Chapter 16

State Taxation of Subchapter C, Subchapter S, and Subchapter K Entities and Their Owners—An Overview

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§ 16:1 Scope of chapter[1]

This chapter examines the state taxation of three different kinds of entities: (1) corporations taxed under subchapter C of the Internal Revenue Code ("C corporations"), (2) so-called "small business corporations" taxed under subchapter S of the Internal Revenue Code ("S corporations"), and (3) entities taxed as partnerships under subchapter K of the Internal Revenue Code (hereinafter collectively called "partnerships").

§ 16:2 Federal tax rules applicable to C corporations

Because state taxation of corporations and partnerships often mirrors the federal income tax treatment of these entities, it is helpful first to review briefly the federal tax rules. Under the

[Section 16:1]

[1]For further information, see J. Maule, 1510 T.M., State Taxation of S Corporations (2005), and K. Jamison et al., 2010 Multistate Tax Guide to Pass-Through Entities (CCH 2009). These useful treatises examine the state taxation of S corporations and other forms of pass-through entities in much more depth than this chapter. For more background information on choice of entity generally, see B. Ely and C. Grissom, 1550 T.M., Choice of Entity: An Overview of Tax and Non-Tax Considerations (2006).

Internal Revenue Code (the "Code" or "I.R.C."), a C corporation is treated as a tax-paying entity separate from its owners. Thus, a C corporation must pay corporate income tax on its taxable income, regardless of the identity or federal income tax classification of its shareholders.[1] A corporation's taxable income is defined as its gross income, minus allowable deductions.[2] Because corporations are not permitted standard deductions or personal exemptions, all of a corporation's allowable deductions are itemized deductions.[3]

Shareholders must also generally pay income tax on cash or property distributed to them from a C corporation in the form of a dividend.[4] The tax rate imposed on dividends distributed to individuals is determined by whether the distribution will be classified as generating either net capital gains or ordinary income, which in turn depends on whether the dividends are qualified dividends and whether the stock has been held for the appropriate length of time.[5] Dividends distributed to other entities will be taxed at ordinary income rates.[6]

C corporation status is available to all entities. A business entity that is a per se corporation under the U.S. Treasury Department's entity classification regulations (discussed elsewhere in this treatise), such as an entity formed under a state incorporation statute, may only be classified as a corporation for federal income tax purposes.[7] Any domestic (U.S.) business entity that is not a I corporation under the entity classification regulations is an "eligible entity" and may make an affirmative election to be taxed as a corporation.[8] If a domestic eligible entity fails to make an affirmative classification election, the default classification rules will apply. For example, a single-member LLC formed under state law will be classified by default as a disregarded entity unless it makes an affirmative election to be taxed as a corporation.

Forming a C corporation is generally a non-taxable event.[9] Shareholders receive an adjusted basis in their stock equal to the amount of money and the adjusted basis of property they

[Section 16:2]

[1]I.R.C. §§ 11, 61.

[2]I.R.C. § 63(a).

[3]I.R.C. § 63(b), (d).

[4]I.R.C. §§ 61, 301, 316.

[5]I.R.C. §§ 1(h)(11), 301.

[6]I.R.C. §§ 1(h)(11), 301. C corporation dividends received by C corporations, however, are eligible for the dividends received deduction. See I.R.C. §§ 243 to 246.

[7]Treas. Reg. § 301.7701-2(b)(1), (3) to (8).

[8]Treas. Reg. § 301.7701-3(a).

[9]I.R.C. § 351, 1032; but see I.R.C. §§ 357(c), 351(e).

contributed to the corporation.[10] The corporation receives an adjusted basis in the contributed property equal to the basis of the property in the hands of the contributing shareholder.[11] As a separate taxable entity, the income and losses of a C corporation do not pass through to its shareholders—unlike the pass-through tax treatment of S corporations and partnerships. Distributions in the form of dividends, while generally taxable to shareholders, are not deductible expenses for corporations.[12] C corporations distributing appreciated property must recognize as income the difference between the property's fair market value and its adjusted basis.[13]

Sales of C corporation stock are taxable to the extent the amount realized exceeds the shareholder's adjusted basis in the stock.[14] Assuming the required holding period is met and the shareholder is not considered a dealer in stocks, the sale of the stock typically generates long-term capital gain for the shareholder.[15] In contrast to the sale of a partnership interest,[16] it is irrelevant whether the subject C corporation owns inventory, substantially appreciated assets, or depreciated assets with built-in depreciation recapture.

§ 16:3 Federal tax rules applicable to S corporations

An S corporation is an entity that combines the limited liability associated with the corporate form with pass-through taxation to its shareholders. In contrast to C corporations, the taxation of S corporations is similar—but not identical to—the taxation of partnerships. As such, the S corporation itself ordinarily is not subject to federal income tax; the shareholders are taxed instead on the corporation's items of income, gain, loss and deduction.[1] These items are computed at the corporate level and then allocated or "passed through" to the shareholders, generally on a per share-per day basis.[2]

S corporation shareholders, like partners or members of subchapter K entities, are taxed on their pro rata shares of the items that are allocated to them, whether or not those items are actually distributed to the shareholders. Generally, the character of these items is determined at the corporate level;[3] special allocations are prohibited and items must be allocated in propor-

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[10] I.R.C. § 358(a).

[11] I.R.C. § 362(a).

[12] I.R.C. § 162.

[13] I.R.C. § 311(b).

[14] I.R.C. § 1001(a).

[15] I.R.C. §§ 1221 to 1223.

[16] See I.R.C. § 751.

[Section 16:3]

[1] I.R.C. § 1366.

[2] I.R.C. §§ 1366(a), 1377(a).

[3] I.R.C. § 1366(b).

tion to the number of shares held by each shareholder.[4] As will be illustrated below, the states generally conform to the federal income tax rules, but not uniformly.

No federal income tax is levied on the corporation itself, with a few exceptions relating to certain (1) "built-in gains,"[5] (2) passive investment income,[6] and (3) LIFO recapture.[7] Generally, these corporate level taxes are applicable only to S corporations that formerly operated as C corporations. The taxation of S corporations differs from that of partnerships in two other main areas: (1) restrictions on the types of investments and types of business in which the S corporation may engage,[8] and (2) certain rules that force earlier recognition of gain or later recognition of losses than for partnerships.[9]

S corporation status is not available to all corporations, but only to certain defined "small business corporations."[10] The Code imposes several requirements on the permissible shareholders of an S corporation. There must be one hundred or fewer shareholders, and each shareholder must be a U.S. resident individual, with exceptions for certain trusts and estates.[11] No corporations or partnerships (including LLCs classified as partnerships) are permitted as shareholders.[12] The S corporation must be formed under state law and may not have more than one class of stock.[13] Voting common and non-voting common stock, however, generally qualify as one class of stock for this purpose.[14] An S corporation may not operate as an insurance company or as certain financial institutions.[15] The corporation must meet these eligibility requirements when it first elects S status and throughout the period that it maintains its S status.[16] Some states impose additional qualifications, as described below.

A corporation elects federal S status by filing Form 2553 with the Internal Revenue Service. All shareholders must consent in writing to the election.[17] The election must be made and filed before the fifteenth day of the third month of any taxable year; if it is made later in the year, it will not be effective until the fol-

[4] I.R.C. §§ 1366(a)(1), 1377(a).

[5] I.R.C. § 1374.

[6] I.R.C. § 1375.

[7] I.R.C. § 1363(d).

[8] See, e.g., I.R.C. § 1361(b)(2).

[9] See, e.g., I.R.C. §§ 752 (allowing partners to increase their basis in the partnership for their share of partnership liability; no analogous provision exists for S corporations), 311(b) (requiring corporations to recognize gain on certain distributions of appreciated property, while no counterpart exists in subchapter K).

[10] I.R.C. § 1361(a)(1).

[11] I.R.C. § 1361(b)(1), (c)(2).

[12] I.R.C. § 1361(b)(1)(B).

[13] I.R.C. § 1361(b)(1)(D).

[14] I.R.C. § 1361(c)(4).

[15] I.R.C. § 1361(b)(2).

[16] I.R.C. § 1362(a)(1), (d)(2).

[17] I.R.C. § 1362(a)(2).

lowing taxable year.[18] The corporation will later lose its S status if persons holding a majority of the shares consent to revoke the election or if the corporation fails to meet the continuing eligibility tests previously described.[19] The termination of S status generally does not have a retroactive effect.[20]

As with partnerships and C corporations, forming an S corporation is usually a non-taxable event.[21] Shareholders receive an adjusted basis in their stock equal to the amount of money and the adjusted basis of property they contributed to the S corporation.[22] Items of income and gain allocated to the shareholders increase the shareholders' respective bases in their stock.[23] Losses allocated to a shareholder reduce that shareholder's basis.[24] Generally, a shareholder cannot deduct losses in excess of that shareholder's basis in the corporate stock and in the corporation's indebtedness to the shareholder.[25] Losses that exceed the stock and debt basis do not pass through but are suspended for the benefit of that particular shareholder and may be carried forward to subsequent taxable years.[26] Distributions from the corporation to the shareholder are not taxable to the extent of the shareholder's adjusted basis but reduce the shareholder's adjusted basis accordingly.[27] Sales of S corporation stock are taxable to the extent the amount realized exceeds the shareholder's adjusted basis in the stock.[28] Assuming there is a sufficient holding period and the shareholder is not considered a dealer in stocks, the sale of the stock typically generates long-term capital gain for the shareholder.[29] In contrast to the sale of a partnership interest,[30] the S corporation's ownership of inventory, substantially appreciated assets, or depreciated assets with built-in depreciation recapture is irrelevant in determining the character of gain from the sale of S corporation stock.

§ 16:4 State income taxation of corporations generally—State jurisdiction and the required "nexus"

In order to impose a tax on corporations (C or S) or the shareholders of an S corporation, a state first must have taxing jurisdiction over the corporation. Only businesses that have suf-

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[18] I.R.C. § 1362(b)(2).

[19] I.R.C. § 1362(d).

[20] I.R.C. § 1362(e).

[21] I.R.C. §§ 1032, 1371(a).

[22] I.R.C. §§ 358(a), 1371(a).

[23] I.R.C. § 1367(a)(1).

[24] I.R.C. § 1367(a)(2).

[25] I.R.C. § 1366(d)(1). but see Selfe v. U.S., 778 F.2d 769 (11th Cir. 1985). Partners in a partnership, on the other hand, generally obtain an increase in basis equal to their proportionate shares of the partnership's total indebtedness. I.R.C. § 752(a).

[26] I.R.C. § 1366(d)(2).

[27] I.R.C. §§ 1367(b)(2)(A), 1368(b).

[28] I.R.C. § 1001(a).

[29] I.R.C. §§ 1221 to 1223.

[30] See I.R.C. § 751.

ficient contacts or a "nexus" with a state may be taxed by that state.[1] It is difficult to define precisely what constitutes adequate nexus, and literally hundreds of courts and taxing authorities have tried. Generally, however, income tax nexus exists if that corporation regularly and systematically exploits a state's market.[2]

Federal statutes further limit a state's jurisdiction to tax corporations. Under federal Public Law 86-272,[3] a state cannot impose a net income-based tax on corporations doing business in the state if their activities in-state are limited to: (1) the solicitation of orders by employees lacking authority to accept them; (2) promotional activities by corporate employees not engaged in solicitation or accepting orders; (3) solicitation by non-employees even though conducted through an office or business location in the state; and (4) delivery of goods in the state by corporate-operated or hired vehicles.

Several states have interpreted their nexus or levy statutes to extend to the maximum limits prescribed by the United States Constitution and federal statutory law.[4] The states typically apply their nexus rules consistently as between C corporations and S corporations. Once it is determined that a taxpayer has nexus with, and thus is taxable by, a state, it becomes necessary to determine what percentage of the corporation's income arises from within that state. Apportionment and allocation provisions are briefly discussed in the next section.

[Section 16:4]

[1] State of Wisconsin v. J.C. Penney Co., 311 U.S. 435, 61 S. Ct. 246, 85 L. Ed. 267, 130 A.L.R. 1229 (1940).

[2] See, e.g., International Shoe Co. v. State of Wash., Office of Unemployment Compensation and Placement, 326 U.S. 310, 317–20, 66 S. Ct. 154, 90 L. Ed. 95, 161 A.L.R. 1057 (1945). Generally, nexus for sales and use tax purposes requires physical presence. Quill Corp. v. North Dakota By and Through Heitkamp, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992). But see, e.g., N.Y. Tax Law § 1101(b)(8)(vi), colloquially known as the "Amazon Law" (imposing sales tax on a seller with no physical presence with the State of New York based on the seller's solicitation of business within New York through an independent contractor if the seller enters into an agreement with a resident of New York under which the resident, for consideration, refers potential customers, whether by a link on an internet connection or otherwise, to the seller). One of the great unanswered questions in state and local taxation is whether income tax nexus also requires physical presence. See, e.g., Lanzi v. Alabama Dept. of Revenue, 968 So. 2d 18 (Ala. Civ. App. 2006) (rejected by, Prince v. State Dept. of Revenue, 2010 WL 245578 (Ala. Civ. App. 2010)) (reversing its former rulings on the issue and holding that income tax nexus does not require physical presence).

[3] Codified at 15 U.S.C.A. §§ 381 to 384.

[4] See, e.g., Geoffrey, Inc. v. South Carolina Tax Com'n, 313 S.C. 15, 437 S.E.2d 13 (1993).

§ 16:5 State income taxation of corporations generally—Allocation and apportionment

Four states do not levy a net income tax on corporations at all (whether C or S): Nevada, South Dakota, Washington and Wyoming. Michigan, Ohio, and Texas levy taxes that resemble an income tax on corporations in some respects, but are not true income taxes. The remaining states generally tax C corporations on income attributable to activities within that state. Ordinarily, with respect to both C and S corporations engaged in multistate activity, states apply allocation rules and apportionment formulas in order to determine which items of income and what amounts are attributable to activities within that state.

Most states allocate and apportion income earned by a multistate corporation in a manner similar to that of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA allocates specific non-business items of income, gain, and loss derived from real or personal property located in a state to that particular state.[1] An apportionment formula is then applied for items of business income that cannot be specifically allocated.[2] Various apportionment formulas exist in every state that levies a net income tax. The apportionment formula usually consists of some variation of a one to three factor test. The three factors commonly used are the company's property, payroll, and sales or gross receipts factors.[3] The weighting of each varies from state to state, however, with the majority of the states now giving the sales factor more weight.[4] In fact, in a growing number of states, the apportionment factor has been reduced to a sales or receipts factor alone.[5]

The standard property factor is equal to the ratio of the value of taxpayer's in-state property to the value of the taxpayer's property everywhere; the payroll factor is based on where the employees of the corporation work; and the sales or receipts factor is based on the location of the actual receipts of the corporation.[6] Each state then applies its own apportionment factor to determine the proportion of income of the corporation attributable to activities within that state. Most states arrive at the corporation's

[Section 16:5]

[1]UDITPA §§ 5 to 8.

[2]UDITPA § 9.

[3]UDITPA § 9.

[4]See RIA All States Tax Guide ¶ 223 (2010).

[5]See, e.g., 35 Ill. Comp. Stat. § 5/304(h)(3). See also K. Edmiston, "Single-Factor Sales Apportionment in Georgia—What is the Net Revenue Effect?", 31 State Tax Notes 107 (Jan. 12, 2004). See also Cal. Rev. & Tax Code. § 25128.5(a) (allowing certain businesses, effective January 1, 2011, to make an irrevocable election to apportion income using a single sales factor apportionment formula).

[6]See UDITPA §§ 9, 10, 13, 15.

state taxable income by beginning with the federal definition of taxable income, then applying their own modifications to that figure (for example, a state may grant a deduction not allowed under the federal tax code, or it may deny a deduction allowed to federal taxpayers), subtracting "non-business income," then applying the apportionment formula to arrive at apportioned "business income" for that state. Items of specifically allocated non-business income are then added to apportioned business income to determine state taxable income.[7]

§ 16:6 State entity-level taxes on corporations—Income taxes—Effect of S election

Most states recognize a corporation's federal S corporation status for purposes of their corporate income tax. Accordingly, only S corporation shareholders—and not the S corporation itself—are generally subject to tax in these states. There are notable exceptions, however.

States that do not recognize federal S elections. The District of Columbia, Louisiana, Michigan, New Hampshire, Ohio, Tennessee, and Texas do not recognize an S election for purposes of their corporate income tax (although it should be noted that the taxes in Michigan, Ohio, and Texas are not traditional "net income" taxes). In these states, an S corporation is subject to the regular corporate income tax and therefore taxed like a C corporation. Pass-through treatment is not required or available in these states and shareholders do not recognize income from corporate earnings until they receive distributions in the form of dividends, actual or constructive, from the corporation. Their receipt of distributions results in double taxation, the avoidance of which is one of the primary reasons for making the federal S election. In Illinois, S corporations are exempt from the regular income tax but are subject to the "replacement" income tax.[1]

In Louisiana, the federal S election is not formally recognized, and S corporations are taxed the same as other corporations, with one important exception: an S corporation may exclude from its taxable income the percentage of Louisiana net income on which Louisiana taxes have been paid by its shareholders.[2] The Louisiana tax thus functions effectively as a withholding tax on

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[7] See, e.g., 35 Ill. Comp. Stats. §§ 5/202, 5/203(b).

[Section 16:6]

[1] 35 Ill. Comp. Stats. §§ 5/201(c), 5/205(c).

[2] La. Rev. Stat. Ann. § 47:287.732(A), (B). Interestingly, Louisiana S corporations that were formed as true corporations are subject to the franchise tax, but Louisiana S corporations that were formed as LLCs (and that elected for income tax purposes to be taxed as a corporation) are not subject to the franchise tax. La. Revenue Bulletin No. 04-023 (Dec. 1,

the shareholders, similar to withholding and composite return requirements discussed later in this chapter. A more severe situation exists for individual S corporation shareholders in Michigan: S corporations are subject to the Michigan Business Tax just like C corporations, while shareholders are also taxed on their entire pro rata share of net income and not just on distributions, because Michigan employs the federal definition of taxable income for individuals.[3]

In Texas, the earned surplus (net income-based) portion of the former franchise tax applied to S corporations just like it applied to C corporations, except that S corporations did not have to add back compensation paid to directors or officers when computing net taxable earned surplus (effective before January 1, 2008). Texas's new franchise "margin" tax has no special provisions for S corporations and thus applies equally to C and S corporations (effective for franchise reports due on and after January 1, 2008).[4] Ohio's Commercial Activity Tax ("CAT")—a gross receipts-based tax—applies to all entities with gross receipts in excess of $150,000 and makes no exception for S corporations.[5] S corporations were subject to the expanded Kentucky corporation income tax for the period January 1, 2005 through December 31, 2006. Shareholders of Kentucky S corporations were also subject to tax on their pro rata shares, but they were generally allowed a credit equal to their proportionate share of the corporate-level tax.[6] For tax years beginning on or after January 1, 2007, S corporations are generally not subject to the Kentucky corporate income tax, but they are subject to the new "limited liability entity" tax.[7]

States recognizing S elections. States that recognize a corporation's federal S election generally conform to the federal income taxation of S corporations and therefore do not levy a corporate income tax on the S corporation directly. California, New Jersey, and New York, however, recognize the federal S election, but the primary effect of this election is to apply a lower rate to the corporation than that applied to C corporations.[8] In Massachusetts, S corporations with gross receipts greater than

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2004).

[3]Mich. Comp. Laws Ann. §§ 206.28, 206.110, 208.1201(1), 208.1203(1), 208.1113(3). This treatment applied under both the Michigan Single Business Tax, which was effective for the years beginning before January 1, 2008, and for the new Michigan Business Tax. See Michigan Business Tax FAQ B1, Business Income—Flow-Through-Income, Michigan Dep't of Treasury (Aug. 10, 2007).

[4]Tex. Tax Code Ann. § 171.001(A) (effective Jan. 1, 2008).

[5]See Ohio Rev. Code Ann. § 5751.01(A).

[6]See former Ky. Rev. Stat. Ann. §§ 141.010(24), 141.420.

[7]Ky. Rev. Stat. Ann. §§ 141.040(14), 141.0401.

[8]Cal. Rev. & Tax Code § 23802; N.J. Rev. Stat. § 54:10A-5(c); N.Y. Tax Law § 210(1)(g).

$6,000,000 are subject to its corporate income tax.[9] Conversely, twelve states treat the S election as giving the corporation total immunity from all income (though not necessarily franchise) taxation.[10]

The rest of the states follow the federal pattern to a large extent and may impose a tax on an S corporation's built-in gains, passive investment income, or LIFO recapture. Again, these taxes are generally applicable only to an S corporation that was formerly a C corporation, but they may apply in certain circumstances when S corporations that have always been S corporations acquire assets of a separate C corporation in a reorganization under I.R.C. § 381 or spin-off or split-off under I.R.C. § 355.

When an S corporation is subject to federal income tax under one of these three circumstances, in these states it would also be subject to state income tax, to the extent taxable income is apportioned to that state. In other states, such as Vermont,[11] the S corporation is technically liable for the state income tax owed by nonresident shareholders, as noted below.[12]

Procedural Issues. Almost all the states that recognize S corporation status require a valid federal S election in order for a corporation to receive state S corporation treatment. Some states require a copy of the federal election to be filed with the state, and a few states require a separate state election.[13] Generally, states do not impose any more eligibility requirements for a corporation to elect S status than are required for federal tax purposes, and in most states the federal S election is automatically effective for state income tax purposes also. Some states impose additional requirements on nonresident shareholders, however, such as requiring them to consent to taxation in that state. A chart describing each state's qualification requirements, and whether a separate state election is required, is attached hereto as Chart 1 (Appendix 16A). States also may impose a tax on the S corporation directly if the nonresident shareholder(s) or the corporation do not in effect cause the pro rata share of the nonresident shareholder(s) to be taxed in that state. In New York and several other states, S corporations must actually conduct business in the state in order to qualify for state recognition.[14]

States that recognize a federal S election may either automati-

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[9] Mass. Gen. Laws Ch. 63, § 32D.

[10] Colorado, Connecticut, Delaware, Kansas, Missouri, Montana, Nebraska, North Carolina, Ohio (exempt from corporate income tax but subject to CAT), Oklahoma, Virginia, and West Virginia.

[11] Vt. Stat. Ann. 32 § 5914(c).

[12] See §§ 16:17 to 16:20.

[13] For example, in Arkansas, S corporations must file a separate state election on Form AR1103, although a separate state election is apparently not required by statute. See Ark. Code Ann. § 26-51-409.

[14] See, e.g., N.Y. Tax Law § 660;

cally adopt the federal election for the corporation or permit the corporation to make (or not to make) a separate state S election.In most states, the federal election is sufficient to invoke S corporation treatment for state income taxes. Many states also require a copy of the federal election or a statement containing similar information to that required in the federal election to be filed with the appropriate state revenue official, but failure to do so in most cases does not cause the state S election to be lost. Alabama, Arizona, Arkansas, Georgia, Kansas, New Jersey, New York, Pennsylvania, and Vermont require a corporation that has made an effective federal S election to take further affirmative steps to receive state S corporation treatment for state income tax purposes, such as having the nonresident shareholders file consents to be taxed by that state. Although technically not a prerequisite for recognition of S status, several states require the nonresident shareholders either to consent to be taxed by the state or actually to pay tax to the state on their pro rata share of that state's net income; if a nonresident shareholder fails to meet this requirement, the corporation must file a composite income tax return and is itself liable for state income tax on behalf of the recalcitrant nonresident shareholder.[15]

It is essential that a corporation's organizers determine exactly what steps a state requires for the state election whenever a corporation begins doing business in a new state. Failure to make this optional state election or to timely notify the state taxing authority of its federal S election could result in the corporation being treated as a C corporation for state corporate income tax purposes. Such failure could have additional negative consequences: shareholders of federal S corporations that do not make this optional state S election may still be subject to state income tax on their entire pro rata share of the corporation's income apportioned and allocated to that state.

State conformity to federal law changes. Most states begin the calculation of state taxable income with the federal definition of taxable income under the Internal Revenue Code. Accordingly, amendments to federal law automatically carry over to state taxation in these states that "piggy-back" on the Internal Revenue Code. When new federal tax provisions become effective, such as the provisions affecting S corporations in the American Jobs Creation Act of 2004 or the Small Business and Work Opportunity Act of 2007, taxpayers should determine whether their state tax code automatically incorporated these changes. In some cases, states may enact a specific provision denying a new federal

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N.Y. Dep't of Taxation & Finance, Advisory Opinion, TSB-A-88(12)I (Aug. 24, 1988).

[15]See, e.g., Haw. Rev. Stat. § 235.128(c).

benefit.[16] In other cases, states have "frozen" the conformity of their state tax codes to the version of the Internal Revenue Code as it stood on a certain date.[17]

§ 16:7 State entity-level taxes on corporations—Franchise taxes

Most states levy additional taxes on business entities that are not pure net income-based taxes. These taxes are often styled as a "business privilege" tax, a "capital stock" tax, or a "franchise" tax. Several states use *income* as one of the measures of computing the tax; many use the net worth of the corporation or its capital stock as the base. As noted previously, in general an S election can greatly affect the state *income* tax treatment of a corporation; in contrast, the general rule for state net-worth-based or capital stock taxes is that an S election does not affect these taxes.

Various annual registration and business license fees may also apply. Usually, this fee is $250 or less, although in Minnesota it may be as high as $5,000, if the C or S corporation has certain levels of income from Minnesota sources.[1] Utah has a separate gross receipts tax that may apply to S corporations.[2] Franchise and similar entity-level taxes also tend to be higher in states that do not impose an income tax on corporations.[3] A franchise or similar tax is levied upon C and S corporations in Alabama, Arkansas, California, Connecticut, Georgia, Illinois, Kansas, Louisiana, Mississippi, Missouri, Nebraska, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, West Virginia, Wisconsin, and Wyoming.

§ 16:8 Taxation of individual shareholders: residency generally

Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no individual or personal income tax. Tennes-

[16] See, e.g., Okla. Stat. tit. 68, § 2358.6 (requiring taxpayers to add back to their taxable incomes certain amounts of "bonus depreciation" granted by the federal Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009).

[17] See, e.g., W.Va. Code § 11-24-3(a) (changes made to Internal Revenue Code on or after Feb. 14, 2008 have no effect in West Virginia); Or. Rev. Stat. §§ 317.010(7), 317.018(1) (changes made to the internal Revenue Code after May 1, 2009 and before January 1, 2011, have no effect in Oregon, except as the legislature has provided otherwise).

[Section 16:7]

[1] Minn. Stat. § 290.0922, subd.1(a), (b).

[2] Utah Code Ann. § 59-8-103(4).

[3] Compare Tex. Tax Code Ann. § 171.002, with Tenn. Code Ann. § 67-4-2106(a).

see and New Hampshire impose income tax on income from certain intangibles only.[1] The rest of the states to some extent tax the income of resident individuals and personal income of nonresident individuals attributable to or derived from sources within the state. States may constitutionally tax *residents* of their states on their entire income, regardless of the source.[2] A state may only tax the income of *nonresidents*, however, to the extent the income is derived from sources within that state or from property or activities that receive benefits or protection from that state.[3] Usually, states will allow resident individuals a credit for income taxes paid by that individual on income taxed by another state.[4]

§ 16:9 State taxation of shareholders—Resident shareholders of C corporations

As with individuals generally, the taxation of shareholders in a C corporation generally turns on the residency of the shareholders. Resident individual shareholders of a C corporation must pay state personal income tax on the actual and sometimes constructive distributions from the corporation. Generally, the entire dividend is taxable to the state of the shareholder's residence, no matter where it was actually "earned."

Corporate shareholders generally also have to include dividends in income, but there may be no or only minimal tax due as a result of the dividends-received deduction. Most states have dividends received deduction provisions that are modeled on the federal dividends received deduction codified in I.R.C. § 243.[1]

§ 16:10 State taxation of shareholders—Nonresident shareholders of C corporations

A state that has jurisdiction to tax a C corporation does not have jurisdiction to tax the corporation's shareholders merely by

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[Section 16:8]

[1] N.H. Rev. Stat. Ann. §§ 77:1 to 77:36; Tenn. Code Ann. §§ 67-2-101 to 67-2-122.

[2] People of State of New York ex rel. Cohn v. Graves, 300 U.S. 308, 57 S. Ct. 466, 81 L. Ed. 666, 108 A.L.R. 721 (1937).

[3] Shaffer v. Carter, 252 U.S. 37, 40 S. Ct. 221, 64 L. Ed. 445 (1920). A state may also tax a nonresident if the nonresident owner is a beneficiary of public services whose costs are borne by the state. International Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435, 64 S. Ct. 1060, 88 L. Ed. 1373 (1944).

[4] See, e.g., Ga. Code Ann. § 48-7-28.

[Section 16:9]

[1] See, e.g., Ga. Code Ann. § 48-7-21(b)(8)(B).

virtue of their ownership interest in the corporation.[1] Because the C corporation is a separate legal entity and separate taxpayer, the C corporation's nexus with the taxing state does not pass through to its shareholders.[2] A state seeking to tax a C corporation shareholder must have nexus with the shareholder directly. Note, however, that the state may tax the corporation directly on its dividends paid to all shareholders, although to the authors' knowledge, no state currently employs this practice.[3]

While the question of whether a C corporation's nexus may be attributed to its shareholders has been settled law for quite some time, whether an S corporation's nexus may be attributed to its shareholders and whether a partnership's nexus may be attributed to its partners are legal questions that are far from settled, as discussed below.

§ 16:11 State taxation of shareholders—Resident shareholders of S corporations

In states that do not recognize the federal S election, shareholders are not taxed on their undistributed shares of federal S corporation income. The corporation is treated like a C corporation, and the shareholders are taxed instead on actual and sometimes constructive distributions from the corporation. In states that recognize the S election, as noted above, an S corporation is ordinarily a pass-through entity, not a tax-paying entity. The taxable income of an S corporation still must be calculated, however, in order to calculate the amount and character of items that pass through to the shareholders. Resident shareholders will ordinarily be taxed on their entire pro rata share of S corporation income, gain, loss, and deduction, whether those items are distributed or not and regardless of the sourcing of income pursuant to a state's allocation and apportionment rules.[1] A few states, however, require a resident shareholder to include in income only the amount of the pro rata share of the S corporation's income allocated and apportioned to that state.[2]

The income tax liability of resident shareholders in most states begins with the federal S corporation shareholder liability

[Section 16:10]

[1]See International Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435, 64 S. Ct. 1060, 88 L. Ed. 1373 (1944).

[2]Shaffer v. Heitner, 433 U.S. 186, 97 S. Ct. 2569, 53 L. Ed. 2d 683 (1977).

[3]See Int'l Harvester Co., supra note 1.

[Section 16:11]

[1]See, e.g., N.J. Rev. Stat. § 54A:5-1.

[2]See Iowa Admin. Code r. 701-50.1 (allowing resident S corporation shareholders to elect to apportion at corporate level); Mich. Comp. Laws Ann. §§ 206.110(1), 206.115; Neb. Rev. Stat. § 77-2734.01(1), (2); Okla. Stat.

computed under I.R.C. § 1367, with state modifications then applied. For federal purposes, taxable items that could affect individual shareholders in different ways must be "separately stated."[3] Many state modifications to federal shareholder tax liability involve what must be separately stated, for often items that affect federal tax liability may not affect state tax liability in the same way. For example, many states do not recognize Modified Accelerated Cost Recovery System ("MACRS")[4] depreciation. MACRS depreciation is not separately stated for federal tax returns, but a state's income tax laws may require that a shareholder's income be modified to account for disallowed depreciation on state returns. Another example involves interest income from obligations issued by other states or their local governments; interest from these obligations is exempt for federal income tax purposes under I.R.C. § 103, but not for most states' purposes.

Several states provide for computation of state taxable income completely separate from the federal definitions. Alabama, Arkansas, Mississippi, New Hampshire, New Jersey, Pennsylvania, and Tennessee have prescribed specific methodologies for computing individual state taxable income, rather than using the federal income tax base. These states may incorporate all or portions of I.R.C. §§ 1366 and 1367 for purposes of calculating income for resident S corporation shareholders.

§ 16:12 State taxation of shareholders—Nonresident shareholders of S corporations

Perhaps the aspect of S corporations and their shareholders that varies the most among states is the treatment of nonresident shareholders. It is generally agreed, however, that if a state has jurisdiction to tax an S corporation, the state also has jurisdiction to tax the income distributed to nonresident shareholders of that corporation. Nonresident shareholders of S corporations have challenged states' authority to tax them if their only contact with the state is through their ownership of stock in the S corporation, but to the knowledge of the authors, only rarely have they been successful, in contrast to several successful challenges by nonresident owners of limited partnerships or LLCs.[1]

Over half the states specifically subject nonresident sharehold-

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tit. 68, § 2358(A)(4); Okla. Admin. Code § 710:50-21-1(b); Ala. Admin. Code rr. 810-3-14-.01(14)(c), 810-3-162-.01(1)(c). The Alabama Department of Revenue has tried, unsuccessfully, to change this rule in recent years and has indicated that it may seek a legislative change.

[3] I.R.C. § 1366(a)(1)(A).

[4] I.R.C. § 168.

[Section 16:12]

[1] See, e.g., Kulick v. Department of Revenue, 290 Or. 507, 624 P.2d 93

ers to income taxation on their pro rata shares of income arising from the S corporation's business activities in that state. In several other states, application of the general income tax rules, in connection with the absence of any contradicting statutes regarding S corporations, results in the same treatment. Although it is common for states to have reciprocity agreements under which the states agree not to tax certain income of residents of the other party-state, most of these agreements do not apply to a nonresident shareholder's pro rata share of S corporation income (other than wages).[2] Virginia's statutes also apparently subject a nonresident shareholder's entire pro rata share to its income tax, but fortunately state regulations limit the amount included in a nonresident shareholder's Virginia income to "that which is attributable to a business, trade, profession, or occupation carried on in [Virginia]."[3] Nonresident shareholders are generally not taxed on their S corporation pro rata shares in states that do not recognize the S election (and tax the corporation directly),[4] as well as in states that do not levy personal income taxes.

A nonresident shareholder must apply state allocation and apportionment rules to determine which portion of his or her pro rata share of S corporation income arises from or is attributable to sources within the state. Allocation and apportionment rules are most often applied at the S corporation level.[5] The allocation and apportionment rules for business activities and personal compensation differ from those of stock ownership in most states; in these states it is necessary to determine whether the shareholder is engaged in the corporation's business in that state. If the nonresident shareholder is characterized as merely owning stock and not engaging in the corporation's business in that state, most states' allocation and apportionment rules would treat income as coming from sources outside the state. Compare this to the determination of whether a corporate partner or member's business is unitary with that of the partnership or LLC itself and the difference in application of the state's apportionment formula. There is little guidance on determining whether a shareholder is

(1981) (affirming state income tax on nonresident shareholders but rejecting argument that the S election itself created nexus or constituted consent to taxation by the shareholder; instead, effect of tax was same as if imposed on corporation itself and therefore not a violation of due process).

[2]See, e.g., Minn. Stat. § 290.081(a); Minnesota Individual Income Tax Fact Sheet No. 4 (Jan. 2001).

[3]See Va. Code. Ann. § 58.1-325(B); 23 Va. Admin. Code § 10-110-180.

[4]See footnotes 2–6 of § 16:6 and accompanying text.

[5]See, e.g., Colo. Rev. Stat. § 39-22-109(2)(A)(VI); Ala. Admin. Code r. 810-3-162-.01(2) ("Any item included in the shareholder's pro rata share shall retain the same character as if received directly by the shareholder from the source").

merely a shareholder or directly engaged in a corporation's business in a state.

While most states consistently tax items of income, gain, loss, and deduction attributable to or derived from sources within that state, there is no uniform treatment for net operating loss ("NOL") carryovers for nonresident shareholders, even though almost every state allows NOL carryovers to be claimed by their resident shareholders. Some states strictly follow the federal rules and allow the NOL carryovers; while some prohibit NOL carryovers, or carrybacks, entirely.[6] Most states, however, appear to require separate computing for income sources within the state.[7] Other states disallow NOLs when the corporation files a composite return for its nonresident shareholders.[8]

As with resident shareholders, states usually begin with the federal definition of taxable income or adjusted gross income for nonresident shareholders and then apply state modifications. Often, the modifications for resident shareholders and nonresident shareholders are identical, either expressly or implicitly as a result of the general modification provisions. In a few cases, all modifications are made at the corporate level, and nonresident shareholders are taxed only on their state source income.[9]

As a general rule, income from a nonresident shareholder's sale of S corporation stock is allocated to the shareholder's state of residence.[10] This general rule is subject to at least two notable exceptions. First, some states have adopted specific provisions requiring nonresident shareholders to apportion income derived from the sale of S corporation stock to the state in certain situations.[11] Second, if the sale of S corporation stock is treated, for federal income tax purposes, as a deemed sale of all the S corporation's assets pursuant to I.R.C. § 338(h)(10), many states

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[6] See, e.g., Wis. Stat. § 71.365(2).

[7] See, e.g., Conn. Gen. Stat. § 12-711(b)(1)(C); Conn. Agencies Regs. § 12-711(b)-6.

[8] See, e.g., Delaware Form 200-C (Rev. Dec. 3, 2009), Instructions for 2009 Composite Personal Income Tax Return.

[9] Cf. § 16:11, footnote 2 and accompanying text.

[10] See, e.g., In re Mintz, N.Y. State Division of Tax Appeals, ALJ, Dkt. No. 821807 (June 4, 2009); In re Yeager, N.Y. State Division of Tax Appeals, ALJ, Dkt. No. 821806 (June 4, 2009); Virginia Public Document Ruling 09-78 (May 26, 2009).

[11] See, e.g., N.Y. Tax Law § 631(b)(1)(A)(1) (requiring a nonresident shareholder of S corporation stock to allocate gain from the sale or exchange of the stock to New York if the S corporation owns real property located in New York and the New York real property has a fair market value of at least fifty percent of all the assets of the S corporation on the date of the sale or exchange of the stock); Ohio Rev. Code § 5747.212 (requiring nonresident shareholders owning at least twenty percent of the interest in an S corporation to apportion gain derived from the sale or exchange of the S corporation stock).

treat the stock sale as the sale of assets for state income tax purposes as well.[12] In these two instances, a nonresident S corporation shareholder may be subject to income tax in a state other than (or in addition to) the shareholder's state of residence on the sale of S corporation stock.

§ 16:13 Compliance and enforcement

Nearly every state requires S corporation nonresident shareholders to file an individual income tax return with the state, and the states have adopted numerous enforcement mechanisms to ensure nonresident shareholder compliance. As mentioned above, in some states the failure of nonresident shareholders (or the S corporation on their behalf) to pay state income tax revokes the S election in that state.[1] At least fifteen states now require nonresident shareholders to sign and file an agreement to file a tax return and consent to jurisdiction in that state. Other states require or allow the S corporation to file a single composite return on behalf of all nonresident shareholders. Some states bypass attempting to ensure each nonresident shareholder individually complies by requiring the corporation to pay income taxes directly or to withhold taxes from distributions to the shareholders. These enforcement mechanisms are discussed below.

§ 16:14 Compliance and enforcement—Composite tax returns

Corporations may file composite returns on behalf of nonresident shareholders in at least thirty-five states. Composite returns list the shareholders' pro rata shares of income, deductions, and losses, along with any credits the shareholders are allowed to claim on account of the S corporation's payment of taxes on their behalf. States may require other information as well, and some states place other conditions on the shareholders to be included in the composite return, such as allowing only nonresident individuals (and not trusts or estates or resident shareholders) to be included in the return. A few states require a certain mini-

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[12] Compare Prince v. Alabama Dep't of Revenue, Alabama Court of Civil Appeals Case No. 2080634 (January 22, 2010) and South Carolina Revenue Ruling 09-4 (March 31, 2009) (treating the stock sale as the sale of the assets of the S corporation when an I.R.C. § 338(h)(10) election is made), with Trawick Const. Co., Inc. v. Georgia Dept. of Revenue, 286 Ga. 597, 690 S.E.2d 601 (2010), and In re Baum, N.Y. State Division of Tax Appeals, ALJ, Dkt. No. 820837 (April 8, 2009) (treating the sale as a stock sale even though the sale was treated as an asset sale for federal income tax purposes because of the I.R.C. § 338(h)(10) election).

[Section 16:13]

[1] See, e.g., Ark. Code Ann. § 26-51-409(c)(2).

mum amount of shareholders that must be included in the composite return.[1] Some states require prior approval or permission from the taxing authority before allowing S corporations to file composite returns,[2] and others may require permission to stop filing them once an S corporation has begun doing so.[3]

§ 16:15 Compliance and enforcement—Corporation taxed on behalf of nonresident shareholders

In Oklahoma, S corporations are required to pay income tax on behalf on their nonresident shareholders unless the nonresident shareholder files a consent to be taxed by that state.[1] Similar provisions exist in Alabama, Hawaii, Idaho, Mississippi, Utah, Wisconsin and several other states. This mechanism tracks the provisions of the American Bar Association's Model State S Corporation Income Tax Act (or "MoSCITA"), which has been endorsed by the AICPA as well as the Multistate Tax Commission. Apparently, only Connecticut, Delaware, Maryland, and Vermont require payment by an S corporation on behalf of its nonresident shareholders in all events.[2] As will be seen below, many states have adopted similar compliance mechanisms for nonresident partners and LLC members.[3]

§ 16:16 Compliance and enforcement—Withholding

Some states permit or require S corporations to withhold and remit income taxes on behalf of their nonresident shareholders. Usually, the corporation must withhold at a rate equal to the highest marginal personal income tax rate in that state. Withholding for nonresident shareholders is generally required in California, Illinois (effective Jan. 1, 2009),[1] Indiana, Iowa, Michigan, Pennsylvania, Utah,[2] Virginia (effective January 1, 2008),[3] and Wisconsin. In several other states, withholding (or requiring the

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[Section 16:14]

[1] See, e.g., N.Y. Comp. Codes R. and Regs. 20 §§ 151.17, 151.19.

[2] See, e.g., 18-125 Code Me. R. 805. Note that Maine statutes apparently require withholding, see 36 M.S.R.A. § 5250-B, but the state Department of Revenue Services apparently allows taxpayers to elect composite filing instead. See 2009 Maine Composite Income Tax Return Filing Instructions, Schedule 1040C-ME.

[3] See, e.g., Instructions to 2009 Mississippi State Tax Commission Form 85-100.

[Section 16:15]

[1] Okla. Stat. tit. 68, § 2365.

[2] Conn. Gen. Stat. § 12-719; Del. Code Ann. tit. 30, § 1158; Md. Code Ann. Tax-Gen. § 10-102.1(b); Vt. Stat. Ann. § 5914(c). See also Visions Unlimited, Inc. v. Director of Revenue, Delaware Tax Appeals Board, Dkt. No. 1444 (April 8, 2009).

[3] See Appendix 16A.

[Section 16:16]

[1] 35 Ill. Comp. Stats. § 5/709.5.

[2] Technically, S corporations in Utah must "pay or withhold" tax on

corporation itself to pay taxes on behalf of the nonresident shareholders) is triggered by an outside event, usually a nonresident shareholder's failure to file a written consent to taxation by a state or to comply with the state's individual tax return requirements.[4] In several states, withholding is the default rule, but shareholders can elect out of S corporation withholding if they file a consent to be taxed in that state or if the S corporation files a composite return and pays the state income tax on their behalf.[5] In a few states, S corporations are required to file estimated tax payments on behalf of the nonresident shareholders.[6] While most states require withholding from a shareholder's entire pro rata share as sourced to that state, a few states require withholding only if that share (or a portion thereof) is actually distributed to the shareholder.[7] De minimis exceptions in some states allow S corporations to refrain from withholding if the pro rata share is below the applicable dollar threshold.[8]

§ 16:17 Credits for taxes paid to other states

Because a state may constitutionally tax the income of its residents from all sources,[1] a resident shareholder of an S corporation doing business in another state faces the possibility of double taxation—in the state of residency (on the entire pro rata share of the corporation's income) and in the other states where the S corporation is doing business (on the portion of the pro rata share allocated to those states). In contrast, the problem of double taxation of C corporation distributions at the shareholder level does not exist. This problem occurs with S corporations because states often attribute or pass through the nexus of the S corporation to its shareholders. In contrast, as discussed above, the nexus that a C corporation has with a state cannot be attributed to its shareholders. States generally use credits for taxes paid to other states to mitigate the specter of double taxation of S corporation distributions.

Generally, states do not allow credits to a *shareholder* for taxes paid by the *S corporation* to another state. Most states do, however, allow credits to a resident shareholder for taxes paid by

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behalf of nonresident shareholders. Utah Code Ann. §§ 59-10-1403.2(1)(a), 59-10-1402(10).

[3] Va. Code Ann. § 58.1-486.2.

[4] See, e.g., N.J. Stat. §§ 54:10A to 5.22.

[5] See, e.g., Mo. Rev. Stat. § 143.471(5).

[6] See, e.g., N.Y. Tax Law § 658(c)(4)(A).

[7] See, e.g., Okla. Stat. Tit.68, § 2385.30.

[8] See, e.g., Cal. FTB Info. Pub. No. 1017 (Jan. 1, 2009) (withholding not required if distributions to a shareholder total less than $1,500).

[Section 16:17]

[1] See § 16:11, supra.

the shareholder to another state. A similar credit is allowed by many states to nonresident shareholders, but only if the nonresident shareholder's home state has reciprocity provisions. Both credits usually require that the income must be taxable in both states. Some states also limit the credit to certain types of income, such as compensation income.[2] Some 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 an S corporation on behalf of a nonresident shareholder, e.g., through withholding or a composite return, although a credit would seem necessary in order to avoid double taxation. Further complications arise when the S corporation does business in at least one state that does not recognize the S election. States that do not recognize the S election may not give credits for taxes paid on a shareholder's pro rata share of net income to a state that recognizes the S election, because that pro rata share is not taxable in both states. Similar results occur when the circumstances are reversed.

§ 16:18 State taxation of partnerships, limited liability companies classified as partnerships, and their owners

The ownership of an interest in a flow-through entity raises a number of state and local tax issues including: (a) whether the mere ownership of the interest in the flow-through entity creates nexus for the owner; (b) how the corporate owner's distributive share of the flow-through entity's income or loss will be treated for state tax purposes; (c) whether the flow-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.

The use of flow-through entities has evolved in recent years 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 or use tax savings

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[2] See, e.g., Okla. Stat. tit. 68, § 2357(B)(1).

can be achieved. Adoption by numerous states of simple legal entity conversion provisions has provided an easier avenue to change the legal classification of a subsidiary into a flow-through entity, typically a single member LLC.

§ 16:19 Summary of federal income tax rules applicable to partnerships

A partnership is not ordinarily subject to federal income tax. Instead, 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 tax year.[2]

Partners, like shareholders in an S corporation, are taxed on their "distributive" shares of the items that are allocated to them, whether or not 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 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 15% capital gains rate to the highest ordinary income rate of 35%.[7] As will be illustrated 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. Under the U.S. Treasury Department's landmark "check-the-box" regulations, 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] A partnership is the default tax classification for any domestic entity with two or more members.[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.

[Section 16:19]

[1] I.R.C. §§ 701, 703.

[2] I.R.C. §§ 702, 703, 704, 706.

[3] I.R.C. §§ 702, 703, 704, 706.

[4] I.R.C. § 702(b).

[5] I.R.C. § 704(a).

[6] Treas. Reg. § 1.704-1(b).

[7] I.R.C. § 1(a), (h).

[8] Treas. Reg. § 301.7701-3(a); see infra at § 16:20.

[9] Treas. Reg. § 301.7701-3(b)(1).

As with C and S corporations, forming 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 they 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 partnership interests.[13] Losses allocated to a partner reduce that partner's outside basis.[14] Generally, a partner cannot deduct losses in excess of that partner's basis in his partnership interest.[15] Losses that exceed the partner's outside basis do not pass through but 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 partner 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 an S corporation, ordinary income will be realized by the selling partner on the sale of his or her partnership interest to the extent the partnership holds inventory and unrealized receivables (this category of assets is broad and includes, among other things, assets with built-in depreciation recapture).[20]

§ 16:20 Entity classification—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 C corporation. Before reviewing the state rules, it is helpful to review the federal entity classification rules.

The U.S. Treasury Department's so-called "check-the-box"

[10] I.R.C. § 721(a); but see I.R.C. §§ 721(b), 707.

[11] I.R.C. § 722.

[12] I.R.C. § 723.

[13] I.R.C. § 705(a).

[14] I.R.C. § 705(a).

[15] I.R.C. § 704(d).

[16] I.R.C. § 704(d).

[17] I.R.C. §§ 705, 731(a); but see I.R.C. §§ 731(c), 704(c), 751(b).

[18] I.R.C. §§ 741, 1001(a).

[19] I.R.C. §§ 741, 1221, 1223(1).

[20] I.R.C. § 751(a) and (c).

regulations became effective as of January 1, 1997.[1] These landmark regulations simplify the way in which business entities are classified for federal income tax purposes and replace the old corporate characteristics test. As indicated elsewhere in this treatise in more detail, these regulations replaced the existing four characteristics test previously used to classify business entities: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) free transferability of interest. The much simpler approach of the regulations generally allows noncorporate entities to elect corporate or partnership tax status.

Under the check-the-box regulations, state law corporations must be treated as corporations for federal income tax purposes, whereas entities not automatically treated as corporations (referred to as "eligible entities") may elect their federal tax classification. An eligible entity with more than one owner can elect to be classified as either a corporation or a partnership. An eligible entity with only one owner can elect to be classified either as a corporation or as a disregarded entity (i.e., treated as a sole proprietorship, branch, or division, depending on the tax status of the owner).

The election must be filed on Form 8832 within 75 days after or up to twelve months before the desired effective date. Treasury Regulations § 301.7701-3(b) prescribes certain default rules that apply if no election is made. If a domestic eligible entity (generally, most U.S. entities that are not corporations) makes no election, it will be treated as a partnership if it has more than one owner and will be disregarded if it has only a single owner. If a foreign eligible entity makes no election, it will be treated as (1) a partnership if it has more than one owner and any owner does not have limited liability, (2) an association taxable as corporation if all owners have limited liability, or (3) disregarded if it has a single owner that does not have limited liability. If an election is made on Form 8832 to change the way an existing entity is taxed, a new employer identification number ("EIN") is not necessary. Effective January 1, 2009, however, a disregarded entity must obtain its own EIN in order to pay employment taxes. Disregarded entities without employees presumably may continue to use their owners' EIN and would not have to obtain a separate employer number.[2]

While the check-the-box regulations make selecting corporate or partnership taxation relatively easy, the state and local tax

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[Section 16:20]

[1]T.D. 8697, 61 Fed. Reg. 66584 (Dec. 18, 1996). For a discussion of "check-the-box" regulations as they relate to choice of entity, see Chapter 12.

[2]Treas. Reg. §§ 301.6109-1(d)(2)(ii), 301.7701-2(c)(2)(iv), and 301.7701-3(a).

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.[3]

§ 16:21 Entity classification—State entity classification conformity

In most states, the decision to conform to the check-the-box regulations for income tax purposes was not controversial. Almost all states that impose a corporate income tax, or its equivalent, have enacted legislation or announced in formal or informal guidance that they will classify an LLC in the same manner as it is classified for federal income tax purposes.[1] Full conformity, in this context, means that the state will classify an eligible entity as a partnership, corporation, or disregarded entity in accordance with the entity's federal classification under the check-the-box regulations. A few of the more notable non-conformity states are identified below.[2]

§ 16:22 Entity classification—Examples of state disconformity with check-the-box rules

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 have elected 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.

Alabama. Effective January 1, 2010, Act 2009-621 enacts the Alabama Uniform Limited Partnership Act of 2010, which includes language 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 regarding sales, use, rental, lodging, excise, and property taxes.

Florida. Florida follows the check-the-box regime for LLCs.[1] For purposes of its corporate income tax, however, it appears that any kind of state law partnership (including LPs and LLPs)

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

[Section 16:21]

[1]See Appendix 16A, Chart 2, Tax treatment of LLCs/LLPs/LPs ("LLEs") by states imposing net worth- or debt-based corporate franchise taxes.

[2]For the appropriate statutory citations, see the chart in Appendix 16A.

[Section 16:22]

[1]Fla. Stat. §§ 220.02(1), 608.471.

may not elect to be taxed as a corporation.[2]

Kentucky. As discussed below in § 16:26, effective for tax years beginning on or after January 1, 2005 but before January 1, 2007, Kentucky disavowed an entity's federal tax classification in most cases and imposed its corporate income tax on the entity. For taxable years beginning on or after January 1, 2007, however, 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.

Louisiana. In Revenue Ruling 01-013, the Louisiana Department of Revenue concluded that the classification of LLCs for Louisiana franchise tax (as opposed to income tax) purposes will not be governed by the check-the-box regulations. The ruling focused on those entities that affirmatively checked the box to be taxed as corporations for federal income tax purposes. Nonconformity has its advantages, however. For instance, the Louisiana Department of Revenue concluded that an LLC that is taxed federally as an S corporation (which is permitted by the IRS) is not subject to the state franchise tax, even though a state law corporation taxed federally as an S corporation generally is subject to the tax.[3]

Massachusetts. For tax years beginning on or after January 1, 2009, Massachusetts fully conforms to the check-the-box regulations. The previous differences between the Massachusetts and federal entity classification rules are eliminated and the filing status for business entities in Massachusetts must conform to their filing status for federal tax purposes. The conformity to the check-the-box regulations has resulted in changes to state filings for corporate trusts, S corporations, and financial institution S corporations.[4]

New Hampshire. Despite following the check-the-box regime in determining a partnership's or an LLC's classification as a corporation or a partnership, New Hampshire does not conform to the federal classification for single-member entities. A single-member entity must file its own New Hampshire business profits tax return that corresponds to the type of entity filed with the

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[2] Fla. Stat. § 220.03(1)(e).

[3] La. Info. Bulletin No. 04-023 (Dec. 1, 2004).

[4] See Mass. Gen. L. ch. 63 §§ 30(1), (2) and (16); see also Massachusetts Tech. Information Release 08-11 (Aug. 15, 2008).

IRS and cannot file a joint return with another entity.[5]

Tennessee. Tennessee no longer fully conforms to an entity's classification under the check-the-box regulations. Entities that are disregarded for federal tax purposes, except for LLCs whose single member is a corporation subject to Tennessee tax, are not disregarded for Tennessee franchise and excise tax purposes.[6]

Texas. For Texas franchise tax reports due before January 1, 2008, all LLCs (but not LPs, LLPs, or LLLPs)—including single-member LLCs—are treated as corporations.[7] Beginning January 1, 2008, most pass-through entities (including LPs, LLPs and LLCPs) are subject to the new franchise "margin" tax.

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 likewise 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 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.

In addition, 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 is intended to protect the owners of the entities from facing use tax liability solely on account of this legislation.

§ 16:23 Entity classification—Series limited liability companies

At least eight states have enacted series LLC legislation.[1] In a "series" LLC, each "series" of members, managers, and member-

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[5] N.H. Admin. Rules § 307.01(h); see also Tech. Information Release 2008-001 (Mar. 4, 2008); and Tech. Information Release 2010-002 (Mar. 15, 2010).

[6] Tenn. Code Ann. § 67-4-2106(c).

[7] Tex. Admin. Code § 3.562.

[Section 16:23]

[1] Del. Code 6 § 18-215; 805 Ill. Comp. Stat. 180/37-40; Iowa Code § 489.1201; Nev. Rev. Stat. §§ 86.161; 18 Okla. Stat. tit. 18, § 2005; Tenn. Code Ann. § 48-249-309; Tex. Bus. Org. Code § 101.601 et seq., (eff. Sept. 1. 2009); Utah Code Ann. § 48-2c-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).

ship interests is treated separately, almost as if each series were a separate LLC, so that "the debts, liabilities, and obligations incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and not against the assets of the limited liability company."[2]

Although the initial presumption was that states would treat the entire LLC as one entity for tax purposes—even though the main purpose of the series is to segregate the assets of the different series and the ownership thereof—a recent IRS private letter ruling held to the contrary.[3] Precedent for having more than one entity for tax purposes in a single state law business entity can be found in an IRS ruling involving a Delaware business trust.[4] The IRS announced that guidance on classification of series entities is included in its 2008–2009 Priority Guidance Plan, at the urging of the American Bar Association Section of Taxation.[5]

The early trend among state taxing authorities appears to treat each series as a separate entity, although there are very few rulings on the issue and apparently no statutory or regulatory guidance, with the possible exception of Illinois as discussed at bottom. This treatment appears to be the simplest and fairest from a state tax perspective; treating different series in the same LLC as being in the same entity could present difficult accounting and other issues. For example, noncompliance with a withholding requirement or failure to file a jurisdictional consent form by a single nonresident member of one series could subject the entire LLC to income tax or penalties.

To date, only Massachusetts has published any sort of in-depth analysis of series LLC taxation issues, and that analysis was very fact-specific.[6] The ruling concluded that each series would be classified in accordance with its federal tax classification, which was similar to a private ruling received from the Delaware Department of Finance by the authors' firm.[7] A New York ruling indicates that each series LLCs would be treated as a

[2]Iowa Code § 490A.305(2).

[3]Priv. Ltr. Rul. 200803004 (Oct. 15, 2007). See also A. Donn, et al., "Series LLCs," Choice of business Entity—2010 (ALI-ABA Feb. 18, 2010).

[4]Priv. Ltr. Rul. 9435015 (June 3, 1994).

[5]U.S. Department of Treasury 2008–2009 Priority Guidance Plan, Highlights and Documents, Sept. 10, 2008 Tax Analyst Doc. 2008-19306, http://www.irs.gov/pub/irs-il/2008-2009pgp.pdf.

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

[7]Delaware Dept. of Finance, Div. of Revenue, Private Letter Ruling (Sept. 16, 2002) (on file with the authors).

"partnership."[8] In its publication on LLCs, the California Franchise Tax Board summarily provides that "[e]ach series in a Series LLC is considered a separate LLC" and requires that each series in a Delaware series LLC file its own Form 568, Limited Liability Company Return of Income, and pay its own separate LLC annual tax and fee.[9]

It is also interesting to note that the Illinois series LLC statute provides that "[a] series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization."[10] The statute further provides that the "limited liability company and any of its series may elect to consolidate their operations as a single taxpayer to the extent permitted under applicable law," thereby indicating that the default rule is to treat each series as a separate taxpayer.[11]

Although additional federal guidance is expected to be released soon, the IRS has implicitly indicated its intention to treat each series in a series LLC as a separate entity. Indeed, in PLR 200803004, the IRS provided its first published ruling on the taxation of a series LLC. The private letter ruling was issued 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 would be a separate entity for federal income tax purposes and each series is therefore entitled to choose its own entity 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.

§ 16:24 State entity-level taxation—In general

Although the majority of states do not impose entity-level taxes on partnerships or LLCs treated as partnerships for federal

[8] N.Y. TSB-A-98(8)I (Sept. 4, 1998).

[9] California FTB Informational Publication No. 3556 (rev. July 1, 2008); see also "California Takes a Stand on Delaware Series LLC But There's No News From IRS . . .", 104 Journal of Taxation 315 (May 2006). See generally M. McLoughlin & 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).

[10] 805 ILCS 180-370(b).

[11] 805 ILCS 180-370(b).

income tax purposes,[1] 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. Some of the more significant entity-level taxes are noted below.[2] 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; the discussion below generally does not include these types of "fees" totaling less than $1,000.[3] The discussion in the next two sections also generally does not include withholding-like taxes that may technically be imposed on the entity but are measured by the distributive shares of non-resident members or partners. States may have alternative taxation schemes for particular industries, such as financial institutions or insurance companies; these also are not considered below.

§ 16:25 State entity-level taxation—Income or receipts-based taxes

California. California imposes an entity-level franchise (income) tax on LLCs unless the owner or owners consent, in writing, to state tax jurisdiction. In addition, LLCs are annually subject to the $800 minimum franchise tax and the controversial LLC fee ranging from $900 to $11,790, depending on the LLC's "total income" from California sources.[1] Before 2007, this fee was not apportioned (it was based on gross receipts from all sources) and was quickly declared unconstitutional in violation of the Commerce Clause. Litigation continues concerning the amount of refunds available for taxpayers in differing situations.[2]

District of Columbia. D.C. imposes a 9.975% franchise (income) tax on unincorporated businesses with gross receipts in

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[Section 16:24]

[1]See Appendix 16A, Chart 2.

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

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

[Section 16:25]

[1]Cal. Rev. & Tax. Code §§ 17941, 17942.

[2]Northwest Energetic Services, LLC v. California Franchise Tax Bd., 159 Cal. App. 4th 841, 71 Cal. Rptr. 3d 642 (1st Dist. 2008), as modified on denial of reh'g, (Mar. 3, 2008) and review denied, (June 11, 2008); Ventas Finance I, LLC v. California Franchise Tax Bd., 165 Cal. App. 4th 1207, 81 Cal. Rptr. 3d 823 (1st Dist. 2008), review denied, (Nov. 12, 2008) and cert. denied, 129 S. Ct. 1917, 173 L. Ed. 2d 1076 (2009); see also Bakersfield Mall LLC v. Franchise Tax Board, Cal. Super. Ct., No. CGC-07-462728 (currently pending in the trial court, this case involves an LLC that derived its income solely from within California).

excess of $12,000. Certain service-based partnerships may be exempt.[3] In addition, entities with gross receipts in the District 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.[4]

Illinois. Flow-through entities, such as S corporations, partnerships and multi-member LLCs, are subject to the 1.5% "personal property replacement tax," which is based on net income. Certain investment partnerships are exempted from this tax.[5] C corporations are taxed at a rate of 2.5%. While a multi-member LLC would only pay the tax on 1.5% of its net income, a corporate member would 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.

Kentucky. In 2005 and 2006, Kentucky imposed its corporate income tax on virtually all entities (other than general partnerships, publicly-traded partnerships, and other "qualified investment partnerships"). "Corporations" that were members or partners in LLCs, LPs, and LLPs in turn could exclude from their gross income their allocable share of entity items determined according to federal income tax principles only if the LLC, LP, or LLP was also doing business in the state and subject to corporate income tax.

Effective January 1, 2007, however, many of these changes were undone, and Kentucky now exempts entities treated for federal income tax purposes as partnerships from the Kentucky corporate income tax. LLCs, LPs, and LLPs are instead subject to a new Kentucky "limited liability entity tax," which is generally the lesser of 0.095% of Kentucky gross receipts or 0.75% of Kentucky gross profits. The pass-through entity members are generally allowed a credit against their respective Kentucky income tax liabilities in the amount of their shares of the entity-level tax.[6]

Michigan. Prior to 2008, the Michigan Single Business Tax ("MSBT") was imposed on "every person with business in this state that is allocated or apportioned to this state;" including LLCs (but not SMLLCs) and partnerships. The MSBT was a type of value-added tax; its tax base began with either federal taxable

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[3] D.C. Code §§ 47-1805.02, 1805.08.

[4] D.C. Code § 47-2762.

[5] 35 Ill. Comp. Stat. 5/205(b).

[6] Ky. Rev. Stat. Ann. § 141.0401. See M. Foster, "Kentucky Modifies Recent Tax Act to Give Small Business Tax Relief, Pass-Through Entity Changes," 16 Journal of Multistate Taxation and Incentives 42 (Oct. 2006).

income or gross receipts, depending on the taxpayer.[7]

The MSBT phased out at the end of 2007. In 2008, the Michigan Business Tax (MBT) became effective and applies to all persons, which is defined to include LLCs and partnerships. The MBT consists of both a business income tax, which is equal to 4.95% of the business income base apportioned to Michigan; a modified gross receipts tax equal to 0.8% of gross receipts apportioned to Michigan; and a 21.99% surcharge on allocated and apportioned income before credits with a cap of $6 million. Taxpayers may deduct purchases from other firms from their gross receipts base. Financial institutions and insurance companies are subject to their own tax regimes and not to MBT.[8]

New Hampshire. Partnerships and LLCs doing business in New Hampshire are subject to the 5% tax on dividends and interest and the 8.5% business profits (income) tax.[9] Note that the entities are also subject to the business enterprise tax, which is based on compensation, interest, and dividends paid, as discussed below.

New York. Effective January 1, 2008, New York imposes a filing fee based on the New York source gross income of LLCs and LLPs. The fee ranges from $25 to $4,500.[10]

Ohio. Ohio's relatively new Commercial Activity Tax (CAT)—a gross receipts-based tax—applies to all entities with gross receipts in excess of $150,000 and makes no exception for partnerships or LLCs.[11]

Tennessee. Tennessee's excise tax (6.5% of net earnings) and franchise tax ($0.25 per $100 of net worth) applies to LLCs, LLPs, and LPs. General partnerships and sole proprietorships are not taxed. Several exemptions apply, including for certain venture capital funds, family-owned limited liability entities that engage in farming or hold personal residences, and closely-held entities engaged in certain other financing activities (such as acquiring notes or accounts receivable), often called "FONCEs."[12]

Texas. Texas's new franchise "margin" tax, generally taxes all business entities in the same manner. Only a few entities, such as general partnerships owned by natural persons, certain "passive entities," family limited partnerships, and insurance

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[7] Mich. Dept. of Tax. Revenue Administrative Bulletin 1999-9 (Nov. 29, 1999).

[8] Mich. Comp. Laws. Ann. §§ 208.1101 to 208.1579; See S. Grob and W. Roberts, "The Michigan Business Tax Replaces the State's Much-Vilified SBT," 17 Journal of Multistate Taxation and Incentives 8 (Oct. 2007).

[9] N.H. Rev. Stat. chs. 77, 77-A.

[10] N.Y. Tax Law § 658(c)(3).

[11] See Ohio Rev. Code Ann. § 5751.01(A).

[12] Tenn. Code Ann. §§ 67-4-2004(32), -2005, -2007, -2105.

companies, are exempt. Thus, effective January 1, 2008, LLCs, LPs, and LLPs are subject to a "margin" tax equal to 0.5% (for retailers and wholesalers) or 1% (all others) of the lowest of: (1) 70% of total revenue; (2) total revenue minus cost of goods sold; or (3) total revenue minus compensation.[13]

Washington. All entities are subject to the Washington Business & Occupations ("B&O") Tax on gross receipts.[14]

§ 16:26 State entity-level taxation—Net worth or other taxes

Alabama. Alabama imposes a net-worth based "business privilege" tax on all corporations as well as certain limited liability entities, including single member LLCs if the member-owner is not itself subject to the tax. The tax is generally capped, however, at $15,000, and for "family limited liability entities" the maximum is $500—but the cap is $3 million annually for a "financial institution group."[1]

Kansas. Pass-through entities (except general partnerships) and SMLLCs with capital accounts in the state of at least $1 million are subject to Kansas franchise tax. This tax is being phased out by 2011; in 2010, the rate is 0.03125% of capital accounts located in or used in Kansas.[2]

Minnesota. Non-farming pass-through entities in Minnesota are subject to a fee or tax ranging from $0 to $5,000. The amount of the fee is based on the sum of the partnership's Minnesota property, payroll, and sales or receipts.[3]

New Hampshire. Partnerships and LLCs doing business in New Hampshire are subject to the 0.75% business enterprise tax. The tax is based on the "enterprise value tax base" of the entity. The enterprise value tax base is equal to the sum of all (1) compensation paid or accrued, (2) interest paid or accrued, and (3) dividends paid by the business enterprise during the tax period, before special adjustments and apportionment.[4]

New Jersey. New Jersey imposes a fee equal to $150 per

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[13] Tex. Tax Code Ann. § 171.001. For an overview of the franchise tax changes in Texas, see D. Jackson & J. Wellington, "Major Tax Reform in Texas: An Overview of the State's New Margin Tax," 16 Journal of Multistate Taxation and Incentives 8 (Oct. 2006).

[14] Wash. Rev. Code § 82.04.030.

[Section 16:26]

[1] Ala. Code § 40-14A-22(a) to (d).

[2] Kan. Stat. Ann. § 79-5401(a)(2).

[3] Minn. Stat. § 290.0922, Subd. 1(b).

[4] N.H. Rev. Stat. chs 77-E.

owner of pass-through entities, with a maximum fee of $250,000.[5]

Pennsylvania. LLCs—but not LPs or LLPs—are subject to the Pennsylvania capital stock and franchise tax, which is based on "taxable stock value." Taxable stock value includes a capitalized average net income component and a net worth component.[6] This tax is scheduled to be phased out after 2010, with rates declining to 1.89 mills in 2009 and 0.89 mills in 2010.[7]

§ 16:27 State entity-level taxation—Taxes on single member LLCs

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 single-member LLC with a corporate member is not subject to a tax, while a LLC with a single individual member is subject to the tax.[1]

Because a single-member LLC 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 on its own taxable sales or acquisitions. 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, the sale may be subject to various state transaction and transfer-related taxes.

Also, in selecting the form of business entity, it is wise to consider whether the states follow the IRS pronouncements and new regulations on whether a single-member LLC 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.[2]

§ 16:28 Nexus and doing business

If a corporate owner's only connection with a state is the owner-

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[5] N.J. Rev. Stat. § 54A:8-6(b)(2).

[6] Pa. Stat. Ann. Tit. 72, §§ 7601, 7602.

[7] Pa. Stat. Ann. Tit. 72, § 7602(h).

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

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

ship of an interest in a flow-through entity doing business in the state, is the corporate owner subject to that state's net income-based tax?

In many states, by statute a corporation is subject 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 in the state. A few states (such as Alabama and Louisiana) have adopted both a net worth- or debt-based franchise tax and a corporate income tax and thus impose their franchise tax on corporations doing business in the state, while imposing the corporate income tax on corporations that are not necessarily doing business in the state but are deriving income from sources in the state.

Is a corporate or LLC partner or member considered to be doing or transacting business in the state merely because it owns an interest in a flow-through entity that is doing business in the state? Until recent statutory and regulatory changes, a number of states varied the treatment of corporate partners depending on the type of ownership interest, thereby taxing corporate general partners but not taxing limited partners. A few states still make this distinction.

Several states have applied the aggregate or conduit theory in determining that the partnership's nexus with a state passes through to the corporate partner. Under this theory, the corporation is treated as having a ratable share of each partnership item, and thus it would have nexus in the states where the partnership is engaged in activities that create taxable nexus.[1] While an LLC may be taxed like a partnership, an argument can be made that the entity and aggregate theories applicable to partnerships are not applicable with respect to an LLC. Although it is unlikely many states will easily accept that position, a corporation should not automatically assume that it is subject to state tax if its only connection with the state is holding an interest in an LLC doing business in the state.[2]

If an LLC is treated as a partnership for state tax purposes, it

[Section 16:28]

[1] Borden Chemicals and Plastics, L.P. v. Zehnder, 312 Ill. App. 3d 35, 244 Ill. Dec. 477, 726 N.E.2d 73 (1st Dist. 2000).

[2] For a thoughtful treatment of this issue involving a nonresident limited partner of a limited partnership, see Lanzi v. Alabama Dept. of Revenue, 968 So. 2d 18 (Ala. Civ. App. 2006) (rejected by, Prince v. State Dept. of Revenue, 2010 WL 245578 (Ala. Civ. App. 2010)) (holding, on Due Process Clause grounds, that the nonresident limited partner did not have nexus with the state); see also J. Hellerstein & W. Hellerstein, State Taxation ¶ 20.08[2][a][ii] (2006); B. Ely & M. Houser, "Alabama: No Income Tax Nexus for Nonresident Limited Partner in Investment Partnership," 17 Journal of Multistate Taxation and Incentives 38 (August 2007).

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 similar to general partners.

Regardless of the theory adopted by a state, partnership law has changed such that the prior theories may no longer be valid.[3]

§ 16:29 Nexus and doing business—Selected states

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. In Arizona Dept. of Revenue v. Central Newspapers, Inc., 222 Ariz. 626, 218 P.3d 1083 (Ct. App. Div. 1 2009), 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.

California. Effective January 1, 2007, Cal. Corp. Code § 17001(ap)(1) provides that 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.

Georgia. In 2002, the Georgia Department of Revenue amended Revenue Rule 560-7-7-.03 to provide that a corporation will be considered to be owning property or doing business in

[3]See, e.g., Revised Uniform Partnership Act (RUPA) (1996) §§ 201(a) ("a partnership is an entity distinct from its partners"), 203 ("property acquired by a partnership is property of the partnership and not of the partners individually"); Uniform Limited Liability Company Act (ULLCA) § 201 ("A limited liability company is a legal entity distinct from its members"); Calif. Corp. Code § 17300 ("A membership interest . . . constitute[s] personal property of the member . . . A member . . . has no interest in specific limited liability company property"): Minn. Stat. Ann. § 322B.30 ("A member has no interest in specific LLC property. All property of the LLC is property of the LLC itself"); New York LLC Law § 601 ("A membership interest in the limited liability company is personal property. A member has no interest in specific property of the limited liability company.").

Georgia whenever the corporation is a partner, whether limited or general, in a partnership that owns property or does business in Georgia. The amended rule also provided that a corporation that is a limited partner in a business partnership must include its pro rata share of partnership property, payroll, and gross receipts in its own apportionment formula. The validity of the regulation is questionable given that it runs contrary to case law and previous Georgia Attorney General opinions.

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."[1]

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.[2]

In *Asworth Corporation v. Revenue Cabinet*,[3] the Kentucky Board of Tax Appeals determined that a foreign corporation was not subject to that state's corporate income tax based solely on its ownership of the interest in a partnership doing business in Kentucky. 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, 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.[4] Interestingly, 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 taxpayer has filed a motion for discretionary review with the Kentucky Supreme Court seeking review of the Court of Appeals' decision.

Massachusetts. The activities of a partnership are generally

[Section 16:29]

[1] Idaho Admin. Rule 35.01.01. 620(02).

[2] 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.

[3] Order No. K-19449 (Jan. 27, 2006).

[4] Revenue Cabinet v. Asworth Corp., 2009 WL 3877518 (Ky. Ct. App. 2009), as modified, (Feb. 5, 2010).

attributed to all partners, including limited partners, for purposes of determining whether a corporate partner is "doing business" in Massachusetts.[5] 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 this de minimis rule.

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 partnership).[6]

In addition, North Carolina Department of Revenue regulation, 17 N.C. Admin. Code § 5C.17.01, attributes income tax nexus to partners or members of LPs or LLCs with income from sources in North Carolina.

Oregon. In *Criv Investments, Inc. v. Department of Revenue*,[7] the Oregon Tax Court held that a foreign corporation that was a limited partner in partnerships engaged in real estate activity in Oregon was subject to corporate income tax. The court held that although the taxpayer's Oregon activities may not rise to the level of "doing business" within Oregon, the taxpayer is sufficiently connected to Oregon because it is a limited partner in partnerships doing business within Oregon and realizing income from this activity. Accordingly, Oregon can tax the entity on its distributive share of the partnership's income.

Texas. Texas Franchise Rule 34 Texas Admin. Code § 3.546(c)(12)(B) provides that a non-Texas corporation that is a limited partner in an LP doing business in Texas is not doing business in Texas. This regulation is of limited use in future years, however, since the limited partnership itself must pay the new Texas "margin tax" beginning in 2008.

Virginia. In Va. Pub. Doc. Rul. No. 95-19 (Feb. 13, 1995), the Virginia Department of Taxation ruled that a corporate limited partner of an LP doing business in Virginia is subject to corporate income tax unless: (a) all general partners are unrelated third parties; (b) the combined capital and profits interests held by the corporate partner and all related parties are 10% or less of the total outstanding partnership interests; and (c) the structure is not a "device primarily designed to avoid Virginia taxation." In

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[5]Mass. Reg. 830 CMR 63.39.1(8)(a).

[6]N.C. Final Decision No. 97-548 (Apr. 4, 1998).

[7]Criv Investments, Inc. v. Department of Revenue, 14 Or. Tax 181, 1997 WL 215719 (1997).

this ruling, the Department found that a 99% corporate limited partner, affiliated with the 1% general partner, was subject to tax in Virginia, notwithstanding a prior ruling, Va. Pub. Doc. Rul. No. 88-235 (Aug. 10, 1988), that exempted limited partners from corporate income tax liability.

In *DiBelardino v. Virginia Department of Taxation*,[8] and *Dutton v. Virginia Department of Taxation*,[9] however, 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 does not have the requisite minimum contacts with the state under the Due Process Clause. The court also relied in part on the Commerce Clause although its analysis was not complete. In both cases the taxpayer-members were found to be passive owners, but in the DiBelardino's case, they were found to have nexus because they also owned two bed-and-breakfast inns in Norfolk. The circuit court at Richmond agreed with the Virginia Department of Taxation that the income in question was Virginia source income but nevertheless ruled for Mr. Dutton in his case because nothing in the record indicated that he had any contact with Virginia other than the ownership of his LLC membership interest.

Both cases were appealed to the Virginia Supreme Court but dismissed on procedural grounds. Parallel with the State of Alabama and the *Lanzi* ruling, the Virginia legislature enacted a nonresident owner withholding statute, effective for tax years beginning in 2008.[10]

Wisconsin. In 2001, the definition of "doing business" was expanded to include "owning, directly or indirectly, a general or limited partnership interest in a partnership that does business in Wisconsin, regardless of the percentage of ownership; and owning, directly or indirectly, an interest in an LLC that does business in this state, regardless of the percentage of ownership, if the LLC is treated as a partnership for federal income tax purposes."[11] In addition, the law provides that the LP's or LLC's apportionment factors are attributed to its partners/members for purposes of computing their Wisconsin tax liability.

Prior to the law change, the Department of Revenue had ruled that a corporation's limited partnership interest in a partnership doing business in Wisconsin did not establish nexus over the out-

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[8]DiBelardino v. Virginia Department of Taxation, Case No. CL06-5696 (June 22, 2007).

[9]Dutton v. Virginia Department of Taxation, Case No. 06-6291 (June 22, 2007).

[10]See S.B. 1238 (Va. 2007).

[11]Wisconsin 2001 Budget Act (Act 16).

of-state corporation.[12]

§ 16:30 Inclusion in corporate owner's tax base

While most states have taken the position that merely holding a partnership or LLC interest in an entity doing business in or deriving income from that state creates nexus for the nonresident partner or member, the manner in which the distributive share of the flow-through entity's income is taxed varies among those states. If the corporate owner's distributive share of flow-through income constitutes business income to the corporate owner, the two primary methods under which a corporate owner that is incorporated or commercially domiciled in another state is to report its state tax base are by (1) separate accounting (apportionment at the flow-through entity level) or (2) total corporate business income (i.e., the partnership income or loss is aggregated with the corporation's other business income or loss). In most cases, the resulting tax liability in the taxing state varies significantly under these two methods.

In several states, resolution of this question depends on whether the owner and entity are engaged in a unitary business or, conversely, a discrete business enterprise. In the authors' view, the constitutionally correct position is that consolidating the corporate owner's and the pass-through entities' income and apportionment factors is permissible only when the pass-through entity and the corporate owner are engaged in a unitary business.

In *BP Oil Pipeline Company v. Illinois Department of Revenue*,[1] the Illinois Appellate Court affirmed a Cook County Circuit Court ruling that a corporate partner of a unitary partnership must combine its distributive share of partnership income with its own income for apportionment of the partner's income. The Illinois Department of Revenue recently amended its apportionment regulation to require the flow-up of apportionment factors in a tiered partnership structure where the partner and partnership are unitary. Previously, second-tier partnerships were not considered to be unitary, and the apportionment factors from such partnerships did not flow up.

Is the business/nonbusiness income determination made at the partnership (LLC) level or at the partner (member) level? While the answer can result in sizeable tax differences for the corporate partners, surprisingly few states have provided any formal guid-

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[12] Wisconsin DOR Private Letter Ruling W9853009 (Oct. 12, 1998).

[Section 16:30]

[1] BP Oil Pipeline Co. v. Illinois Dept. of Revenue, 212 Ill. 2d 528, 291 Ill. Dec. 706, 824 N.E.2d 282 (2004).

ance on this issue.

Pennsylvania Department of Revenue regulations provide that the determination is always made at the partner level. Pa. Reg. § 153.29(c)(2) provides: "[I]ncome is determined to be either business or nonbusiness income depending upon the relationship to the trade or business of the corporate partner, not of the partnership." Illinois DOR Regulation 100.3500(b)(1), on the other hand, provides that "the determination of whether an item of base income is business income or nonbusiness income shall be based on the facts and circumstances of the partnership itself." The latter approach seems to reflect the majority rule.

§ 16:31 Composition of corporate owner's apportionment factors

Where separate accounting is not allowed, the composition of a corporate owner's apportionment factors (which are used to determine the portion of the corporation's income taxable by a state) also varies among the states. Under the primary methods, the corporation's apportionment formula may: (1) be based solely on the corporation's own apportionment factors (without regard to the apportionment fractors of the pass-through entity); (2) pass through the corporation's share of the flow-through entity's payroll, property, and sales and then aggregate those amounts with the corporation's own factors; or (3) be based on the corporation's own factors, except that the distributive share of the flow-through entity's income is included in the receipts or sales factor (i.e., schedule K-1 income is treated like a receipt).

Many states provide that the apportionment factors of a partnership flow-through or "flow-up" to the corporate partner only if the partnership and partner are engaged in a unitary business. If they are not engaged in a unitary business, the partnership income is apportioned at the partnership level and then treated similarly to allocable income for the corporate partner. For example, California Reg. § 25137-1 provides that if a partner and partnership are unitary or engaged in the same trade or business, the partner's proportionate share of factors, income and loss flow-up and are apportioned (or allocated) at the partner level. If the partner and partnership are non-unitary, income is apportioned at the partnership level. Income apportioned or allocated to California at the partnership level then flows-up and is added to the partner's California taxable income.

Even where the state may require the flow-up of the owner's pro rata share of the flow-through entity's apportionment factors, the state may or may not require the elimination of the sales and rentals between the owner and the flow-through entity. For example, California Reg. § 25137-1(f)(3) provides that intercompany transactions are eliminated, even if the partner and partnership are non-unitary. Oregon has a similar rule for transactions between a corporate member and the pass-through entity, but requires elimination of transactions between an affiliate of the corporate member and the pass-through entity only if the affiliate is unitary with the corporate member.[1] As one can imagine, significant apportionment factor traps or planning opportunities exist.

In many states, it is unclear how the sales throwback rule applies in situations involving flow-through entities. For example, assume a partnership has a factory located in State A and has sales in every state, but only has nexus in State A, which has adopted a sales throwback rule. The partnership is equally owned by Corporation X and Corporation Y; Corporation X is taxable in every state, but Corporation Y is taxable only in State D. Is the sales throwback rule computed at the partnership or the partner level? Obviously, the answer could provide significantly different tax liabilities for the two corporate partners.

For example, the Illinois Department of Revenue issued guidance on this issue. Question and Answer 6 of the Income Tax section of the 2001 Practitioners' Questions and Answers provides insight into the sales factor throwback calculation for Illinois tax purposes.

> Question 6: Illinois Income Tax Sales Factor Throwback Calculation. For purposes of computing throwback for a partnership's sales originating in Illinois, is the partnership deemed to be subject to tax in every state where its unitary corporate partner is subject to tax or does the partnership determine its taxable presence in other states on a stand-alone basis?
>
> Response: Illinois is a "Joyce rule" state.[2] Under the Joyce rule, the partner's nexus is irrelevant to the computation of the partnership's sales factor. Sales by the partnership to a state with which it has no stand-alone nexus are thrown back, even when that sales factor will be combined with the sales factor of a unitary partner who does have nexus with that state. Similarly, sales by a partnership with no stand-alone nexus with Illinois will not be in the numerator of its sales factor, even when that sales factor will be combined with that of a unitary partner who does have nexus with Illinois. This is no different from the application of the Joyce rule to a combined group in which some of the corporations have no stand-alone nexus with Illinois or other states in which they make sales.

§ 16:32 Resident and nonresident partners generally

As is the case with S corporation shareholders, resident members of pass-through entities are generally taxable on their

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[1] Or. Admin. Rul. 150-314.650(8), to (9).

[2] See Ill. Reg. § 100.9720(f).

entire distributive share of the entity's income. Thus, there generally is no apportionment of the entity's income for resident members. They may, however, often take credits for taxes paid to other states on portions of this same income.[1] A few states, however, allow apportionment at the entity-level for individual members; in these states residents are only taxed on their share of the entity's income apportioned or allocated to that state.[2]

Subject to the discussion of nexus above,[3] nonresident individual members of pass-through entities are generally subject to income tax on their share of a pass-through entity's income apportioned to that state (at the entity level).

§ 16:33 Compliance and enforcement mechanisms for nonresident owners

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

There is little question the state has the power to tax the pass-through entity directly on income attributable to that state, and most states 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 members and partners.

The Multistate Tax Commission Uniformity Committee has issued one such proposal to increase compliance for flow-through entities and their nonresident owners.[1] The initial draft would have required mandatory withholding or composite returns for flow-through entities that have nonresident owners; a later draft would have made the entity liable for the tax for nonresident owners who either (1) do not sign a content-to-taxation-in-the-

[Section 16:32]

[1]See § 16:11 and § 16:17, supra.

[2]See, e.g., Ala. Admin. Code r. 810-3-14-.01(16).

[3]See § 16:28 and § 16:29, supra.

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[1]J. Biek, "Multistate Tax Commission Attempts to Bring Uniformity to Passthrough Entity Income Tax Compliance for Nonresident Members," 7 Journal of Passthrough Entities 13 (May/June 2004).

state agreement, or (2) do sign the consent but fail to pay the tax. The final draft was similar to the first draft, which does not relieve the entity of liability even if the nonresident owners file consents.[2]

A growing number of states are following the S corporation paradigm and adopting a composite return mechanism, which in many of those states is required unless all nonresident partners or members file with the state taxing authority a one-time consent to taxing jurisdiction and agreement to file income tax returns with that state so long as the nonresident owns an interest in the partnership.[3] Appendix 16A contains a brief discussion of withholding requirements in each state.

§ 16:34 Credits for taxes paid to other states

Because a state may constitutionally tax the income of its residents from all sources,[1] 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 distributive share) and in the other states where the partnership is doing business (on the portion of the distributive share allocated or apportioned to that state). This problem occurs with both partnerships and S corporations because states often attribute or pass-through the nexus a partnership or S corporation has with a state to its partners or shareholders. 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 paid by the partnership 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 shareholders, 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. Other states further limit the credit to certain types of income, such as compensation income.[2] Some 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

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[2]See http://www.mtc.gov/meetings/0103ExecComm__Files/IX__B.pdf.

[3]For S corporations, see § 16:13 to § 16:16, supra. For an in-depth survey of each state's withholding or composite return requirements, see J. Fenwick et al., State Taxation of Pass-Through Entities and Their Owners, chap. 4–6 (2009).

[Section 16:34]

[1]See § 16:17, supra.

[2]See, e.g., Okla. Stat. tit. 68, § 2357(B)(1).

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.

§ 16:35 Tax planning strategies

Recognizing of the fact that there are divergent rules with respect to the state-to-state or state-federal tax treatment of a particular partnership entity provides the multistate taxpayer with the chance to use the differences to its benefit. Savings can be achieved, for example, with planning mechanisms that take advantage of the fact that an LLC is recognized as a separate taxable entity in one jurisdiction, yet treated as part of a larger one in another. Resulting tax benefits may include desired nexus creation or severance, non-recognition of gains due to the fact that a transaction is classified as "intercompany," jurisdictional tax exemptions based on entity status, additional factor flow-through denominator representation, and the netting of gains and losses between separately-viewed entities.

All suggested tax planning strategies should be reviewed, however, in light of practical business considerations and the additional administrative and other costs that might be incurred—or would be ongoing. In some cases, the minimization of state taxes may not be prudent from a business perspective—or recently, from a political perspective.

Tax Base Opportunities. Although not as useful in many states as it once was, the use of a limited or other partnership structure still is a viable nexus or tax base planning vehicle in a few states. In addition, in some states the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and NCCUSL comments may be used to support positions that the mere ownership of a partnership or LLC interest in an entity operating in the state is not sufficient to create nexus and a filing obligation for a corporate partner or member.[1]

Allocation and Apportionment Opportunities. It may be possible to use flow-through entities to generate apportionment factor dilution or allocable, rather than apportionable, income to generate state tax savings.

Use of Limited Liability Companies to Avoid or Reduce Net Worth-based Taxes. Since several states impose a franchise or net worth tax only on true corporations, using LLCs and

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[Section 16:35]

[1]See, e.g., Revenue Cabinet v. Asworth Corp., 2009 WL 3877518 (Ky. Ct. App. 2009), as modified, (Feb. 5, 2010). See also M. Sommer, "Kentucky Circuit Court Holds Nonresident Corporations Have Nexus Through Partnerships Interests," 2007 State Tax Today 246-5 (Dec. 21, 2007).

partnerships can reduce the overall franchise tax liabilities of the affiliated group.

Use of Single-member LLCs to 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.[2]

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[2] See, e.g., Ala. Rev. Rul. 98-005 (June 18, 1998) (no taxable sale between corporate member and SMLLC since LLC disregarded for sales/use tax purposes, as well as income tax purposes).

APPENDIX 16A

Tax Treatment by State

Bruce P. Ely / Christopher R. Grissom / William T. Thistle*

State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships**

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Alabama	Yes [1] (check-the-box regs followed only for LLCs; LP and LLP classification criteria uncertain)	LLC/LLP pays tax on nonresident member's/ partner's distributive share of AL income unless nonresident consents filed; but even if consent filed, LLC/LLP is contingently liable if nonresident fails to pay the tax	Annual $100 minimum and $15,000 maximum business privilege tax (electing family investment LLCs/ LLPs subject to $500 annual cap; "financial institution groups" subject to Alabama deposits-based alternative tax capped at $3 million annually)	LLP: Ala. Code §§ 10-8A-1001 to 10-8A-1010 [2, 4] LLC: Ala. Code §§ 10-12-1 et seq.
Alaska	Yes	No	No	LLP: Alaska Stat. §§ 32.06.911 to 32.06.925 [2, 4] LLC: Alaska Stat. §§ 10.50.010 to 10.50.995
Arizona	Yes [1]	No	No	LLP: Ariz. Rev. Stat. §§ 29-1026, 29-1101 to 29-1109 [2, 4] LLC: Ariz. Rev. Stat. §§ 29-601 to 29-857

*Bradley Arant Boult Cummings LLP, Birmingham, Alabama (205) 521-8000 (as of January 2, 2009).

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Arkansas	Yes [1]	LLP/LLC withholds 7% of distributions of AR-source income to nonresident partners/members unless consents or composite return filed	NoLLCs pay minimum $300 franchise tax. Every LLC formed under the Small Business Entity Tax Pass Through Act (Ark. Code Ann. §§ 4-32-10 et seq.), must pay the minimum franchise tax (currently $150)	LLP: Ark. Code §§ 4-42-703, 4-46-1001 to 4-46-1003 [2, 4] LLC: Ark. Code §§ 4-32-101 to 4-32-1401
California	Yes [1]	LLC/LLP pays tax on nonresident member's/ partner's distributive share of CA income at 7% (for U.S. partners) unless nonresident consents filed; if consents filed, still must withhold (but may request waiver from state)	Annual $800 minimum franchise tax on all LLCs/ LLPs; and gross receipts tax ranging from $900 to $11,790 on LLCs (unapportioned prior to 1/1/07; unapportioned fee declared unconstitutional in *Northwest Energetic Services, LLC v. Franch. Tax Bd.*, 159 Cal. App. 4th 841, 71 Cal. Rptr. 3d 642 (1st Dist., 2008) and *Ventas Finance I, LLC v. Franch. Tax Bd.*, 165 Cal. App. 4th 1207, 81 Cal. Rptr. 3d 823 (1st Dist., 2008), rev. den. Cal. S. Ct., Dkt. No. S166870, 11/12/2008))	LLP: Cal. Corp. Code §§ 16951 to 16962 [2, 4] (listed "professionals" only) LLC: Cal. Corp. Code §§ 17000 to 17655 (not available to listed "professionals") [5]
Colorado	Yes	LLC/LLP withholds at 4.63%, or pays tax at 4.63% in composite return on nonresident member's/ partner's distributive share of CO income unless nonresident consents filed	No	LLP: Colo. Rev. Stat. §§ 7-60-144, 7-64-1001 to 7-64-1010 [2, 4] LLC: Colo. Rev. Stat. §§ 7-80-101 to 7-80-1101
Connecticut	Yes [1]	LLC/LLP pays tax on nonresident noncorporate partner's distributive share of CT source income at highest marginal rate (group returns, est. payments no longer allowed)	LLCs, LLPs subject to annual "business entity tax" of $250	LLP: Conn. Gen. Stat. Ann. §§ 34-406 to 34-434 [2] LLC: Conn. Gen. Stat. Ann. §§ 34-100 to 34-242
Delaware	Yes [1]	No	LLCs/LLPs subject to $200 ($250 eff. 1/1/08) tax per year; LLPs subject to $200/partner/year fee w/ $120,000 cap	LLP: Del. Code Ann. tit. 6, §§ 15-1001 to 15-1105 [2, 4] LLC: Del. Code Ann. tit. 6, §§ 18-101 to 18-1109 [5, 9]

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
District of Columbia	Yes [1]	No	9.975% tax on DC source income earned by unincorporated business but no tax on SMLLC owned by another entity subject to tax in D.C. ($100 minimum) or on professional firms where 80% of income derived from personal services and capital not material income-producing factor "Ballpark Fee" based on DC gross receipts from previous year in excess of $5 million, ranges from $5,500 to $16,500	LLP: D.C. Code Ann. §§ 33-110.1 to 33-111.06 [2, 4] LLC: D.C. Code Ann. §§ 29-1001 to 29-1075
Florida	Yes [1] (no state personal income tax)	No	No	LLP: Fla. Stat. §§ 620.9001 to 620.9105 [2, 4] LLC: Fla. Stat. §§ 608.401 to 608.705, 621.01 to 621.14 (professionals)
Georgia	Yes [1]	LLC/LLP withholds 4% tax on nonresident members/partners distributive share of GA income, with exemptions, unless composite return filed (entity and partners are jointly and severally liable)	No	LLP: Ga. Code Ann. §§ 14-8-44 to 14-8-64 [2] LLC: Ga. Code Ann. §§ 14-11-100 to 14-11-1109
Hawaii	Yes [1]	No	No	LLP: Haw. Rev. Stat. §§ 425-151 to 425-173 [2, 4] LLC: Haw. Rev. Stat. §§ 428-101 to 428-1302
Idaho	Yes [1]	Composite returns permitted for nonresident member/partner individuals; if nonresident fails to pay the tax, LLC/LLP is contingently liable	No	LLP: LLP: Idaho Code § § 53-101 to 53-1205 [2, 4] LLC: Idaho Code §§ 53-601 to 53-672 [Eff. 7/1/2010, Idaho Code § § 30-101 to 30-1104]

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Illinois	Yes [1]	For each taxable year ending on or after Dec. 31, 2008, LLC/LLP must withhold from each nonresident partner an amount equal to the partner's distributable share of the IL business income of the partnership, multiplied by the applicable tax rates for that partner.	1.5% "replacement" income tax on partnerships and LLCs; partners liable if LLC/ LLP fails to pay; "investment partnerships" exempt Domestic LLPs subject to $100/ partner/year fee with a $200 minimum and $5,000 cap	LLP: 805 Ill. Comp. Stat. 215/0.01 to 215/ 1402, 206/100 to 206/1299 [2, 4] LLC: 805 Ill. Comp. Stat. 180/1-1 to 180/ 60-1 [9] (attorneys may use LLPs or LLCs but remain jointly and severally liable for malpractice of other owners/ employees unless adequate insurance carried) [5]
Indiana	Yes [1]	LLC/LLP pays withholding tax on nonresident member's/ partner's distributive share of IN income at applicable state rate	No	LLP: Ind. Code Ann. §§ 23-4-1-44 to 23-4-1-53 [2] LLC: Ind. Code Ann. §§ 23-18-1-1 to 23-18-13-1
Iowa	Yes [1]	LLC/LLP pays 5% withholding tax on nonresident member's/ partner's distributive share of IA income unless certificate of release obtained from IDOR and estimated tax paid by nonresident member/ partner	No	LLP: Iowa Code §§ 486.1001 to 486.1105 [2, 4] LLC: Iowa Code §§ 490A.100 to 490A.1601 [9]
Kansas	Yes	LLC/LLP pays withholding tax on nonresident member's/ partner's distributive share of KS income at highest state rate unless nonresident consents filed	LLCs/LLPs subject to 0.09375% (.0625% for tax years after 12/31/08) franchise tax on net capital accounts with a $20,000 cap, but only if net capital accounts located or used in KS are $1,000,000 or more, to be phased out by 2011 (2007 H.B. 2264).There is an annual report fee of $40.	LLP: Kan. Stat. §§ 56a-1001 to 56a-1203 [2, 4] LLC: Kan. Stat. §§ 17-7662 to 17-76,142

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Kentucky	No (eff. 1/1/07, 2006 H.B. 1)	Eff. 1/1/07, LLCs/ LLPs must withhold at 6% unless nonresident member/partner filed return and timely paid KY income tax in immediately prior year (but if member/partner does not pay tax in current year, LLC/LLP still liable). Withholding required for corporate partner/ member only if it is only doing business in KY through its ownership interest in a pass-through entity.	Eff. 1/1/07, LLCs/ LLPs subject to limited liability entity (LLE) tax equal to lesser of 0.095% of KY gross receipts or 0.75% of KY gross profits, with exceptions. Must pay minimum tax of $175. Partners generally allowed credit against KY personal income tax for proportionate share of LLE tax	LLP: Ky. Rev. Stat. §§ 362.555 to 362.605 LLC: Ky. Rev. Stat. §§ 275.001 to 275.455 (Ky. S. Ct. rules amended to allow attorneys to use LLCs & LLPs, but must maintain minimum insurance levels)
Louisiana	State classification follows federal classification of LLC but only with respect to corporate income tax, not franchise tax [1]	LLC/LLP required to make composite tax payments on nonresident partner's/ member's distributive share of LA income at highest individual state rate unless nonresident consents filed	No	LLP: La. Rev. Stat. Ann. §§ 9:3431 to 9:3435 LLC: La. Rev. Stat. Ann. §§ 12:1301 to 12:1369
Maine	Yes [1]	LLC/LLP pays quarterly withholding tax on nonresident member's/ partner's proportionate share of ME income at highest applicable state rate unless composite return filed or certain exemptions apply	LLC "financial institutions" are taxed at the entity level at a rate of 1% of ME net income and $.08 per $1,000 of ME assets	LLP: Me. Rev. Stat. Ann. tit. 31, §§ 801 to 876 (eff. 7/1/07, P.L. 2005, c. 543) LLC: Me. Rev. Stat. Ann. tit. 31, §§ 601 to 762
Maryland	Yes [1]	For tax years beginning after 12/31/07, LLC/ LLP pays tax on nonresident partner's distributive share of MD income at rate of 7.5% for individuals, 8.25% for entities, limited to amount of nonresidents' share of distributable cash flow	No	LLP: Md. Code Ann., Corps. & Ass'ns §§ 9A-1001 to 9A-1111 [2, 4] LLC: Md. Code Ann., Corps. & Ass'ns §§ 4A-101 to 4A-1103

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Massachusetts	Yes [1] (except SMLLCs owned by S corps) (check-the-box regs followed only for LLCs; LP and LLP classifications determined by common law, *Kintner* regs) Eff. 1/1/09, will follow check-the-box regs.	Eff. 1/1/09, LLC/ LLP pays quarterly withholding tax on nonresident partner's distributive share of MA income unless composite return or nonresident consents filed or certain exemptions apply (2008 H. 4900; 830 Mass. Code Regs. 62B.2.2 (8/ 8/2008))	No	LLP: Mass. Gen. L. ch. 108A, §§ 45 to 49 [2] LLC: Mass. Gen. L. ch. 156C, §§ 1 to 69
Michigan	Yes [1]	LLC/LLP pays withholding tax at a rate of 4.35% on nonresident partner's distributive share of MI taxable income, unless certain exemptions apply; withholding does not apply to corporate nonresident partners	Single Business Tax levied at 1.9% of specified SBT tax base (phased out by 12/31/07) Michigan Business Tax (eff. 1/1/ 08) applies to LLCs and LLPs; tax is 4.95% of business income and 0.80% of modified gross receipts tax base.	LLP: Mich. Comp. Laws Ann. §§ 449.44 to 449.48 LLC: Mich. Comp. Laws Ann. §§ 450. 4101 to 450.5200
Minnesota	Yes [1] (except foreign SMLLCs disregarded for federal income tax purposes)	LLC/LLP pays withholding tax on nonresident member's/ partner's distributive share of MN income at highest individual rate unless composite return filed	$0 to $5,000 fee based on sum of entity's MN property, payroll and sales	LLP: Minn. Stat. §§ 323A.10-01 to 323A.11-05 [2, 4] LLC: Minn. Stat. §§ 322B.01 to 322B.960
Mississippi	Yes [1] (SMLLC's apportionment factors included in calculation of corp. owner's *franchise* tax, but not income tax)	Generally no, but LLC/LLP and members/partners are jointly and severally liable for any unpaid tax unless LLC/ LLP withholds and remits 5% of the LLC's/LLP's net profit or gain for the year	No	LLP: Miss. Code Ann. §§ 79-12-87 to 79-12-117 LLC: Miss. Code Ann. §§ 79-29-101 to 79-29-1204
Missouri	Yes [1]	LLC/LLP pays withholding tax on nonresident individual member's/ partner's distributive share of MO income at highest state rate unless either nonresident consents or composite return filed	No	LLP: Mo. Stat. §§ 358.440 to 358. 510, 358.150.2 [2] LLC: Mo. Stat. §§ 347.010 to 347.189

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Montana	Yes [1]	LLC/LLP liable for income tax at applicable state rate for individual nonresident partner's distributive share of MT income unless either composite return or nonresident consents filed	No	LLP: Mont. Code Ann. §§ 35-10-701 to 35-10-710 [2, 4] LLC: Mont. Code Ann. §§ 35-8-101 to 35-8-1307
Nebraska	Yes [1]	LLC/LLP liable for income tax at highest state rate on nonresident individual member's/ partner's distributive share of NE income unless nonresident consents filed	No	LLP: Neb. Rev. Stat. §§ 67-344 to 67-346, 67-454 to 67-465 [2, 4] LLC: Neb. Rev. Stat. §§ 21-2601 to 21-2653
Nevada	No state income tax	No	No	LLP: Nev. Rev. Stat. §§ 87.440 to 87.560 ("professionals" only if domestic RLLP) LLC: Nev. Rev. Stat. §§ 86.011 to 86.590 [9]
New Hampshire	Yes [1] (conforms to check-the-box regs but only with respect to multi-member LLCs)	No	5% on dividends and interest exceeding $2,400; 8.5% on business profits (only for LLCs/LLPs with more than $50,000 in gross business income); and 0.75% on the "business enterprise value tax base" of the LLC/LLP. Note: a dollar for dollar credit is allowed against the business profits tax for the amount of business enterprise tax owed	LLP: N.H. Rev. Stat. §§ 304A:44 to 304A:55 LLC: N.H. Rev. Stat. §§ 304C:1 to 304C:85, 304D:1 to 304D:20 (professional LLCs)

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
New Jersey	Yes [1]	None, but entity level tax or on nonresident partners'/ members' distributive shares of N.J. net income	$150/member/ partner annual fee w/ $250,000 cap for partnerships with 2 or more members/ owners; no annual fee for LLCs/ LLPs with less than 3 members/ partners; and LLCs/LLPs pay 6.37% of its NJ net income allocated to all nonresident noncorporate members/ partners and 9% for all nonresident noncorporate members/partners and 9% for all nonresident corporate members/parners (N.J. Stat. Ann. 54:10A-15.11(a)); eff. 1/1/07, LLCs/ LLPs must make quarterly payments (P.L. 2005, Ch. 288)	LLP: N.J. Stat. Ann. §§ 42:1A-47 to 42:1A-54 [2, 4] LLC: N.J. Stat. Ann. §§ 42:2B-1 to 42:2B-70
New Mexico	Yes	LLC/LLP required to withhold tax on nonresident partner's/ member's distributive share of NM income at highest individual rate unless nonresident consents filed	No	LLP: N.M. Stat. Ann. §§ 54-1A-1001 to 54-1A-1105 [2, 4] LLC: N.M. Stat. Ann. §§ 53-19-1 to 53-19-74

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
New York	Yes [1]	LLCs/LLPs make quarterly estimated tax payments on behalf of C corp./ nonresident individual owners that owe more than $300 in tax, unless commissioner authorizes "group returns." No estimated tax payments required on behalf of C corp./ nonresident individual owners that file an exemption certificate with the LLC/LLP certifying their compliance with all NY income tax estimated tax and income tax return filing requirements	LLCs/LLPs subject to annual filing fee based on NY-source gross receipts, min. $25, max. $4,500(eff. 1/1/08, S6807-C) SMLLCs that are treated as disregarded entities for federal income tax purposes are subject to a $25 annual filing fee (eff. 1/1/08, S6807-C) Prior to 2008, LLCs/LLPs subject to annual fee based on number of partner	LLP: N.Y. Partnership Law §§ 121-1500 to 121-1506 [2] ("professionals" only) LLC: N.Y. L.L.C. Law §§ 101 to 1403
North Carolina	Yes [1]	LLC/LLP pays withholding tax on <u>individual</u> nonresident member's/ partner's distributive share of NC income at the applicable individual income tax rate LLC/LLP pays withholding tax on <u>non-individual</u> nonresident member's/ partner's distributive share of NC income at the applicable income tax rate unless nonresident consent filed	If book value of LLC assets exceeds $150,000, corp. member required to include LLC's assets, directly or indirectly owned, in its franchise tax base if collective ownership by corp. and its affiliates of capital interests of the LLC is more than 50% Eff. 1/1/07, LLC electing to be taxed as a C corporation subject to franchise tax (2006 S.B. 1741) Eff. 1/1/09, LLC electing to be taxed as S corporation also subject to franchise tax (2008 H.B. 2346)	LLP: N.C. Gen. Stat. §§ 59-84.2 to 59-84.4, 59-90 to 59-94 LLC: N.C. Gen. Stat. §§ 57C-1-01 to 57C-10-07
North Dakota	Yes [1]	LLC/LLP pays 5.54% withholding tax on distributions to nonresident members/partners unless composite return filed	No (nominal annual filing fee based on number of LLP managing partners)	LLP: N.D. Cent. Code §§ 45-22-01 to 45-22-27 [2, 4] LLC: N.D. Cent. Code §§ 10-32-01 to 10-32-156

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Ohio	Yes [1]	LLC/LLP pays 5% withholding tax on distributions to nonresident individual partners and a 1.7% (to be phased out by 2009) withholding tax on distributions to non-individual partners after certain adjustments unless composite return or consents to jurisdiction filed	Franchise tax credit calculations include corporation's proportionate share amounts from any pass-through entity Unless gross receipts less than $150,000, LLCs/ LLPs subject to Commercial Activity Tax of $150 plus 0.26% of Ohio gross receipts in excess of $1 million, to be phased in by 2009	LLP: Ohio Rev. Code Ann. §§ 1775.61 to 1775.65 [2] LLC: Ohio Rev. Code Ann. §§ 1705.01 to 1705.58
Oklahoma	Yes [1]	LLC/LLP pays 5% withholding tax on distributions to nonresident member/partner OK income unless nonresident consents filed	No	LLP: Okla. Stat. tit. 54, § § 1-1001 to 1-1105 [2, 4] LLC: Okla. Stat. tit. 18, § § 2000 to 2060 [9]
Oregon	Yes [1]	LLC/LLP withholds tax on nonresident members/partners distributive share of OR income computed at the highest individual or corporate rate, as applicable, unless composite return filed or other exceptions apply	No	LLP: Or. Rev. Stat. §§ 67.500, 67.770 [2, 4] ("professionals" only) LLC: Or. Rev. Stat. §§ 63.001 to 63.990
Pennsylvania	Yes [1]	LLC/LLP pays withholding tax on nonresident individual and "nonfiling corporate" member's/ partner's distributive share of PA income at the applicable income tax rate	LLCs, except for "restricted professional companies," subject to capital stock tax on taxable capital stock value (to be phased out by 2011) Professional LLCs subject to $300/PA member/ year fee; LLPs subject to $240/PA partner/ year fee	LLP: 15 Pa. Cons. Stat. §§ 8201 to 8221 LLC: 15 Pa. Cons. Stat. §§ 8901 to 8998 [5]

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Rhode Island	Yes [1] (for withholding purposes, corporate-owned SMLLC treated as C corporation)	LLP/LLC pays 9% withholding tax unless composite return filed	$500 tax on LLCs taxed as partnerships	LLP: Codified at various sections beginning with R.I. Gen. Laws § 7-12-13 (available to listed "professionals") LLC: R.I. Gen. Laws §§ 7-16-1 to 7-16-75 (available to listed "professionals")
South Carolina	Yes [1]	LLC/LLP pays 5% withholding tax on nonresident member's/ partner's distributive share of SC income unless nonresident consents or composite return filed	No	LLP: S.C. Code §§ 33-41-370; 33-41-1110 to 33-41-1220 LLC: S.C. Code §§ 33-44-101 to 33-44-1207
South Dakota	No state income tax	No	Domestic LLCs subject to $125 initial report fee; foreign LLCs subject to $550 initial report fee; all LLCs subject to $50 annual report fees thereafter	LLP: S.D. Codified Laws Ann. §§ 48-7A-1001 to 48-7A-1105 [2, 4] LLC: S.D. Codified Laws Ann. §§ 47-34-1 to 47-34-59
Tennessee	Yes [1] (but LLCs subject to franchise, excise tax anyway and SMLLCs only disregarded if member is a corporation)	No	LLC/LLP subject to franchise/excise tax of (1) $0.25 per $100 of greater of (a) net worth or (b) book value of TN assets & (2) 6.5% of net earnings; corporate member of disregarded SMLLC subject to TN franchise/ excise tax; all entities classified as partnerships also subject to 6% dividends and interest income tax; LLC/LLPs subject to $50/ partner annual fee, min. $300, max. $3,000 for LLCs; $250/ $2,500 for LLPs	LLP: Tenn. Code Ann. §§ 61-1-1001 to 61-1-1005 [4] LLC: Tenn. Code Ann. §§ 48-201-101 to 48-249-1133 [9]

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Texas	State taxes LLCs as corporations (no state personal income tax)	No	LLCs subject to franchise tax equal to the greater of.25% of capital or 4.5% of earned surplus LLPs subject to $200/partner/year fee For reports due on or after Jan. 1, 2008, LLCs and LLPs subject to Texas franchise tax at 0.5% (retailers and wholesalers) or 1% (all other businesses) of lowest of: (1) 70% of total revenue; (2) total revenue minus cost of goods sold; or (3) total revenue minus total compensation.	LLP: Tex. Rev. Civ. Stat. Ann. tit. 105 Art. 6132b § 3.08 [2, 4] (eff. 1/1/06: Tex. Bus. Org. Code §§ 152.801 to 152.805) (Revised Tex. Partnership Act based on UPA (1997) but differs in some respects) LLC: Tex. Rev. Civ. Stat. Ann. tit. 32 Art. 1528n §§ 1.01 to 11.07 (eff. 1/1/06 LLC Act found at Tex. Bus. Org. Code §§ 101.001 to 101.552)
Utah	Yes [1]	No	No	LLP: Utah Code Ann. §§ 48-1-41 to 48-1-48 LLC: Utah Code Ann. §§ 48-2c-101 to 48-2c-1902 [9]
Vermont	Yes [1]	LLC/LLP must make quarterly estimated tax payments at second lowest marginal rate (currently 7.2%) on nonresident partner's distributive share of VT income	LLC/LLP must pay annual tax of $250	LLP: Vt. Stat. Ann. tit. 11, §§ 3291 to 3305 [2, 4] LLC: Vt. Stat. Ann. tit. 11, §§ 3001 to 3162
Virginia	Yes [1]	Eff. 7/1/07, LLC/ LLP must pay withholding tax of 5% of nonresidents' allocable shares of VA income. (2007 SB 1238)	No	LLP: Va. Code §§ 50-73.132 to 50-73.143 [2, 4] LLC: Va. Code §§ 13.1-1000 to 13.1-1073; 13.1-1100 to 13.1-1123 (professionals)
Washington	State taxes LLCs as partnerships (no state personal income tax)	No	Business and Occupation T ("B&O") Tax of 0.138% to 1.5% of gross income	LLP: Wash. Rev. Code §§ 25.05.500 to 25.05.570 [4] LLC: Wash. Rev. Code §§ 25.15.005 to 25.15.902
West Virginia	Yes	LLC/LLP pays 6.5% (4% for tax years prior to 2008) withholding tax on nonresident partner's distributive share of WV income unless nonresident consents filed	Greater of $50 or 0.55% (0.48%, eff. 1/1/09) of "capital" (generally, average balance of partners' capital accounts per Form 1065)	LLP: W. Va. Code § § 47B-10-1 to 47B-10-5 LLC: W. Va. Code § § 31B-1-101 to 31B-13-1203; 31B-13-1301 to 31B-13-1306 (professionals)

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
Wisconsin	Yes [1]	LLC/LLP pays withholding tax on nonresident shares of WI income at highest individual/ corporate rate (as applicable, currently 6.75% and 7.9%, respectively) (Wis. Stat. § 71.775 (eff. 1/1/05))	LLC/LLPs with more than $4 million in gross receipts are subject to recycling surcharge tax of up to $9,800	LLP: Wis. Stat. §§ 178.40 to 178.53 [2] LLC: Wis. Stat. §§ 183.0102 to 183.1305
Wyoming	No state income tax	No	Greater of $50 or.02% of capital, property, and assets (capital employed)	LLP: Wyo. Stat. §§ 17-21-1101 to 17-21-1105 LLC: Wyo. Stat. §§ 17-15-101 to 17-15-147; 17-25-101 to 17-25-109 (close LLCs) (domestic LLCs having one or more members may elect to be either a “flexible LLC” or a “close LLC”)

[1] Indicates that the state taxing authority has publicly announced that it will follow the I.R.S. “check-the-box” regulations for state income tax purposes, the state LLC act adopts the regulations either explicitly or implicitly, or the state adopts them by separate statute. Note that many states, such as Florida, Georgia, Michigan, and the District of Columbia, do not conform to the “check-the-box” regulations for sales, use, and other related taxes.

[2] Indicates “bulletproof” (broad form liability shield) LLP statute, which can result from adopting the 1997 version of the Revised Uniform Partnership Act, known as “UPA (1997).”

[3] Assumes entity is classified as a partnership for federal income tax purposes. See supplemental chart regarding net-worth or debt-based corporate franchise taxes.

[4] Indicates that the state has adopted UPA (1997).

[5] States such as California, Delaware, Illinois, and Pennsylvania restrict the use of LLCs by banks and/or insurance companies.

[6] Currently, the following states authorize the formation of limited liability *limited* partnerships (LLLPs): Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Hawaii, Illinois, Iowa, Maryland, Minnesota, Missouri, Nevada, New Mexico (eff. 1/1/09), North Carolina, North Dakota, Pennsylvania, South Dakota, and Virginia. Arizona and Texas do not authorize formation of an entity called a “limited liability limited partnership,” but they allow an LP to be treated also as an LLP and require such entities treated as both an LP and an LLP to include “LLLP” in their name. Other states, including New Hampshire, Ohio, Rhode Island, and Tennessee, permit functional equivalents of LLLPs.

[7] “Partner” in this column and throughout the chart means both partners of LLPs and members of LLCs unless otherwise clear from the context. This column does <u>not</u> list those states which permit, but do not require, composite income tax returns.

[8] The following states exempt the distributive share of nonresident partners of investment partnerships (as defined in varying ways) from income taxation: Arkansas, California, Georgia, Idaho, Illinois, Kentucky, Maryland, New Jersey, New York, North Carolina, Ohio, and Texas. A few states, such as Connecticut and New Mexico, do not specifically exempt nonresident partners of investment partnerships but have rules that effectively allocate that income to the domicile of the nonresident partner. Massachusetts statutorily exempts nonresident limited partners of certain investment LPs but not other pass-thru entities. Thus, any income tax withholding, jurisdictional. consent waivers, or composite return requirements in these states may not apply to nonresident partners of qualified investments partnerships. Pending legislation in Alabama.

State	State Income Tax Classification of LLCs Follows Federal? [5]	Nonresident Partner/ Member Withholding? [7, 8]	Entity-Level Tax on LLPs or LLCs? [3]	Citation to LLP/ LLC Acts [6]
[9] Currently, the following states authorize the formation of series LLCs: Delaware (Del. Code Ann. tit. 6, § 18-215), Illinois (805 ILCS § 180/37-40), Iowa (Iowa Code § 490A.305 (§ 489.1201 eff. 1/1/09)), Nevada (Nev. Rev. Stat. § 86.161), Oklahoma (Okla. Stat. tit. 18, § 2005), Tennessee (Tenn. Code Ann. § 48-249-309), and Utah (Utah Code Ann. § 48-2c-606). Several other states, e.g., Wisconsin, Minnesota, and North Dakota, have language in their LLC statutes about "classes" and "series" of membership interests, but no provisions for the layers or "firewalls" of protection that the typical series LLC act contains.				

Tax Treatment of LLCs/LLPs/LPs ("LLEs") by States Imposing Net Worth- or Debt-Based Corporate Franchise Taxes (as of March 1, 2010)***

STATE	APPLY FRANCHISE TAX? [2]	NOTE:
Alabama	YES	LLCs, LLPs, and LPs subject to "business privilege tax" based on modified net worth. Sliding rate scale based on apportioned federal net income with $100 min. and $15,000 max. (generally). "Family limited liability entities" subject to $500 cap. ALA. CODE § 40-14A-22.
Arkansas	NO [1]	But LLCs are subject to the minimum $300 franchise tax ARK. CODE ANN. § 26-54-104(5).
Connecticut	NO [1]	
Delaware	NO [1]	
Georgia	NO	
Illinois	NO	
Kansas	YES	Franchise tax on LLCs, LLPs, and LPs of 0.125% of net capital accounts located or used in state, but only if federal partnership income is at least $1,000,000; $20,000 max; to be phased out by 2011. KAN. STAT. ANN. § 79-5401(a)(2) (as amended by 2007 HB 2264).
Kentucky	NO	
Louisiana	NO	Note: An LLE's election under the check-the-box regulations to be taxed as a corporation for federal income tax purposes has no significance in determining whether the LLE is subject to LA franchise tax. LA. DOR Rev. Rul. No. 01-013 (Oct. 1, 2001). LLE electing S corp or C corp status not subject to franchise tax. La. Info. Bulletin No. 04-023 (Dec. 1, 2004); La. Priv. Ltr. Rul. 05-015 (Dec. 28, 2005).
Massachusetts	NO [1]	
Mississippi	NO	
Missouri	NO	
Nebraska	NO	
New Jersey	NO	
New Mexico	NO [1]	

STATE	APPLY FRANCHISE TAX? [2]	NOTE:
N. Carolina	NO	LLCs exempt from franchise tax by statute. N.C. GEN. STAT. § 105-114(b)(2). A corporate member is now required to include the LLC's assets in its franchise tax base if the corporate member or its affiliates collectively own 50% or more of the capital interests of the LLC. Eff. 1/1/07, LLC electing C corporation status subject to franchise tax (2006 S.B. 1741). Eff. 1/1/09 LLC electing S corporation status subject to franchise tax (2008 H.B. 2346).
Ohio	YES	Prior to July 1, 2005 and during the 5 year phase-out, "qualifying pass-through entities" are subject to an 8.5% franchise tax on sum of distributive shares of income to: (i) corporations not paying the OH franchise tax; (ii) partnerships which are themselves investors in a pass-through entity if the partnership's ultimate owners are corporations not paying OH franchise tax; and (iii) trusts which are investors in pass-throughs if the beneficiaries are ultimately corporations not paying OH franchise tax. Entity-level tax can be avoided by filing nonresident member jurisdictional consents. OHIO REV. CODE § § 5733.40, 5733.41. Franchise tax credit calculations include a corporation's proportionate share from LLCs and LLPs. OHIO REV. CODE § 5733. 057.
Oklahoma	NO	LLCs exempt from franchise tax by statute. OKLA. STAT. TIT. 68 § 1201.
Pennsylvania	YES	All LLCs except "restricted professional companies" are subject to the capital stock and franchise taxes. 15 PA. CONS. STAT. § 8925. Tax phasing-out by 2011.
Rhode Island	NO [1]	
S. Carolina	NO	
Tennessee	YES	LLCs, LLPs, and LPs subject to franchise, excise tax of $0.25 per $100 of net worth. TENN. CODE ANN. § § 67-4-2105(a), 67-4-2106(a).
Texas	YES	LLCs subject to franchise tax by statute. Tax is based on greater of 0.25% of net taxable capital or 4.5% of earned surplus. TEX. TAX CODE ANN. § 171.002. For reports due on or after 1/1/08, LLCs and LLPs subject to Texas franchise tax at 0.5% or 1% of lowest of: (1) 70% of total revenue; (2) total revenue minus cost of goods sold; or (3) total revenue minus total compensation (H. 3).
W. Virginia	YES	Generally, the tax is the greater of $50 or 0.70% (0.55%, eff. 1/1/07) of capital accounts. W. VA. CODE § § 11-23-3(b)(2)(C), 11-23-6.
Wyoming	YES	Generally, annual report license tax is the greater of $50 or 0.02% of assets employed in Wyoming. WYO. STAT. § § 17-15-132(a)(vi), 17-16-1630(a).

[1] Several states impose a de minimis (e.g., $150 Arkansas, $250 Connecticut, $250 Delaware; $500 Massachusetts, $50 New Mexico, and $500 Rhode Island) annual franchise tax/filing fee on LLEs.

[2] As a general rule, states that follow the federal income tax classification guidelines for LLEs will impose a net worth- or debt-based franchise tax only on those LLEs treated as C corporations.