



Disharmony in Alabama's Conformity to the Federal Tax Classification of Business Entities

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Joe, the owner of a successful plumbing business operating as a sole proprietorship, is concerned that an accident or other job-related calamity may subject his personal assets to liability claims. Joe talks to his accountant, who advises him to consider operating his business through a limited liability company ("LLC"). Joe complains that he does not want to file separate income tax returns for his business. Joe's accountant assures him, however, that because he will be the single owner of his LLC, the LLC will be a disregarded entity ("DRE") for federal income tax purposes. Joe's income tax return preparation will remain the same as when he was conducting his business as a sole proprietor. Satisfied with his accountant's advice, Joe now comes to you, his lawyer, to help him transfer his plumbing business to an LLC. After the appropriate documents are drafted and executed, Joe asks you whether he needs to file his Alabama and local sales and use tax returns in his name (as he did before as a sole proprietor), or in the name of his new LLC. Instinctively, you advise Joe that his LLC should now make all filings, including sales and use, payroll withholding, personal property tax returns and business licenses, in the name of the LLC. You, of course, caution Joe that in order for his liability shield to be effective, he

should observe all required formalities of conducting his business in the new LLC, such as preparing all non-income state and local tax filings in the name of the LLC.

Sound familiar? Many readers of this publication have undoubtedly counseled a Joe or Jane who needed guidance with respect to operating their business in an LLC, or perhaps a limited partnership or S corporation. Many will be surprised to learn, however, that for *most* (but not all) Alabama and local non-income tax purposes, your advice above was incorrect: a single-member LLC that is disregarded for federal income tax purposes is also generally disregarded for *all* Alabama and local tax purposes, including sales, use, payroll withholding and rental taxes.¹ Technically, Joe should complete his Alabama sales and use tax returns using his individual name and Social Security number because his LLC does not exist for Alabama sales and use tax purposes. In practice, however, many practitioners and taxpayers believe that a single-member LLC, or any other entity that is disregarded for federal tax purposes, is only treated as a DRE for Alabama *income* tax purposes. That understanding is indeed consistent with the general rule for most other states that impose a net income-based tax.²

While corporations are generally treated as separate entities for all federal and Alabama tax purposes,³ what about other business entities that may be DREs, such as qualified subchapter S subsidiaries (“Q Subs”), which are wholly-owned subsidiaries of S corporations? How are these entities classified for Alabama tax purposes? Does it depend on the tax? This article summarizes the various classification rules applicable to pass-through business entities with respect to Alabama taxes, including income, sales and use, rental, property, payroll withholding, and business license taxes. This article also provides recommendations on legislative changes that would conform the classification rules to common practice and the general rule prevailing in other states, while preserving certain exemptions that exist under Alabama’s current classification regime.

The central question in evaluating Alabama’s classification regime is to determine which entities should be treated as separate taxpayers for purposes of the various Alabama taxes. This question arises primarily because the Internal Revenue Service (“IRS”) in 1997 simplified the classification rules for business entities. The IRS did so by promulgating the so-called “check-the-box” (“CTB”) regulations, which provide that for federal tax purposes, except in the case of *per se* corporations, an entity with two or more owners is classified as either a partnership or

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a corporation, and an entity with only one owner is taxed as either a DRE or a corporation.⁴ Many practitioners assume that treating a single-member LLC as a DRE applies just to Alabama income taxes—to conform Alabama income tax rules with their federal counterpart, but that the same “disregarded” treatment does not apply to other state and local taxes, such as sales and use taxes and property taxes, which do not exist at the federal level.

Alabama’s classification provisions are not centrally located—some provisions are included in Title 10 (provisions that create and govern various forms of business entities), while others are located in Title 40, the general state tax code. These provisions typically provide that an entity will

be treated the same way for Alabama tax purposes as federal tax purposes. This principle, probably intended to govern income tax consequences, presents problems as applied to other taxes where general legal principles would suggest that the entity, even though a DRE, is the taxpayer. While the table below should give readers an idea of the uncertainty in this area, additional explanation by entity type is warranted:

Brief History of LLC Conformity Provisions: As discussed above, for all Alabama taxes except the business privilege tax (“BPT”), an LLC “shall be treated as a partnership unless it is classified otherwise for federal income tax purposes, in which



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case it shall be classified in the same manner as it is for federal income tax purposes.⁵ Alabama's LLC conformity provision as originally enacted applied to all Alabama taxes.⁶ However, the conformity provision was amended in 2000 to provide an exception to the statute's general rule of conforming to the federal entity classification rules for Alabama's BPT.⁷ By negative implication, the amendment excluding the BPT from the scope of the LLC conformity provision made it clear that the application of this provision was not limited to Alabama's income tax.

LLC (multi-member): Unless it elects to be taxed as a corporation, an LLC with at least two members is classified as a partnership for federal tax purposes,⁸ and that treatment will be the same for all Alabama tax purposes (except for the BPT). One consequence of the LLC conformity provision is, at least according to the Alabama Department of Revenue, to transform an LLC into a *general* partnership for tax purposes, and thus subject the members to joint and several personal liability for the LLC's tax debts, *e.g.*, sales and use taxes, despite the fact that members of an LLC are generally not liable for the entity's debts.⁹ The proposed legislation discussed below would limit the application of Alabama's conformity with the federal entity classification rules to Alabama's income tax and

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thereby eliminate the issue of whether members of an LLC are personally liable for the non-income taxes of the entity solely by virtue of the LLC's classification as a partnership for tax purposes.

Single-member LLC: Under the default classification rule, a single-member LLC will be treated as a DRE for federal income, and therefore all state (except for BPT) and *most* local, tax purposes. Technically, the sales tax and property tax should be assessed against the owner, not the entity,¹⁰ although the Attorney General has reached a different conclusion with respect to property taxes.¹¹ As noted by the

chart, there may be a disconnect in the classification rules for employer taxes (wage withholding, FICA and unemployment) due to a recent amendment to the CTB regulations that changes the general rule and now treats the single-member LLC as a separate tax-paying entity, not a DRE, for federal employer taxes.¹² Now that the IRS treats the owner of the DRE as the income tax payer and the DRE as the employment taxpayer, Alabama's tie to the federal income tax classification for all Alabama tax purposes creates a confusing situation for Alabama DREs: the DRE pays the federal employment taxes but the owner should pay the Alabama employment taxes! Ironically, Alabama's conformity to federal income tax entity classification

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has now created nonconformity between the Alabama and federal employment taxes.

Of course, a single-member LLC may affirmatively elect to be taxed as a corporation (either C or S) for federal income tax purposes, and that classification automatically applies for all Alabama state tax (and most local tax) purposes and eliminates any DRE issues.

Limited Partnership ("LP"): Federal tax conformity for an LP and a limited liability limited partnership ("LLLP") was recently clarified by the Alabama Uniform Limited Partnership Act of 2010, which limited Alabama's conformity to the federal entity classifications to state income tax purposes.¹³ Because conformity is limited to income taxes, the Department of Revenue does not assert personal liability for non-income taxes of the entity against the partners of an LP or LLLP solely because of the conformity provision. A limited liability partnership ("LLP") should likewise be taxed under the default rule, *i.e.*, as a partnership, for state income tax purpose and should also be recognized as a separate taxpayer for all other state and local taxes.¹⁴ In certain complex structures, the LP, LLP or LLLP could be treated as a DRE for federal and Alabama income tax purposes if all of the partners were also classified as DREs.

Q-Sub: A Q-Sub is an S corporation that is wholly-owned by another S corporation and affirmatively elects to be treated as a DRE for federal income tax purposes.¹⁵ Alabama conforms to the federal tax treatment for income tax purposes, and to some extent, for rental tax purposes.¹⁶ For other state and local taxes, the Q-Sub should be taxed as a separate entity and not disregarded.

Business Trust: A business trust is generally an arrangement where property is conveyed to trustees for the benefit of the beneficiaries, but the purpose of the trust is to operate a profit-making business. A business trust will be classified either as an association, a partnership or a corporation, depending on the number of beneficiaries and whether a classification election is made to change the default rule. Alabama has conformed its classification to the federal rules but, again, only for income tax purposes.¹⁷

Does Alabama Treat the Entity As A Separate Taxpayer?

Type of Alabama Tax	LLC	SMLLC (DRE)	LLP	LP/LLLP	Q-Sub	Business Trust
Income	Yes	No	Yes	Yes	No	Yes
Sales & Use	Yes	No	Yes	Probably	Yes	Yes
Rental/ Lease	Yes	No	Yes	Probably	Exempted	Yes
Employers'	Probably	Doubtful	Yes	Probably	Probably	Yes
Business Privilege	Yes	Yes	Yes	Yes	Yes	Yes
Ad Valorem Property	Yes	Unclear	Yes	Probably	Yes	Yes
Business License—State/County	Yes	No	Yes	Probably	Yes	Unclear
Business License—Municipal	Unclear	Unclear	Unclear	Unclear	Unclear	Unclear

The proposed legislation would harmonize the classification of various pass-through business entities for Alabama state and local tax purposes, and to some extent, conform the law to current practice.

Proposed Conformity Legislation: As evident from the preceding table, Alabama's current "conformity" to the federal classification regime leaves open many questions regarding the treatment of an entity / taxpayer for purposes of state and local taxes other than income taxes. This creates several traps for the unwary practitioner when advising clients regarding the proper choice of entity and state taxes. A task force, consisting of members from the Alabama Department of Revenue, the Alabama State Bar Tax Section, the Alabama Society of CPAs, the Alabama League of Municipalities, and the Business Council of Alabama, was formed last year to study the current classification regime and determine whether clarifying legisla-

tion was necessary. After extensive study, the so-called Entity Harmonization Task Force recommended to its constituent members the following changes and clarifications:

- In line with the large majority of other states, limit conformity with the federal CTB rules to only Alabama income and financial institution excise taxes (the bank equivalent of the income tax);
- Provide that DREs are treated as separate taxpayers for all non-income taxes, including employer taxes (wage withholding and unemployment), except as provided below;
- Preserve the sales, use and rental tax exclusions that exist under the current classification regime for certain transactions (e.g., sales and leases) between DREs and their single-member-owners;
- Preserve the property tax, BPT and sales and use tax exemptions that exist under the current classification regime for charitable and other tax-exempt DREs; and
- Provide/clarify that members of a multi-member LLC are not personally liable for sales, use and other non-income taxes solely because their LLC is classified as a partnership for federal and Alabama tax purposes.

The proposed legislation would harmonize the classification of various pass-through business entities for Alabama state and local tax purposes, and to some extent, conform the law to current practice. The proposal would also eliminate the possibility that the owners of an LLC will receive an unexpected sales, use or rental tax assessment. The task force's proposed legislation should be introduced this spring, and the authors hope that the revenue-neutral proposal will be enacted in the current session of the Alabama legislature.



The opinions expressed herein are those of the authors, and not necessarily those of the organizations or entities which they represent. The authors thank Bruce Ely, chair of the Task Force and a senior partner with Bradley Arant Boult Cummings LLP in Birmingham, for his editorial comments. Ely, Garrett and Long are all former students of Professor Bryce, and he continues to learn from them.

Endnotes

1. *Ala. Code* § 40-12-8(b). One notable exception under current law is Alabama's business privilege tax, *Ala. Code* §40-14A-21 *et seq.*, where all business entities, including single-member LLCs that are DREs, are subject to the tax.
2. See ROBERT R. KEATINGE & ANNE E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY 459-60 (2009).
3. See Treas. Reg. § 301.7701-2(b); *Ala. Code* § 40-18-1(8). For federal and Alabama tax purposes, "the income of a C corporation is subject to double taxation (once at the corporate level and once at the shareholder level) while the income of partnerships and sole proprietorships is taxed only once (at the individual taxpayer level)." *Pierre v. Comm'r*, 133 T.C. No. 2 (2009); see also *Ala. Code* §§ 40-18-1(35); 40-18-24.
4. See Treas. Reg. § 301.7701-2(b). The default classification for an entity with only one owner is a DRE; the default classification for an entity with two owners that is not a corporation is a partnership. Treas. Reg. § 301.7701-2(c). The extent to which the CTB rules apply to various federal taxes is not always clear, as illustrated by a recent 9-to-6 decision of the U.S. Tax Court. See *Pierre*, 133 T.C. No. 2 (holding that transfers of membership interests in a single-member LLC, which was treated as a DRE, were valued for gift tax purposes as transfers of interests in the LLC (vs. the underlying assets) and thus subject to valuation discounts for lack of marketability and control). The majority in *Pierre* rejected the arguments by the IRS that the underlying property should be valued for gift tax purposes, instead of the membership interest, because the LLC was a DRE. The dissent argued that the majority "is either ignoring the plain language of the [CTB] regulation or silently invalidating it." *Id.* at 29-30.
5. *Ala. Code* § 10-12-8(b). Full conformity with federal law for LLCs was preserved by the *Alabama Business and Nonprofit Entities Code*, enacted by Acts of Ala. 2009-513, which becomes effective January 1, 2011. See also *Ala. Rev. Proc.* 98-001 (Mar. 16, 1998) (providing that for purposes of Title 40 taxes, LLCs "will be classified as they are classified for federal income tax purposes under the Internal Revenue Service's 'check-the-box' regulations").
6. 1993 Ala. Acts 724, § 8; 1997 1st Ex. Sess. Ala. Acts 920, § 1.
7. 2000 Ala. Acts 705, § 4.
8. Treas. Reg. § 301.7701-3(b)(1)(i).
9. Alabama law provides that "all [general] partners are liable jointly and severally for all obligations of the partnership," however, "a member of a [LLC] is not liable ... for a debt, obligation, or liability of the [LLC]." *Ala. Code* §§ 10-8A-306(a); 10-12-20(a). The Department of Revenue's position stems from the language "for purposes of taxation ... [an LLC] ... shall be treated as a partnership," which the Department interprets as transforming the LLC into a general partnership, thereby potentially subjecting the members to personal liability for tax debts of the LLC. *See Bayside Tire & Exhaust, LLC v. Alabama Dep't of Revenue*, Admin. Law Div. Dkt. No. W. 98-272 (Oct. 13, 1998). The Department of Revenue supports this argument by pointing out that if the classification of a multi-member LLC as a partnership for non-income tax purposes does not affect the liability of the members, then the classification would seemingly be without effect at all for those non-income taxes. To the contrary, it could be argued that the use of "partnership" in section 10-12-8(b) was not referring to a state law partnership, but rather a partnership in the context of the federal CTB regulations as one of the three possible entity classifications (corporation and DRE being the other two) for tax purposes. The Department of Revenue's Administrative Law Division temporarily overruled its earlier decision in *Bayside Tire*, holding that members of LLCs that are taxed as partnerships are still LLC members, and thus, pursuant to §10-12-20(a), are not personally liable for the tax obligations and other debts of the LLC. *Capitol Machine & Equip. Co., LLC v. Alabama Dep't of Revenue*, Admin. Law Div. Dkt. No. S. 08-619 (April 20, 2009) withdrawn (Final Order Dep't Appl. Reh'g June 9, 2009). However, that opinion was subsequently withdrawn by joint stipulation of the parties that the disputed assessment was voided due to the division's ruling in favor of the LLC on the substantive issue.
10. See, e.g., *First American Holding, LLC v. State Dep't of Revenue*, Admin. Law Div. Dkt. No. MISC. 07-773 (Final Order Dec. 20, 2007) (upholding an assessment of state/county business license tax against the single-member of the disregarded LLC because "[f]or Alabama purposes, a single-member LLC is automatically disregarded unless the LLC 'checks the box,' i.e., affirmatively elects for federal tax purposes to be recognized and taxed as a corporation").
11. See *Ala. Op. Att'y Gen.* No. 2008-049 (Jan. 31, 2008) (noting that "a limited liability company is a distinct and separate entity apart from its member or members for ad valorem tax purposes. Therefore, it is irrelevant whether the LLC is disregarded or whether it is single-member or multi-member.")
12. Treas. Reg. § 301.7701-2(c)(2)(iv), effective for wages paid on or after January 1, 2009.
13. *Ala. Code* § 10-9C-1208, enacted by Acts of Ala. 2009-621, effective January 1, 2010 (providing that "[f]or purposes of income taxation, other than under Chapter 14A of Title 40, a domestic or foreign limited partnership or limited liability limited partnership shall be treated as a partnership unless it is classified otherwise for federal income tax purposes, in which case it shall be classified in the same manner as it is for federal income tax purposes"); see also *Ala. Code* §§ 40-18-1(35).
14. See *Ala. Code* § 10-8A-1109 (providing that a LLP "shall be taxed as a partnership in accordance with Section 40-18-24 ... and shall for all other tax purposes be taxed as a partnership"). To the authors' knowledge, the Department of Revenue has not taken the same position with respect to LLCs being taxed as a general partnership in assessing partners of a LLP for non-income taxes.
15. I.R.C. § 1361(b)(3). The Q-Sub election should be made by the parent corporation by filing IRS Form 8869.
16. See *Ala. Code* § 40-18-160(d) (providing that "[w]ith respect to a qualified subchapter S subsidiary for which there is in effect an election under 26 U.S.C. § 1361(b)(3), all of its assets, liabilities, and items of income, deductions, and credit shall be treated as assets, liabilities, and such items, as the case may be, of the Alabama S corporation owning the stock of the qualified subchapter S subsidiary"). For rental tax purposes, transactions between a parent corporation and its Q-Sub, or transactions between two Q-Subs owned by the same parent, are exempt from Alabama rental tax. *Ala. Code* § 40-12-223(11).
17. See Treas. Reg. §§ 301.7701-2(a); 301.7701-4(b); *Ala. Code* § 40-18-25(i) (providing that "for purposes of the taxation of the income (or the net income) of a business trust under this title, a business trust shall be classified for tax purposes in the same manner as it is classified for federal income tax purposes").



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