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STATE TAXATION

STATE TAX UPDATE FOR PASS-THROUGH ENTITIES AND THEIR OWNERS

Recent developments involve such areas as jurisdictional questions, reporting requirements, real property transfers, entity-level taxes, and eligibility for various credits and deductions.

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State and local taxation of pass-through entities[1] continues to be a complex issue, especially when the entities are multistate in nature. Compared with resident owners, over which a state has jurisdiction because of their physical presence in the state, nonresident owners of pass-through entities may be presented with challenging questions. As a way to collect additional revenue and potentially avoid difficult constitutional issues, many states (some quite recently) have enacted entity-level taxes or withholding requirements on distributions to nonresident owners. The application of these new entity-level taxes and withholding requirements has presented states with a variety of issues.

States may look to federal income tax law when imposing net-income based taxes on pass-through entities. However, for multiple reasons, the application of federal rules at the state and local level often presents more questions than it answers. First, the federal rules do not address jurisdictional issues in a domestic context. Second, domestic entities must only comply with one federal taxing regime, while multistate pass-through entities must comply with the taxing systems of each state in which they have nexus.

At the state and local tax level, owners of pass-through entities that operate in multiple states are faced with often vexing questions as to where they must file and what income must be included in the return for each state in which they are required to file. Recent developments involve jurisdictional questions, apportionment issues, and reporting requirements with respect to owners of pass-through entities that are resident in states other than the state or states where the entity does business. States continue to assert that an ownership interest in a pass-through entity doing business in that state is alone sufficient to give the state jurisdiction over the nonresident owners. But the states often ignore or do not give adequate weight to U.S. constitutional issues that arise when taxing the nonresident owner in these situations.

As a way around addressing these constitutional questions, many states have begun to require the pass-through entity to either withhold tax on payments to nonresident owners or file composite returns on behalf of those owners. Some states have gone even further and imposed entity-level taxes on the pass-through entity itself in order to foreclose any issues as to whether the state can tax the distributions the pass-through entity makes to nonresidents. However, such states may not have realized that these types of taxes raise their own constitutional questions.

Nexus Issues for Entity Owners

Jurisdictional issues raised by the ownership of an interest in a pass-through entity by a nonresident continue to arise at the state level. The question of whether the ownership of a partnership interest, especially a limited partnership interest, is sufficient to create nexus for a nonresident individual or nondomiciliary corporation has been argued and discussed for many years. A recent Louisiana Court of Appeal decision [2] highlighted the lengths a state department of revenue will go to assert that an owner of a limited partnership interest had nexus with the state, even absent any state contacts other than an ownership interest. As discussed more fully below, the court upheld the taxpayer's challenge that its contacts with the state were insufficient to establish nexus under the federal Due Process Clause.

In addition to Louisiana, other states are continuing to push the boundaries of nexus as a way to generate additional revenue from out-of-state businesses. Besides aggressively asserting nexus on audit, some states are enacting questionable statutory and regulatory provisions that detail what kind of presence is required to establish income tax nexus. These new nexus tests are presumably resting on the premise that *Quill Corp. v. North Dakota*[3] only applies in the sales and use tax context. As discussed below, California, Connecticut, and Michigan are the most recent states to jump on the bandwagon of new factor presence nexus standards. While physical presence in a state is generally sufficient to create nexus, a state should arguably not be able to assert that a business is taxable in the state based solely on the fact that it makes sales into the state.

The jurisdictional issues faced by pass-through entities and their owners are not confined to questions of U.S. Constitutional nexus. Questions still arise regarding the applicability of federal Public Law 86-272[4] to pass-through entities. For example, Michigan's new factor presence nexus test might very well conflict with P.L. 86-272.

Several recent state developments have addressed various aspects of the jurisdictional issues faced by owners of pass-through entities. Below is a discussion of a few of these developments.

California.

Effective for tax years beginning on or after 1/1/2011, California adopted a new “doing business” standard that affects out-of-state corporations and pass-through entities and their owners that have property, payroll or sales sourced to the state.[5] Beginning in 2011, a taxpayer is considered to be “doing business” in California if it meets any of the thresholds listed below:

(1) The taxpayer is organized or commercially domiciled in California.

(2) The taxpayer has sales in California in excess of the lesser of $500,000 or 25% of its total sales.

(3) The taxpayer's real and tangible personal property in California exceeds the lesser of $50,000 or 25% of the taxpayer's total real and tangible personal property.

(4) The amount paid in California by the taxpayer for compensation exceeds the lesser of $50,000 or 25% of the total compensation paid by the taxpayer. For the conditions above, the sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of the pass-through entity's factors.

In January 2011, the California Franchise Tax Board (FTB) issued guidance asserting that the activities of a disregarded entity doing business in California will be attributed to the owner of the entity for state income/franchise tax purposes.[6] Thus, the in-state activities of a SMLLC or QSub that elects to be treated as a disregarded entity for federal and state income tax purposes will be treated as the activities of a branch or division of its corporate owner. Accordingly, if the entity's California activities are sufficient to create nexus with the state, then its corporate owner will automatically be deemed to be “doing business” in California.

In a news release issued in March 2011, the FTB admitted that California's expanded definition of “doing business” may create new franchise tax filers.[7] The release indicated that the expanded definition may cause corporate limited partners previously subject to the corporate income tax to now be subject to the corporate franchise tax, including the minimum tax.

Connecticut.

The Connecticut Department of Revenue issued guidance regarding economic nexus legislation for purposes of its corporation business tax and personal income tax.[8] The new legislation,[9] enacted on 9/5/2010, became effective for all tax years beginning on or after 1/1/2011. The new legislation provides that any corporation or pass-through entity that derives income from Connecticut or has substantial economic presence within the state is subject to tax in Connecticut. Economic presence is defined as “the purposeful direction of business activities toward Connecticut” and will be evaluated based on the frequency, quantity, and systematic nature of the business's economic contacts with the state.

The guidance also sets forth a new bright-line test for economic nexus, stating that any corporation or pass-through entity not otherwise subject to income taxation or a filing requirement is subject to taxation in Connecticut if the entity has yearly receipts of $500,000 or more attributable to sources within the state. However, P.L. 86-272 continues to provide protection against Connecticut income tax for sales of tangible personal property by businesses that have economic nexus with the state.

The new guidance also stated that the ownership and use of intangible property within Connecticut would subject an entity to tax on income when:

(1) The intangible property generated gross receipts within the state, including through a franchise or license.

(2) The activity through which the corporation obtained the gross receipts from the intangible property was purposeful.

(3) The corporation's presence within the state satisfied the bright-line test.

The Department clarified, however, that income arising from passive investment activities within Connecticut is not considered a basis for a finding of economic nexus.

Iowa.

In a December 2010 revenue ruling, the Iowa Department of Revenue found an out-of-state LLC's members to have sufficient nexus with the state even though the LLC itself had no physical presence within the state.[10] The LLC, a registered agent service, conducted business within Iowa and was registered with the Iowa Secretary of State, but all of its property and employees were located in Idaho. The Department, citing a number of court decisions, stated that physical presence was not required for Iowa income tax nexus because the taxpayer was “exploiting the Iowa market.” Thus, according to the Department's logic, nonresident members of the LLC were automatically subject to tax on Iowa-source income. Additionally, the Department ruled that any receipts where the benefit of the service is received in Iowa would be considered an Iowa receipt. What is more troubling is that the Department now requires any nonresident member who receives income of $1,000 or more from Iowa sources to file an Iowa individual tax return—regardless (apparently) of their lack of nexus with the state.

Louisiana.

In an important decision for limited partners, the Louisiana Court of Appeal unanimously held that the mere ownership of a limited partnership interest in a limited partnership that conducted business within the state was not sufficient to subject a nonresident corporate limited partner to the Louisiana corporate franchise tax.[11] Petitioners, UTELCOM, Inc. and UCOM, Inc., were foreign corporations maintaining commercial domicile exclusively outside of Louisiana. Neither corporation was registered or qualified to do business in Louisiana during the relevant periods, and neither engaged in any business activities or had any physical or other presence in the state. The court also found that the petitioners did not:

> (1) Render any services to or for any affiliate company or other party in Louisiana.
>
> (2) Have any employees, independent contractors, agents, or other representatives in Louisiana.
>
> (3) Buy, sell, or procure services or property in Louisiana.
>
> (4) Maintain a bank account in Louisiana.

The court held that these contacts were insufficient to subject the petitioners to Louisiana's franchise tax. The court also held that the Louisiana Department of Revenue's regulation "ignored the clear wording of the [franchise tax] statutes and the interpretation of the Supreme Court and seeks to expand the scope of the specific incidents of taxation at issue." The court granted summary judgment in favor of the petitioners, holding that the Department's attempts to administratively expand the scope of the franchise tax beyond what was statutorily allowed was impermissible. On 3/2//2012, the Louisiana Supreme Court declined to review the Court of Appeal's ruling.

Maryland.

In September 2011, the Maryland Court of Appeals upheld the Maryland Special Nonresident Tax (SNRT) against federal Commerce, Equal Protection, and Privileges and Immunities Clause challenges, as well as against a state constitutional challenge.[12] The petitioners were residents of Pennsylvania who worked outside of and owned no property in Maryland, but paid state income taxes and local real and personal property taxes there. Those taxes, however, were not disputed by the petitioners. The sole issue was the additional SNRT imposed on their income attributable to sources in Maryland.

Maryland residents are subject to both a state-level income tax and a county-level income tax based on their residency. Because nonresident taxpayers escape the county level income tax, Maryland enacted the SNRT in 2004 to subject nonresident income to a tax equal to the lowest county income tax rate set by any Maryland county.[13] While the revenues from the county-level income tax are distributed to the counties, the state retains the revenues from the SNRT. The distribution of tax revenues was one of the main reasons why the petitioners claimed the SNRT violated both the U.S. Constitution and the Maryland Declaration of Rights.

Applying the compensatory tax doctrine of *Fulton Corp. v. Faulkner,*[14] the court found that the SNRT did not violate the Commerce Clause of the U.S. Constitution because:

> (1) The SNRT is compensating for the burden of the county income tax on intrastate commerce and the burden of providing local government services, directly or indirectly, to all persons or entities physically present or doing business within the local borders of Maryland.
>
> (2) The county income tax and the SNRT are imposed on the same in-state activity of earning income in Maryland.
>
> (3) Both taxes are general revenue taxes designed to support government services which benefit both residents and nonresidents.

The court also held that the SNRT did not violate the Equal Protection Clause of the U.S. Constitution because the distinction made between residents and nonresidents serves a rational purpose of equalizing the income tax burdens of residents and nonresidents. The court concluded that even though the SNRT distinguishes between residents and nonresidents, it seeks to treat each class equally by taxing those who earn income in Maryland. The court further held that the SNRT did not violate the Privileges and Immunities Clause of the Constitution because it placed all taxpayers, resident or nonresident, on equal footing. Finally, the court held that the SNRT did not violate Article 24 of the Maryland Declaration of Rights because the SNRT bears a fair and substantial relationship to the goal of requiring residents to pay for governmental services.

Michigan.

The Michigan Business Tax (MBT) was replaced with the Michigan Corporate Income Tax (CIT) that largely parallels the federal corporate income tax, effective 1/1/2012.[15] The CIT is comprised of three separate taxes:

(1) A corporate income tax.

(2) A premiums tax on insurance companies.

(3) A franchise tax on financial institutions.

The CIT only applies to C corporations and entities taxed as C corporations for federal tax purposes (e.g., a limited liability company that makes a check-the-box election to be taxed as a corporation). Individuals and pass-through entities,[16]—including partnerships, S corporations, and trusts—are not subject to the CIT, but they may be subject to nonresident owner withholding.

Most striking about the changes to the Michigan corporate tax regime are the expanded nexus rules. According to the new legislation, a taxpayer has nexus with Michigan and is subject to the CIT if it satisfies any of the following:

(1) Has physical presence in Michigan for more than one day during the tax year.

(2) Actively solicits sales in Michigan and has Michigan gross receipts of $350,000 or more.

(3) Has an ownership or beneficial interest in a pass-through entity, either directly or indirectly through one or more pass-through entities that has nexus with Michigan.

The nexus rule could run afoul of P.L. 86-272, which prohibits a state from assessing an income tax when a taxpayer's activities are limited to certain protected activities, such as sales solicitation.

New Jersey.

Affirming a Tax Court ruling, the New Jersey appellate court recently held that a foreign corporation's interest in a limited partnership doing business within the state does not create nexus for purposes of New Jersey's Corporate Business Tax (CBT).[17] The Division of Taxation argued that the foreign limited partner had nexus with the state because it was deriving taxable receipts from a partnership doing business in the state. The Division of Taxation also argued that the relationship between the limited partner and the partnership was a unitary one. In rejecting both arguments, the court found that the limited partner and partnership were not integrally-related and that the limited partner was merely a passive investor that had no control or potential to control the partnership. The court also noted that the two entities were not in the same line of business.

In addition, the court rejected the Division of Taxation's argument that certain provisions in the partnership agreement, namely a right of consent in order to admit additional partners, merge, or consolidate the partnership into another entity, created a unitary relationship. That issue was not appealed by the Division.

New York.

In a ruling with potentially broad implications, the New York Tax Appeals Tribunal, in *Matter of Shell Gas Gathering Corp. No. 2*,[18] upheld an administrative law judge's determination that two nonresident members of an LLC doing business in the state were subject to the state's corporate franchise tax because of their indirect receipt of New York-source income, even though the nonresident members themselves had no presence in New York. The court, agreeing with the Department of Revenue, found that it could tax the LLC members based, not on their presence in the state, but on the presence of the LLC in which they held a membership interest. The court stated that the ability of the state to tax a nonresident member is not dependent on the investor's presence in the state, but rather on the income derived from sources within New York. The administrative law judge found that the critical relationship was between the source of the income being taxed and the taxing jurisdiction, not the relationship between the taxing jurisdiction and the entity being taxed. Applying this reasoning, any owner of a corporation (or other entity) could be subject to New York's corporate franchise tax by virtue of the entity's contacts with the state, regardless of the owner's.

Pennsylvania.

In two companion cases, the Pennsylvania Commonwealth Court upheld assessments of Pennsylvania personal income tax on the income (deemed) received by nonresident partners from discharge of debt resulting from the foreclosure on commercial property located in Pittsburgh.[19] The foreclosed property was owned by a Connecticut limited partnership in which each nonresident limited partner owned an interest. Each nonresident limited partner was a passive partner and took no part in the management of the partnership. The sole purpose of forming the limited partnership, however, was the ownership and management of the commercial property at issue.

Taxpayers first argued that they lacked sufficient contacts with Pennsylvania to be subject to the personal income tax. The court, however, found that the nonresident limited partners were not just passive investors with no ties to Pennsylvania. Rather, the taxpayers knowingly invested in a partnership whose sole purpose was to own and manage real property within Pennsylvania. All of the policies and objectives of the partnership were directed at maximizing the limited partners' returns and this provided the necessary minimum contacts needed for Pennsylvania to impose the tax.

The taxpayers also argued that the differing treatment of residents and nonresidents violated the Equal Protection Clause of both the U.S. and Pennsylvania Constitution because Pennsylvania resident partners were allowed to offset the gain from the foreclosure with losses incurred in the liquidation of the partnership, while nonresident partners were not. The court stated that according to Pennsylvania law, the sale of a partnership interest is the sale of an intangible asset. Thus, the loss from liquidation was not Pennsylvania-source income to the nonresident taxpayers.

Withholding and Reporting for Nonresident Owners

Because of the uncertainty surrounding whether a state can require a nonresident owner of a pass-through entity to file a return or in some instances to pay its income tax, many states have enacted withholding requirements for pass-through entities with nonresident owners. Withholding requirements help ensure that a state is able to tax the income earned by a pass-through entity in the state regardless of whether the income is allocated or distributed to the nonresident owners. Some states have also enacted composite filing requirements for pass-through entities. Withholding and composite return requirements, as demonstrated below, are constantly evolving and can create compliance headaches for the owners, both resident and nonresident, of pass-through entities.

Idaho.

Effective retroactively to 1/1/2011, a new Idaho law prohibits nonresident individuals who (1) are officers, directors, or owners of an interest in a pass-through entity transacting business in Idaho; and (2) have non-entity Idaho taxable income from electing to have the entity report and pay Idaho tax on their behalf at the Idaho corporate income tax rate.[20] Interestingly, the Idaho legislature yet again amended the state's composite return and withholding requirements, retroactively effective 1/1/2012, to provide that nonresident individual owners of pass-through entities transacting business in Idaho may have Idaho income tax relating to their distributive share remitted by the pass-through entity on a composite return.[21]

This act also provides that a publicly traded partnership is not required to withhold taxes under the backup withholding provisions of Idaho Code §63-3006B if it is treated as a partnership for federal income tax purposes and has agreed to file an annual information return reporting the names and contact information of each of its owners whose distributive share of Idaho income is more than $500.[22]

Kentucky.

The Kentucky Department of Revenue has issued guidance summarizing recent changes in Kentucky's income tax laws.[23] For tax years beginning after 12/31/2011, every pass-through entity in Kentucky that is required to withhold Kentucky income tax must make a declaration and pay estimated tax if the tax liability can reasonably be expected to exceed a specific amount. For nonresident individual owners, the threshold for withholding is $500 and for corporate owners the threshold amount is $5,000. The Department also reminded taxpayers that when withholding on the distributive share of income for nonresident individuals, estates, trusts, and corporations, no withholding is made for partners or members that are themselves pass-through entities. The distributive share of income for these partners or members will continue to pass through as Kentucky-source income, requiring withholding at each level in a multi-tier structure.

Michigan.

As mentioned above, a new Michigan law imposes changes on pass-through entities.[24] For instance, pass-through entities that withhold income tax on their member's distributive shares are now required to file a reconciliation return. In addition, the Department of Treasury may require pass-through entities to file a business income information return and may revise the applicable withholding requirement on the failure or refusal of the entity to provide certain information.

New Mexico.

The New Mexico Taxation and Revenue Department issued proposed amendments and new rules regarding corporate and individual income and withholding tax rules.[25] The withholding requirements for pass-through entities for periods beginning on or after 1/1/2011 are governed by the Oil and Gas Proceeds and Pass-Through Entity Withholding Act. The withholding rate for periods beginning on or after 1/1/2011 are posted on the Department's website, along with past and current rates and any changes to future rates. With respect to net income from pass-through entities, no withholding is required if the sum of all payments in the calendar quarter is less than $30. Pass-through entities are not required to withhold amounts from corporations whose principal place of business is within the state or from individuals who are residents of the state.

Utah.

In October 2011, the Utah State Tax Commission updated its guidance on withholding requirements for pass-through entities and their owners and also clarified its definition of an upper-tier pass-through entity.[26] For tax years 2010 and after, pass-through entities (including downstream pass-through entities) may request a waiver of the Utah withholding requirements by checking a box on two tax forms. This waiver may be requested for all or some of the entity's partners, members, or shareholders. If the waived owner fails to file a return or make the required payments, however, the pass-through entity will not be eligible for the waiver and is liable for Utah withholding on the unpaid amounts, plus penalties and interest.

Wisconsin.

The Wisconsin Tax Appeals Commission affirmed an interest and negligence penalty assessment against a partnership for failure to properly withhold income tax from its nonresident partners.[27] The taxpayer was a partnership organized under the laws of Wisconsin and had numerous partners, many of whom were not Wisconsin residents. The taxpayer admitted to not withholding income tax from its nonresident partners for the 2005 and 2006 tax years. Thus, the Tax Appeals Commission held that the taxpayer violated the withholding requirements and, pursuant to Wisconsin law, the interest and penalties were appropriate. Ironically, the fact that the taxpayer had since paid the tax deficiencies did not, according to the Commission, relieve the taxpayer of the mandatory payment of interest and late charges due under Wisconsin law. The Commission further stated that not being aware of the legal requirements is no excuse; taxpayers are responsible for knowing and adhering to the tax laws of the states in which they do business. Further, the taxpayer's compliance with the withholding requirements since the tax years at issue did not negate the penalty assessed by the Department.

Transfer of Real Property Between Related Entities

Another issue that frequently arises is whether transfers of real property between a pass-through entity and its owners are subject to state realty transfer taxes. Surrounding these transactions are questions of whether there was, in fact, a change in the ownership of the property or if taxable consideration was given in exchange.

Alabama.

Notwithstanding the general rule that Alabama conforms to the federal entity classification rules, the Alabama Court of Civil Appeals upheld a trial court's denial of a refund claim for recording tax paid on real property deeded to three disregarded SMLLCs, of which the taxpayer was the single member.[28] The taxpayer argued that, for Alabama tax purposes (except the business privilege tax), deeds and assignments recorded were not actual conveyances of property because each SMLLC is disregarded; thus, the single member was deemed to still own the property. The court held instead that the act of recording the deeds and assignments is subject to the recording tax. The tax, the court said, is a tax on the recording of the documents, rather than a tax on the underlying transaction, thereby implicitly acknowledging that a conveyance did not actually occur.

The recording tax statute contains four exemptions and the court held that the list of those exemptions naturally excludes all other exemptions from the recording tax. Because the taxpayer did not fall within any of the four exemptions, the recording tax applied and the refund claim was denied.

Florida.

Readers may recall that in October 2010, the Florida Department of Revenue adopted an emergency rule. The rule imposes a tax on transfers of ownership interests in a conduit entity when the transfer is within three years of a transfer of Florida real property into the conduit entity, without the grantor having paid tax on the full consideration of the real property.[29] However, the sale of membership interests in an LLC that owns Florida real property acquired before 7/1/09, is not subject to the documentary stamp tax imposed on conduit entities.[30] The statutes creating the documentary stamp tax do not provide a basis for assessments of tax for periods before 7/1/09.

More recently, the Florida DOR issued guidance regarding the transfer of real property between entities.[31] Where the taxpayer is the sole beneficiary of a trust and the trust is the sole member of an LLC, a transfer of real property between the taxpayer and the LLC and subsequent transfer from the LLC to the trust is subject only to the minimum tax. If at the time of the transfer to the LLC, the real property is unencumbered and the taxpayer continues to own the property, either directly or indirectly, in the same proportion, then absent other circumstances only the minimum documentary stamp tax would be required on the deed.

New Hampshire.

The New Hampshire Supreme Court has held that transfers of commercial real property between two affiliated LLCs were subject to the state's real estate transfer tax because the transfers were bargained-for exchanges.[32] The transfers were considered taxable because each transfer involved the exchange of “money, or other property and services, or property or services valued in money.” The court rejected the taxpayer's contention that a tax on a single-purpose entity used to obtain financing violated the New Hampshire Constitution. The court stated that the transfer tax applied “whenever there is a contractual transfer of real estate or an interest in real estate” and the tax applies uniformly to all similarly situated taxpayers.

Virginia.

In a November 2011 ruling, the Virginia Tax Commissioner upheld the imposition of recording tax on real property transferred to a newly organized LLC pursuant to the merger of two corporations.[33] Virginia imposes a tax on the recordation of documents related to real estate transactions. The tax is imposed on all recorded instruments unless the transaction is exempted by statute. The taxpayer claimed that the transaction at issue fell under one of the three exemptions provided by Virginia statute.

The first exemption applies to deeds conveying real estate to certain surviving entities in a merger, consolidation, or reorganization under **IRC Sections 368(a)(1)(C)** and (F). The Commissioner found that in order for this exception to apply, one or both of the corporations must cease to exist following the merger or consolidation. Because both corporations survived the merger, the Commissioner found this exemption inapplicable. Also, because the newly-formed entity was an LLC and not a corporation, the transaction did not qualify under **IRC Section 368**.

The second exemption applies to transactions between parent and subsidiary corporations. The real property at issue here, however, was not conveyed between corporations; rather it was conveyed to an LLC. Thus, the Commissioner held that this exemption did not apply.

Finally, the third exemption requires the grantor corporation to receive at least 50% of the profits and surplus from the newly-formed LLC. The grantor corporation, however, only received a 42% interest in the LLC; thus, the Commissioner ruled that the exemption did not apply.

Entity-Level Taxes on Pass-Through Entities

As an attempt to generate tax revenue without triggering the constitutional issues surrounding nexus, some states now impose entity-level taxes on pass-through entities as an indirect tax on the entity's nonresident owners. An added benefit to the states of imposing entity-level taxes is that it removes any concerns or uncertainty about having to tax the income of nonresident owners after it has been distributed to them by the pass-through entity. Entity-level taxes on pass-through entities have been imposed by Michigan, Oklahoma, Ohio, and Texas, although Michigan's entity-level tax, the MBT, has been repealed and replaced by the new CIT, which does not impose an entity-level tax on pass-through entities. In addition, some local governments, like New York City, also impose an entity-level tax on pass-through entities. Other states may use allocation and apportionment rules to tax a pass-through entity's income attributable to a unitary business. Several recent developments in this area are discussed below.

Louisiana.

The Louisiana Department of Revenue issued guidance related to the corporate income tax filing requirements of partnerships and sole proprietorships doing business in the state.[34] Registered LLCs that elect to file federally as partnerships or sole proprietorships, as appropriate, are not required to file a Louisiana corporate income tax return. However, LLCs that have checked the box and elected to file as federal C corporations or S corporations are required to file a Louisiana corporate tax return. In no case is an LLC required to file and pay franchise tax in Louisiana. If an LLC received a non-filing assessment for a corporate income tax return and no return was due, the LLC may return the assessment accompanied by a clarifying letter discussing its federal filing status.

The Louisiana Department of Revenue asks all LLCs that have elected to file as partnerships to disclose the names of their members. Additionally, partnerships with nonresident partners are required to file a partnership income tax return with the department.

Texas.

In November 2011, the Texas Supreme Court held that the 2006 revision to the Texas franchise tax does not violate the state's constitutional requirement that personal income taxes must be enacted by a statewide vote.[35] The “margin tax” follows the entity theory of partnerships. Thus, partnership income and profits are treated as partnership property and the margin tax is imposed on the entity, rather than directly on the individual partners. The court concluded that because Texas has adopted the entity theory of partnerships, a tax could be imposed on a limited partnership and not be considered a tax on the net income of the individual partners. The court found that the margin tax differs from the federal income tax because the tax is imposed at the entity-level, rather than on the individual partners. While the court said it had original jurisdiction over this claim, it declined to hear the arguments that the amendments violated the Texas Constitution's requirement of equal and uniform taxation, stating that those tax challenges must be brought in district court.

Multistate Tax Commission (MTC) Developments

On 03/11/2011, the MTC Executive Committee voted to submit to public hearings the model statute that would subject to corporate income tax a pass-through entity owned by an entity that is not subject to corporate income tax. The model statute, which was previously approved by the MTC's Uniformity Committee, provides for a partnership or disregarded entity to be taxed by a state as if it was a C corporation subject to tax in that state if at least 50% of the entity's ownership interests are owned, directly or indirectly, by an entity that is not subject to that state's corporate income tax. It is believed that this model statute could result in a significant tax increase for insurance companies and other businesses that are not subject to an adopting state's corporate income tax.

Application of Credits and Deductions

Generally speaking, most states allow the credits earned by a pass-through entity to be allocated to its owners. Many questions still arise regarding the eligibility for and application of credits in the pass-through entity context. For example, some states may limit or deny credits for taxes paid to other states if the state where the taxes were paid does not have a reciprocal tax credit agreement with it. States may also limit the pass-through entity's ability to allocate its deductions or credits to its owners.

California.

Last Spring, the California Franchise Tax Board (FTB) released a memorandum[36] summarizing its study of the Revised Texas Franchise (margin) Tax, the Michigan Business Tax, and the Ohio Commercial Activity Tax (CAT). The FTB evaluated those taxes to determine if they are income taxes under California law. Shareholders in S corporations are entitled to claim the Other State Tax Credit (OSTC) for their pro rata share of taxes paid by the corporation to another state if the tax is on, according to, or measured by income or profits paid or accrued. Based on the FTB's analysis, a tax is not an income tax for state purposes if the base includes a return of capital.

Ultimately, the FTB determined that S corporation shareholders are entitled to claim the OSTC for the Texas margin tax under the cost of goods sold method, and the business income portion and surcharge (but not the modified gross receipts portion) of the Michigan Business Tax. The FTB concluded, however, that shareholders are not entitled to the OSTC for the CAT, because it was not an income tax since the tax base includes a return of capital.

Indiana.

A pass-through entity entitled to Indiana's Economic Development for a Growing Economy (EDGE) tax credit may pass the credit through multiple levels of pass-through entities until the credit reaches the ultimate taxpayer(s).[37] A corporate taxpayer owned a direct interest in an LLC, which was entitled to the EDGE credit by virtue of its indirect ownership of an LLC that received the credit. In order for the credit to pass through to the corporate taxpayer, it had to pass through three different layers of entities. The Indiana Department of Revenue concluded that a proper reading of the statute does not stop the credit after passing through one level of pass-through entities, but rather the credit may pass through any entity entitled to the credit until the end taxpayer is reached, who may then claim the credit.

Kentucky.

The Kentucky Board of Tax Appeals ruled that an LLC may not use its members' net operating losses (NOLs) to offset its income because the LLC did not have a vested right to use the NOLs.[38] The taxpayer attempted to use the NOLs in 2005 and 2006. The Department of Revenue sent the taxpayer a notice disallowing the use of NOLs generated by its assets in 2002 and 2003 on the basis that the Kentucky Tax Modernization Act did not expressly permit an LLC to use NOLs from years prior to 2005 to offset income earned in 2005 and 2006. Under the Tax Modernization Act, which was passed in 2005, the taxpayer was classified as if it had elected to be taxed as a C corporation. For prior years, the taxpayer was treated as a pass-through entity.

Relying on the Kentucky Supreme Court's holdings in *Finance and Administration Cabinet v. Johnson Controls, Inc.,*[39] the BTA determined that these NOLs must remain with the members of the LLC because the LLC had no vested right to use the NOLs for the tax years in question. The Board concluded that the taxpayer had no NOL as of 12/31/2004—its members did. The NOLs were not eliminated, however; rather they were left with the members who could have used the NOLs in 2005 and 2006 if they had taxable income in those years.

Pennsylvania.

In *DelGaizo v. Commonwealth of Pennsylvania,*[40] the Pennsylvania Commonwealth Court upheld an administrative rule prohibiting S corporation shareholders from carrying over losses incurred by the S corporation and passed through to them into future tax years because S corporations and C corporations are not similarly situated. The court rejected the taxpayer's contention that treating S corporations and C corporations differently violated both the Pennsylvania and U.S. Constitutions. Holding that S corporations and C corporations are not similarly situated because of the S election and the financial benefits obtained, the court noted that the critical difference between the two business forms is that Pennsylvania S corporations are generally not subject to Pennsylvania corporate net income tax, whereas Pennsylvania C corporations are. The court concluded that the taxpayers, as S corporation shareholders, cannot have S election benefits without also incurring the burdens.

Tennessee.

In November 2011, the Tennessee Court of Appeals concluded that shareholders in two S corporations are not entitled to a Hall income tax credit for tax paid to South Carolina.[41] The Hall income tax is Tennessee's individual income tax on income derived solely from dividends from stocks or interest on bonds. Even though there was no express reciprocity agreement between Tennessee and South Carolina, the taxpayer argued that the tax credit should be implied from the applicable state statutes. The court, however, rejected this argument. Thus, Tennessee holders of out-of-state S corporations may be susceptible to tax in multiple jurisdictions without relief through a credit. The court also rejected the taxpayer's argument that the double taxation resulting from the lack of a credit violated the Commerce Clause of the U.S. Constitution. Surprisingly, the court concluded that the Commerce Clause did not apply because, it said, the income was earned from an intangible dividend distribution, and was thus earned intra-state, rather than interstate.

Virginia.

In a letter ruling issued in September 2010, the Virginia Department of Taxation held that a nonresident taxpayer receiving income from a Virginia S corporation was denied the use of his pro rata share of a Virginia income tax credit under Virginia Code § 58.1-332 B.[42] That section provides a credit to nonresidents on Virginia-source income when their home state provides a substantially similar credit to Virginia residents or imposes a tax on the income derived from Virginia sources that is exempt from Virginia taxation. Because North Carolina does not provide a reciprocal income tax credit to nonresidents, the taxpayer was barred from claiming an individual income tax credit for taxes paid to North Carolina on income from Virginia sources.

In another letter ruling, the Virginia Tax Commissioner provided guidance to corporate taxpayers by stating that the Kentucky Limited Liability Entity Tax (LLE tax) is not added back for purposes of calculating Virginia taxable income.[43] The Commissioner explained that the Kentucky LLE tax is not a tax based on net income because it excludes almost all business expenses normally permitted in determining net income. Corporations and limited liability pass-through entities must pay the Kentucky LLE tax. The Commissioner also stated that Virginia considers the Kentucky corporate income tax to be based on net income, and therefore to be added back, only to the extent that it exceeds the Kentucky LLE tax.

Pass-Through Entity Owner Liability

An issue sometimes overlooked is the extent to which investors in pass-through entities may be responsible for unpaid taxes or other liabilities of the pass-through entity under state “responsible person” statutes or otherwise. Under these statutes, an owner of a pass-through entity that operates a business can be liable for any of the entity's unpaid taxes. Thus, a state can seek recovery of an entity's entire tax liability from an owner who qualifies as a “responsible person,” even though the owner may own a minority interest in the pass-through entity. As one can imagine, this would be a very unpleasant surprise to owners and investors in pass-through entities who may not realize or understand that they may be responsible for all of a business's unpaid taxes. The responsibility to pay may also extend to owners and investors who have no knowledge or control over the taxes being paid or withheld.

Illinois.

An Illinois administrative law judge found an officer and 50% member of an LLC doing business within the state to be personally liable for the LLC's unpaid sales and use taxes.[44] Under Illinois law, personal liability is imposed when a corporate officer, who is responsible for filing corporate tax returns, willfully fails to submit the tax that is due.[45] The court rejected the taxpayer's contention that he was not the responsible officer, instead concluding that a 50% ownership stake, as well as management duties and responsibility for preparing the company's tax returns, did not support the taxpayer's abdication of all authority in the business. In addition, the court found the taxpayer to have acted willfully because of his knowledge of the financial problems of the company and its inability to timely pay its creditors.

New Hampshire.

The New Hampshire Supreme Court held that several resident partners were liable for income tax on distributions from a domestic limited partnership because their beneficial interests in the partnership were represented by transferable shares.[46] This ruling reversed a lower court's holding that the Department of Revenue's regulations pertaining to transferable shares were ambiguous and that the partnership's shares were not transferable. The supreme court reversed after finding that the lower court had misinterpreted and misapplied the Department's regulations. The court concluded that the partners were able to readily liquidate their holdings in the limited partnership and that therefore their beneficial interests constituted transferable shares.

New York.

New York imposes personal responsibility for the payment of sales and use taxes on certain owners, officers, directors, employees, managers, partners, or members of businesses that have outstanding sales or use tax liabilities. In the case of a partnership or LLC, § 1131(1) of the Tax Law provides that each partner or member is a responsible person regardless of whether the partner or member is under a duty to act on behalf of the partnership or LLC. The New York State Department of Taxation and Finance has issued a new policy, which relieves limited partners and LLC members from the responsible person liability. To be eligible for relief, limited partners and LLC members must demonstrate they were not under a duty to act in complying with the Tax Law on behalf of the entity and LLC members also must document that their ownership interest and percentage distributive share is less than 50%.[47]

Ohio.

In *Guernsey County Comm'rs v. Cambridge Property Investors, Ltd.*,[48] the Ohio Court of Appeals held that members of a dissolved LLC were personally liable for unpaid lodgings tax. The taxpayers contended that the tax at issue was an excise tax, rather than a sales tax as required under the state's responsible person statute.[49] The court, after analyzing the statute, held that the statute clearly defines the tax in question as a sales tax.

Series LLCs

Businesses and investors are more and more frequently turning to series LLCs as a viable answer to choice-of-entity questions. Kansas is the latest state to enact a true series LLC act. [50]One of the main issues surrounding series LLCs is whether each individual series is treated as a single taxpayer, requiring separate filings from each series, or if the series as a whole is considered one taxpayer with only one return being due. As discussed below, states have answered this question in a variety of ways. Even with the IRS's proposed regulatory guidance on the federal tax treatment of series LLCs, states continue to differ in their treatment of series LLCs, which will continue to create complexity for the owners of multistate series LLCs.

California.

While California law does not explicitly allow series LLCs to be formed in the state, it does, at least informally, recognize them.[51] A series LLC formed under the laws of another state may register with the California Secretary of State and transact business in California. A series LLC is defined as a master LLC whose organizing documents provide for separate sub-units or series that operate as independent entities. The FTB recently provided a list of six features of series LLCs. If the entity has the six features under the laws of the state in which it was formed, the FTB takes the position that each unit is treated as a separate entity for California filing and tax purposes. Thus, the same filing guidelines and estimated taxes that apply to LLCs also applies to each series of a series LLC. For example, if the LLC has elected to be taxed as a corporation, the LLC is required to follow California corporate filing guidelines and estimated tax requirements, and is subject to the minimum franchise tax.

Tennessee.

The Tennessee Department of Revenue ruled informally that a Tennessee series LLC was required to file separate franchise and excise tax (F&E tax) returns for each individual series rather than filing one single Tennessee return.[52] The Department of Revenue stated that Tennessee law clearly intended for each series to be treated as a separate entity for purposes of the Tennessee F&E taxes and thus each individual series must file on a separate entity basis. Also important to the Department of Revenue's holding was the fact that under the Treasury Department's proposed series LLC regulations, each series is treated as a separate entity for the purpose of determining its federal tax classification. The federal classification of series LLCs, the Department stated, strongly suggested that series LLCs in Tennessee should likewise be treated as separate entities for state tax purposes. Finally, the series did not meet Tennessee's statutory requirements for being treated as disregarded entities, which the Department believed was further support for its position that each series must file a separate F&E return.

Texas.

For purposes of the Texas margin tax, taxable entities include an LLC; in contrast to the California FTB, however, the Texas Comptroller's Office opined that each series of an LLC is not separately identified as a taxable entity. Therefore, the series LLC as a whole is a taxable entity and must file a single margin tax report under its main Texas taxpayer identification number; one series of the LLC cannot file a margin tax report separate from the series as a whole.[53] Also, the entity pays one filing fee and registers as one entity with the Texas Secretary of State.

Conclusion

As the above discussion indicates, numerous recent developments address issues that affect the state taxation of pass-through entities and their owners. Because this is an ever-evolving area of the law, with regard to both the case law and statutory and regulatory changes, it is very important for the owners of pass-through entities to closely monitor developments. This is especially true when making choice-of-entity decisions or determining the state and local tax reporting requirements based on the operations of pass-through entities.

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For purposes of this article, a pass-through entity is one where the income is generally not taxed at the entity level but, instead is passed through and taxed when it is received by the owners of the entity (e.g., partnerships, limited liability companies, and S corporations).

2

Note 11 *infra*.

3

504 US 298, 119 L Ed 2d 91 (1992). For a discussion of Quill, see Eule and Richman, “Out-of-State Mail-Order Vendors Need Not Collect Use Taxes—Yet!,” 2 J. Multistate Tax'n 163 (Sept./Oct. 1992).

4

15 U.S.C. sections 381 and 384 (P.L. 86-272) limits a state's ability to assert income tax jurisdiction over a business whose only activity within the state is solicitation of orders for the sale of tangible personal property, provided the orders are sent out of the state for approval and are filled by shipment from outside the state. P.L. 86-272 does not protect other non-de minimis activities in a state nor does it apply to non-income taxes (i.e., sale or use taxes) or to the sale of

intangibles. See Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 US 214, 120 L Ed 2d 174 (1992). For a discussion of Wrigley, see Marcus and Lieberman, “Does Wrigley Clarify 'Solicitation' for Purposes of Taxing Interstate Commerce?,” 2 J. Multistate Tax'n 148 (Sept./Oct. 1992). See also Lieberman, “MTC Guidelines on P.L. 86-272 Implement the U.S. Supreme Court's Decision in Wrigley,” **5 J. Multistate Tax'n 52 (May/June 1995)**.

5

Cal. Rev. & Tax'n Code § 23101.

6

California Franchise Tax Board, Legal Ruling 2011-01 (1/11/2011).

7

“New Rules for Doing Business in California,” FTB Taxnews (3/4/2011).

8

Connecticut Dep't. of Rev., Informational Publication IP 2010(29) (9/23/2010); See also Connecticut Dep't. of Rev., Informational Publication IP 2010(29.1) (12/28/2010).

9

Conn. Gen. Stat. § 12-216a.

10

Iowa Dep't of Rev., Policy Letter 10240041 (12/16/2010).

11

UTELCOM, Inc. and UCOM, Inc. v. Bridges, 77 So 3d 39 (La. App. 1st Cir., 2011), writ denied, 2011-C-2632 (LA. 2012).

12

Frey v. Compt. of the Treas., 29 A3d 475 (Md., 2011).

13

2004 Md. Laws Ch. 430 § 30.

14

516 US 325, 133 L Ed 2d 796 (1996).

15

Act No. 38, Public Acts of 2011, Michigan H.B. No. 4361, 5/25/2011; Act No. 39, Public Acts of 2011, Michigan H.B. 4362, 5/25/2011.

16

Michigan statutes use the term “flow-through entity.” For purposes of consistency, this article has substituted the term “pass-through entity.” Substantively, these terms are the same.

17

BIS LP, Inc. v. Div. of Tax., No A-1172-09T2, (N.J. Superior Ct., App. Div., 8/23/2011).

18

DTA Nos. 821569 and 821570 (9/23/2010).

19

Wirth v. Pennsylvania, 424 F.R. 2008 (Pa. Commw. Ct., 1/3/2012); Marshall v. Pennsylvania, 933 F.R. 2008 (Pa. Commw. Ct., 1/3/2012).

20

Idaho Code § 63-3022L.

21

H.B. 582, Second Regular Session—2012, amending Idaho Code § 63-3022L.

22

Id.

23

Kentucky Tax Alert, Vol. 31, No. 1 (Jan. 2012).

24

Act No. 193, Public Acts of 2011, Michigan S.B. 679 (10/17/2011).

25

N.M. Stat. Ann. §§ 7-3-12, 7-3A et seq.

26

Utah Informational Pub. 68 (10/1/2011).

27

United Wisconsin Grain Producers, LLC v. Wisconsin Dep't of Rev., Doc. No. 10-W-244 (8/24/11).

28

Sustainable Forests, LLC v. Alabama Dep't of Rev., 80 So 3d 270 (Ala. Civ. App. 2011).

29

Florida Dep't of Rev., 12BER10-07 (10/12/2010). Florida Statute § 201.02(1)(b)3 provides how the tax is imposed, when the tax is due, and examples of transfers of real property that would be subject to the tax.

30

Fla. Dep't of Rev., TAA 11(B)4-002 (1/24/2011).

31

Tech. Assistance Advisement 11(B)4-012, Florida Dep't of Rev. (9/1/2011).

32

First Berkshire Business Trust et al. v. Dep't of Rev. Admin., No. 2009-850 (N.H., 11/24/2010).

33

Virginia Dep't of Tax., Rulings of the Tax Comm'r, Doc. No. 11-186 (11/16/11).

34

Louisiana Dep't of Rev., News Release—Filing Requirements for Partnerships and Sole Proprietorships, “Tax Topics,” (9/29/10).

35

In re Allcat Claims Service LP, Tex., No. 11-0589 (11/28/11). The Texas Supreme Court subsequently dismissed a similar appeal for lack of jurisdiction. See In re Nestle USA, Inc., Switchplace, LLC, and NSBMA, LP, Tex., No. 11-08855 (2/10/12).

36

Cal. Franchise Tax Bd., Tech. Advice Memo, No. 2001-03 (4/13/11).

37

Indiana Dep't of Rev., Letter of Findings, No. 10-0421 (10/27/10).

38

HPCKAL, LLC v. Commonwealth of Kentucky Finance and Admin. Cabinet, File No. K09-R-27, Order No. K-21182 (8/25/11).

39

296 SW3d 392 (Ky. 2009).

40

8 A. 3d 429 (Pa. Commwlth. Ct. 2010), aff'd 23 A 3d 610 (Pa. Commwlth. 2011).

41

Boone v. Chumley, Dkt. No. E2010-0162 (Tenn. Ct. App., 11/30/2011); see also Carter, “Tennessee Court Disallows Credit to S Corporation Shareholders for Tax Paid to South Carolina,” 14 BET 24 (March/April 2012).

42

Virginia Dep't of Tax., Rulings of the Tax Comm'r, No. 10-205 (9/7/10).

43

Virginia Dep't of Tax., Rulings of the Tax Comm'r, Doc. No. 11-147 (8/10/2011).

44

Dep't of Rev. v. John Doe, Admin. Hearing Decision No. St. 10-10, Illinois Dep't of Rev. (8/20/2010).

45

Uniform Penalty and Interest Act, 35 ILCS 735/3-7 (8/16/2010).

46

New Hampshire Resident Limited Partners of the Lyme Timber Co. v. New Hampshire Dep't of Rev. Admin., No. 2010-399 (N.H. Supreme Ct., 5/26/2011).

47

New York State Dep't of Tax. and Finance, Tech. Memo TSB-M-11(6)S (4/14/2011).

48

No. 2010-CA-28 (Ohio Ct. App., 2010).

49

Ohio Rev. Code Ann. § 5739.33.

50

L. 2012, H.B.2207 (eff. 7/1/12)

51

California Franchise Tax Board Tax News (10/1/2011).

52

Tennessee Dep't of Rev., Letter Ruling 11-42, (9/6/11); see also Carter and Long, “State Issues Significant Guidance on the Tax Treatment of Series LLCs,” 21 J. Multistate Tax'n 10 (Feb. 2012).

53

Texas Policy Letter Ruling 201005184L (5/5/2010) (released September 2011); see also Texas Office of the Comptroller, Franchise Tax Frequently Asked Questions, available at http://www.window.state.tx.us/taxinfo/franchise/faq_tax_ent.html#tax_ent13; cf. California Franchise Tax Board Information Directory, Pub. 3556 LLC MEO, available at http://www.ftb.ca.gov/forms/misc/3556.pdf (noting that California considers each series in a series LLC to be a separate LLC for annual tax and LLC fee purposes).