifying that the owner will comply in their individual or corporate capacity with the New York State estimated tax and tax return filing requirements.[139]

[iii] Vermont

Pass-through entities are required to declare and pay estimated income tax on behalf of their nonresident owners. An estimated payment is not required by the entity for a nonresident owner whose distributive share of the income attributable to Vermont does not exceed $100. The estimated tax payment requirement also does not apply to an entity engaged solely in the business of operating one or more affordable housing projects in Vermont, subject to certain restrictions.[140]

[d] Partnership is Contingently Liable

In Idaho, the pass-through entity is contingently liable for the income taxes of its nonresident members or partners if the nonresidents fail to pay their taxes when due.[141] Prior to 2009, this was also the rule in Alabama.

[4] Exemption From Withholding for Investment Partnerships

[a] In General

An exception from composite return filing requirements for investment partnerships and publicly-traded partnerships appears to be the next trend in state taxation of pass-through entities. At least 15 states now exempt certain types of pass-throughs,

---

[137] Wis. Stat. § 71.775.

[138] N.J. Admin. Code § 18:35-5.2(g).

[139] N.Y. Tax Law § 658(c)(4).

[140] Vt. Stat. Ann. tit. 32, § 5920; Vt. Dep't of Taxes, Tech. Bull. TB-05 (May 5, 2005).

[141] Idaho Code § 63-3022L.

such as publicly-traded partnerships or investment partnerships.[142] The following states offer examples of these exemptions.

[b] Alabama

Act 2009-144, effective January 1, 2009, provides that no income tax shall be due from a nonresident partner of a "qualified investment partnership" with respect to the nonresident partner's distributive share of interest, dividends, distributions, or gains and losses from qualifying investment securities owned by the entity. A partnership (or LLC) is a "qualifying investment partnership" if both of the following requirements are met: (1) at least 90 percent of the partnership's cost of its total assets consists of qualifying investment securities and office facilities and tangible personal property reasonably necessary to carry on its activities; and (2) at least 90 percent of the partnership's gross income consists of interest, dividends, distributions, and gains and losses from the sale or exchange of qualifying investment securities. Several other states, including Arkansas, California, Illinois and New Jersey, use some form of the 90 percent tests described above.

[c] Arkansas

Arkansas-source income does not include a nonresident partner's distributive share of income from a qualifying investment partnership.[143]

[d] Georgia

Ga. Code § 48-7-24 uses the same language as the Massachusetts exemption described below but, oddly, excludes from the exemption family limited partnerships "the majority interest of which is owned by one or more natural or naturalized citizens related to each other within the fourth degree of reckoning according to the laws of descent and distribution."

[e] Massachusetts

Mass. Gen. Laws ch. 62, § 17(b) simply exempts from income taxation nonresident limited partners of a limited partnership engaged exclusively in buying, selling, dealing in or holding securities on its own behalf and not as a broker.

[f] New York

The New York State Department of Taxation and Finance recently published an advisory opinion to explain that an LLC that is treated as a partnership for federal income tax purposes and was formed for investment purposes is not subject to an annual filing fee imposed on LLCs with New York source income.[144] Specifically, the opinion holds that a partnership whose sole activity is trading on its own account will not be deemed to carry on a business, trade, profession, or occupation in New York,

---

[142] *See* J. Gotlinger and T. Mahon, "State Tax Exemptions for Investment Partnerships and Their Nonresident Partners," 17 *Journal of Multistate Taxation and Incentives* 24 (Feb. 2008).

[143] Ark. Code § 26-51-202(e).

[144] TSB-A-07(7)I (Nov. 15, 2007).

and therefore, any dividends, interest, and capital gains received by the partnership will not be New York source income.

[g] North Carolina

Interestingly, North Carolina has not statutorily provided for this exemption, but instead has done so via regulation. Discussing partnership income tax returns, N.C. Admin. Code § 6B.3503 provides that "[i]f a partnership's only activities within North Carolina are in the nature of an investment account in which the securities are held for capital appreciation and income, the receipt of dividends and interest and the occasional sales of stocks and bonds does not constitute carrying on a trade or business in this State, and a nonresident partner's distributive share of this income is excludable . . . ."

§ 1.07 CREDITS FOR TAXES PAID TO OTHER STATES

Because a state may, constitutionally, tax the income of its residents from all sources, a resident partner of a partnership doing business in another state faces the possibility of double taxation—in the state of residency (on the entire allocable share) and in the states where the partnership is doing business (on the portion of the allocable share apportioned and allocated to that state). States generally use credits for taxes paid to other states to mitigate the specter of double taxation.

Generally, states do not allow credits to a partner for taxes *imposed on the partnership* and paid to another state. Most states do, however, allow credits to a resident partner for taxes paid *by the partner* to another state. A similar credit is allowed by many states to nonresident partners, but only if the nonresident shareholder's home state has reciprocity provisions. It is usually a condition of both credits that the type of income must be taxable in both states. Some states also limit the credit to certain types of income, such as compensation income.[145] Other states require that the taxes paid to another state be paid on income derived from sources within that other state, using the state's own allocation and apportionment rules.

The law in some states is unclear regarding credits for taxes paid to another state by a partnership on behalf of a nonresident partner, e.g., through a composite return, although a credit would seem necessary in order to avoid double taxation.

§ 1.08 TAX PLANNING STRATEGIES AND CONSIDERATIONS

[1] In General

Manipulation of the sometimes diverse state-to-state or state-federal tax treatment of a particular pass-through entity provides the multistate taxpayer with the opportunity to use the differences to its benefit, or to fall into a trap for the unwary.[146] Favorable results can be achieved, for example, with planning mechanisms that take advantage of the fact that an entity is recognized as a separate taxable entity in one jurisdiction,

---

[145] *See, e.g.*, Okla. Stat. § 2357(B)(1).

[146] *See* B. Ely and S. Ludwig, "Selected Pitfalls Arising from the Use of Hybrid Entities—Parts I and II," (Vol. #4), *Bus. Entities J.* 28 (Sept./Oct. 2002) and 24 (Nov./Dec. 2002).

yet treated as part of a larger one in another. Resulting tax benefits may include: non-recognition of gains due to the fact that a transaction is classified as "intercompany"; jurisdictional tax exemptions based on entity status; additional factor pass-through denominator representation; desired nexus creation or severance; and the netting of gains and losses between separately-viewed entities.

It is important to note, however, that all suggested tax planning strategies should be reviewed in light of practical business considerations and the additional administrative and other costs that might be incurred—or would be ongoing. Indeed, in some instances, the minimization of state taxes may not be prudent from a business perspective. And there should always be a bona fide, provable business purpose for entering into any restructuring transaction.

[2] Allocation and Apportionment

Allocation and apportionment may be substantially affected by entity classification. The issue of who is the taxpayer and what are the apportionment factors may result in lost apportionment factor representation for the income of an entity classified as a division if its income, but not its factors, must be reflected by the reporting corporation. In addition, the statutes and/or regulations of many states that require pass-through of apportionment factors sometimes do not require the elimination of inter-entity transactions. The lack of elimination of these transactions could result in beneficial or detrimental apportionment implications for the corporate owner.

[3] Tax Credits

State and local income tax credits available to a business entity's owners, if the entity is classified as a division or corporation, might not be available if the entity is classified as a partnership. In addition, insufficient separate return tax liability for the entity may limit utilization of existing credits. Furthermore, operating losses incurred by a corporate-like entity might not be able to be used to offset the owners' operating income.

[4] Single Member LLCs May Provide Sales, Use, or Rental Tax Savings

Taxpayers may be able to take advantage of certain states' rules that disregard the single member LLC for sales, use or rental tax purposes (in conformity with the check-the-box regulations for income tax) when engaging in sales or leases with the member.[147][*]

---

[147] *See, e.g.*, Ala. Rev. Rul. 98-005 (June 18, 1998) (no "sale for resale" between corporate member and SMLLC since SMLLCs generally are disregarded for sales/use tax purposes, as well as income tax purposes).

[*] For more on the state tax treatment of pass-through entities, see 1-5 Bender's State Taxation: Principles and Practice § 5.01 through 1-5 Bender's State Taxation: Principles and Practice § 5.04.