Pass-Through Entities Face Myriad State-Level Taxes, Compliance Obligations

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The most common type of business entities in the United States are pass-through entities.

Pass-through entities, such as partnerships, limited liability companies, and S corporations, are the most widely chosen forms of business entities in the U.S. because they escape tax at the entity level for federal income tax purposes. Instead, income is allowed to flow through to the owners (e.g., partners, LLC members, or S corporation shareholders) before being subject to the individual or corporate income tax.

Taxation of these entities, however, is very different at the state level. Some states impose tax not only at the individual level but also at the entity level. Some states don't have an individual income tax but choose to impose tax on pass-through entities at the entity level. While pass-through entities are commonly owned by individuals, states are increasingly applying corporate income tax concepts, such as business or nonbusiness income classification and apportionment, to pass-through entities operating in more than one state. It is frequently unclear how each jurisdiction applies these concepts. The lack of clarity on how states tax these entities creates significant risks for these businesses and their tax advisors.

What You Don't Know Can Cost You – Experts Weigh In

Bruce Ely and **Steven N. Wlodychak** share some of their key findings from their years of experience on this issue, which continues to challenge practitioners on the state level.

State Taxes at the Entity Level

States do not take a uniform approach to the tax treatment of multistate pass-through entities and their owners. The first area of jeopardy is state conformity with the federal tax classification of a specific type of pass-through entity. Since pass-through entities are, in fact, legal persons in their own right, some states choose to "disregard" the federal pass-through treatment, and impose tax directly on the entity.

The motivations for such treatment by a state vary based on its history. The District of Columbia is an example of a jurisdiction that subjects pass-through entities to tax through its unincorporated business tax, while ignoring an S corporation election for purposes of its corporate franchise tax. More recently, the District has become the first jurisdiction to require combined reporting of unitary pass-through entities with corporations, creating enormous complexity in preparing a combined report.

In addition, a state that is prohibited from imposing a net income tax on a pass-through entity or its owners by federal law (e.g., P.L. 86-272) may nevertheless impose a franchise tax or other tax not based on net income either directly on the pass-through entity or its owners since such protections don't exist for non-income taxes.

Many states impose non-income taxes (e.g., minimum taxes, gross receipts taxes, sales taxes, real estate transfer taxes, property taxes) directly on certain pass-through entities. For example, Kentucky imposes a limited liability entity tax on pass-through entities that afford any of its partners, members, shareholders, or owners, through function of the laws of Kentucky or laws recognized by the state, protection from general liability for actions of the entity. As a result, the tax does not apply to general partnerships or limited partnerships, but it applies to limited liability partnerships, limited liability limited partnerships, LLCs, S corporations, and qualified subchapter S subsidiaries.

Different Tax Treatment of Partners and Shareholders

States also approach the tax treatment of partners and S corporation shareholders in a variety of ways. Pass-through entities may be subject to different state modifications to federal taxable income than apply to C corporations (and in some states, C corporations may find they can take deductions as a partner they could not take if taxed directly). Multistate partnerships could be subject to different apportionment rules than those applicable to C corporations.

Some states treat the income distributed to individual partners differently than they do distributions made to corporate partners because state personal income tax laws tend to differ from corporate income tax laws. States that don't impose a personal income tax typically do not require the filing of a partnership return unless the partnership has corporate partners.

A number of potential surprises exist beyond the entity level. Individual recipients of guaranteed payments akin to compensation are often surprised to learn that they are still partners in a multistate business and their income is subject to apportionment and allocation based upon the partnership's apportionment factors, even if they work in a single geographic location for their entire career. And partners may not qualify for their share of the partnership's tax credits available to corporations.

Unitary business principles also have different meanings for partnerships than they do for matters related to corporations. All states that

"Many states have taken a different path when it comes to following the federal income tax paradigm for pass-through entities and their owners.

As we know, under Subchapter K and generally under Subchapter S, the entity itself is not taxable, but instead the partners, members, or shareholders are liable for income tax on their distributive or pro rata shares of the entity's net income. The states are all across the board as to their conformity – or not – with that concept."

Bruce Ely

provide for pass-through treatment allow the direct flow through or "flow-up" of a partner's distributive share of taxable income, but whether the partners, and most importantly, the corporate partners, are entitled to their distributive share of the partnership's apportionment factors depends on whether the corporate partner is engaged in a unitary business with the partnership. If not, the corporate partner is "stuck" with not only the distributive share of partnership income but also the amount apportioned to a state based on the partnership's apportionment factors alone and not mixed with its own factors.

In some states, a partner need not own 50% or more of the partnership's interests to be deemed unitary with the partnership for these purposes, which is a surprise to students of the unitary business principle since common ownership is the only objective standard of unitary analysis.

Following Pass-Through Entity Income Out of State

States have struggled for decades with federal constitutional limitations on taxing nonresident owners of pass-through entities and have devised a variety of different methods to collect tax on their indirect business activities. Commonly, just as in the international tax environment, states impose some measure of withholding on the distributive share of partnership income allocated to nonresidents.

A few states take a unique approach to pass-through entity withholding. For example, Maryland imposes a nonresident member tax on pass-through entities with one or more members who is a nonresident individual or entity. The tax is imposed on the pass-through entity at the entity level but is treated as a tax imposed on the nonresident owners and paid on their behalf.

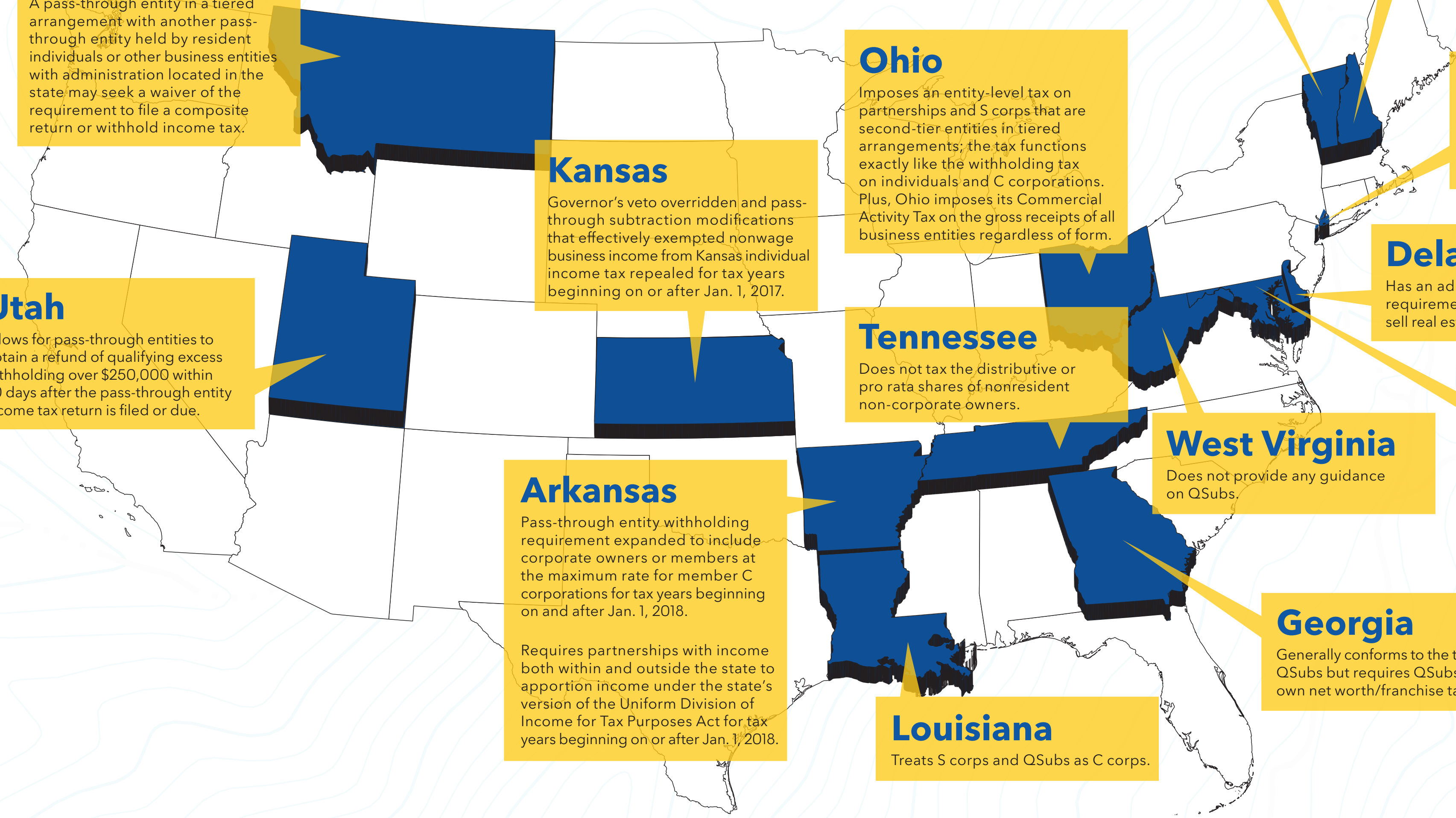
Other states target tiered arrangements. In Ohio, an entity tax, which functions like a withholding tax, is applied to the distributive share of the second-level pass-through entity that owns an interest in the top-level pass-through entity. Virginia also requires a pass-through entity to withhold tax from a second-level pass-through entity's distributive share of pass-through entity income.

Complex Compliance for Nonresident Owners

Sometimes the differences occur within the same state, which may impose differing nonresident owner withholding requirements on corporate and non-corporate owners of pass-through entities. Some states implicitly acknowledge the risk that they might not have constitutional authority to tax nonresident owners and simply require a contractual consent by the owners of the entity to the state tax, and if not obtained, impose withholding at the highest marginal rate. Others have devised composite reporting schemes with variable restrictions that differ from state to state, and sometimes the same state imposes differing composite return requirements on corporate and non-corporate owners of pass-through entities.

There appears to be far less uniformity in the state taxation of partnerships and LLCs than there is for S corporations, let alone C corporations.

Compliance for Pass-Through Entities Is a Moving Target



Montana

A pass-through entity in a tiered arrangement with another pass-through entity held by resident individuals or other business entities with administration located in the state may seek a waiver of the requirement to file a composite return or withhold income tax.

Utah

Allows for pass-through entities to obtain a refund of qualifying excess withholding over $250,000 within 30 days after the pass-through entity income tax return is filed or due.

Kansas

Governor's veto overridden and pass-through subtraction modifications that effectively exempted nonwage business income from Kansas individual income tax repealed for tax years beginning on or after Jan. 1, 2017.

Arkansas

Pass-through entity withholding requirement expanded to include corporate owners or members at the maximum rate for member C corporations for tax years beginning on and after Jan. 1, 2018.

Requires partnerships with income both within and outside the state to apportion income under the state's version of the Uniform Division of Income for Tax Purposes Act for tax years beginning on or after Jan. 1, 2018.

Ohio

Imposes an entity-level tax on partnerships and S corps that are second-tier entities in tiered arrangements; the tax functions exactly like the withholding tax on individuals and C corporations. Plus, Ohio imposes its Commercial Activity Tax on the gross receipts of all business entities regardless of form.

Tennessee

Does not tax the distributive or pro rata shares of nonresident non-corporate owners.

Louisiana

Treats S corps and QSubs as C corps.

Vermont

Imposes an annual minimum tax on PTEs at the entity level, but it does not apply to SMLLCs that make a federal election to be treated as a disregarded entity.

New Hampshire

Does not give pass-through entities pass-through treatment.

New York City

Treats S corps and QSubs as C corps for its general corporate tax but conforms to federal treatment for corporate tax of 2015.

Delaware

Has an additional withholding requirement for partnerships that sell real estate located in the state.

Maryland

Imposes an entity-level tax on pass-through entities that have nonresident owners; it functions much like a withholding tax.

West Virginia

Does not provide any guidance on QSubs.

Georgia

Generally conforms to the treatment of QSubs but requires QSubs to file their own net worth/franchise tax return.

Favored Tax Vehicles at Federal Level, Pass-Through Entities Face Gauntlet of State Taxes and Complex Compliance Requirements

Pass-through entities have become the preferred form of business organization because of the federal tax advantage they receive. A C corporation is subject to direct tax on its profits, and then its individual shareholders are subject to individual income tax upon receiving distributions from the corporation or upon the sale of their shares as capital gain. For federal income tax purposes, pass-through entities generally are not subject to tax at the entity level. Instead, income is allowed to flow through to the owners (e.g., partner, LLC member, or S corporation shareholder) before it is subject to tax.

Pass-through entities are also subject to a multitude of non-income-based taxes at the state level.

The states, though, are different. These entities must still navigate through an elaborate maze of state taxes, some of which are at the entity-level. Since each state sets its own tax rates and rules, they are likely to continue taxing income that passes through to the owners of these entities at the highest marginal rate, which can be as high as 15 percent.

Another problem is the way states impose tax on pass-through entities. Most states conform to the federal tax classification of pass-through entities, but several provide for levies to be imposed on the distributive share of pass-through entity income allocated to nonresident owners or directly on the pass-through entity itself. States like Maryland, Ohio, and Virginia impose a special pass-through entity tax computed at the entity level but that is applied to the distributive share of income of nonresident owners.

Still other states impose tax directly on the pass-through entity. Notably, Texas, which doesn't have a personal income tax, imposes its "corporate franchise" or "margin" tax not only on C corporations but also on S corporations, LLCs, and limited partnerships and all at the same rate. "The Texas Constitution prohibits a direct income tax on 'human beings' and the state's legislature struggled with determining whether an LLC was a corporation or a partnership," said Steven Wlodychak, a principal with EY in Washington, D.C. "The solution was to treat all entities which provide limited liability to their human owners as 'corporations' for franchise tax purposes," he said.

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Pass-through entities are also subject to a multitude of non-income-based taxes at the state level. Many jurisdictions impose levies such as the franchise tax, gross receipts tax, or real estate transfer taxes and even ignore the disregarded treatment applied for federal income tax purposes. "These rules vary widely from state to state (and even within some states, from local jurisdiction to jurisdiction). This is because most state tax codes include pass-through entities within the definition of a 'taxable person,'" Wlodychak said.

Best Practices for Managing Your Pass-Through Entity Research

The states are increasingly willing to move away from strict conformity to federal tax concepts and rules for all pass-through entities, and abandon the concept of pass-through treatment for partnerships and other traditional 'conduits.' With entity-level taxes and inconsistencies among jurisdictions, operating a pass-through entity in multiple states is subject to risks that don't exist at the federal level. This has created an evolving landscape for pass-through entities, punctuated by a patchwork of rules, permissions, and requirements.

A pass-through entity that engages in multistate business activities creates a web of complexities, the navigation of which requires persistence, strong research skills, and an understanding of how a state provides guidance. Some states have a robust framework of statutes about pass-through entities and their owners, while other states rely on regulations, administrative bulletins, and even instructions to their forms. The first step to researching the state tax treatment of pass-through entities and their owners is to identify the players. Determine the type of entity and owners with which you are dealing and the states in which the pass-through entity does or may realize income.

This has created an evolving landscape for pass-through entities, punctuated by a patchwork of rules, permissions, and requirements.

The second step is to define your introductory research questions to determine:

- How the state treats a specific type of entity and whether it differs from the federal tax classification;
- What taxes the state imposes at the entity level, whether there are exceptions for pass-through entities, and the circumstances in which nexus exists and the state has jurisdiction to tax a pass-through entity and its owners; and
- How the state approaches conversions and mergers, and transactions involving pass-through entity ownership interests.

Next, it is important to define your research questions related to the tax treatment of the partners and shareholders, computation of pass-through entity taxable income, and other considerations necessary for determining the amount of an owner's distributive or pro rata share of partnership or S corporation taxable income and taxation of resident and nonresident owners. In addition, you must investigate whether a state requires a pass-through entity to withhold income tax or file a composite return on behalf of nonresident owners.

The first step to researching the state tax treatment of pass-through entities and their owners is to identify the players.

Finally, it is important to consider a wide variety of contexts in which the tax treatment of pass-through entities can arise. Pass-through entities implicate a number of types of tax laws, and it is frequently necessary to navigate between laws applicable to:

In many states, the tax treatment of pass-through entities and their owners is an emerging area of law.

- Different types of taxpayers, including corporations, individuals, estates, and trusts;
- Different types of taxes, including those imposed on the entity level, owner-level income taxes, and withholding and composite return taxes imposed on distributions to nonresident owners; and
- Different types of administrative and filing requirements.

You will likely hopscotch across different areas of a state's tax laws and, if you use a research platform, across different tools to solve the many questions raised by multistate pass-through entities. Most research platforms segregate their coverage of individual income tax and corporate income tax issues. And in many states, the tax treatment of pass-through entities and their owners is an emerging area of law. States use every type of source – from legislation to email alerts – to explain how the agency responsible for the state's tax administration interprets and enforces the laws applicable to pass-through entities. Your research will more than likely involve statutes, regulations, administrative bulletins, instructions to forms, and perhaps Bloomberg BNA's helpful **Survey of State Tax Departments**.

The new Bloomberg BNA Pass-Through Entity Navigator provides a better way to navigate the tax questions that are raised by operating a multistate pass-through entity. Bloomberg BNA provides a home base for pass-through entities in 52 jurisdictions, and tells the story of a pass-through entity from formation to the activities that will create nexus for the business and its owners. The Pass-Through Entity Navigator provides straightforward guidance on how states tax resident owners and nonresident owners, and how they use withholding and composite returns as tools to collect their "fair share" of taxes from nonresident owners.

The new Pass-Through Entity Navigator also provides a practical library of information with comprehensive tax rates and insight into the administrative and procedural requirements that must be met.

The Pass-Through Entity Navigator covers nine types of entities and eight types of entity level taxes and seeks to clarify the computation of partnership and S corporation income.

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