# State and Local Tax Alert

## Multistate Edition

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# Recent Developments in the State Taxation of Pass-Through Entities and Their Owners

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State and local taxation of pass-through entities[1] continues to present complex issues for the owners of those entities, especially when the pass-through entities are conducting business in multiple states. Compared with resident owners over which a state has jurisdiction because of their physical presence in the state, nonresident owners of pass-through entities are presented with more difficult issues. As a way to collect additional revenue and potentially avoid difficult constitutional questions involving how to tax nonresidents, many states have enacted entity-level taxes or withholding or composite return requirements.

Applying these entity-level taxes and withholding/composite return requirements, however, presents 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, applying 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.

In addition, owners of multistate pass-through entities must answer the often troublesome questions of where they must file returns and what income must be included on the return for each state in which they are required to file. Jurisdictional questions, apportionment issues, and reporting requirements for owners of pass-through entities residing in a state other than where the entity does business are just a few of the areas in which there have been numerous recent developments. Many states continue to assert that an ownership interest in a pass-through entity alone is sufficient to give the state jurisdiction over the nonresident owners doing business in that state. States taking this position may often ignore or fail to give adequate weight to federal constitutional issues that arise when taxing nonresident owners.

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[1] For purposes of this article, a "pass-through entity" means a partnership (general or limited) or a limited liability company (LLC) whose income is generally not taxed at the entity level, but, instead, is passed through and taxed when it is received by the owner(s) of the entity.

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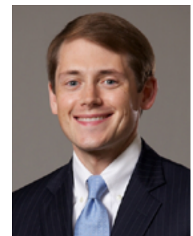

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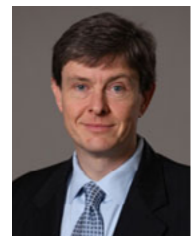

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## LLCs and LLPs STATE TAX WEBINAR

Bruce Ely will be leading a panel discussion during a webinar sponsored by Strafford Publications this Wednesday from noon to 1:45 pm Central time entitled "LLCs and LLPs: Navigating the Variable State Tax Treatment of the Entity and its Owners." The other panelists will be Patrick Smith of PricewaterhouseCoopers LLP in Chicago and co-author of the leading treatise on the topic, and John Fletcher, State Tax Counsel for General Electric Company in Albany, New York and an expert in the field of pass-through entity taxation. The webinar will brief state tax advisors and multistate companies on the differing state tax policies and classifications of LLCs and LLPs, partner/member nexus issues, apportionment variations, entity-level taxes, composite returns and withholding obligations, and the like.

**Wednesday, June 27th**
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What follows is a summary of some of the major developments occurring within the past 18 months surrounding these issues:

## NEXUS ISSUES FOR PASS-THROUGH ENTITIES AND THEIR OWNERS

Jurisdictional issues continue to arise from an ownership interest in a pass-through entity by a nonresident individual. The question of whether a partnership interest, especially a limited partnership interest, is sufficient to create nexus for a nonresident individual or non-domiciliary corporation has been argued and discussed for many years. A recent Louisiana Court of Appeal decision highlighted the length 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 contacts with the state other than an ownership interest. As discussed more fully below, the Louisiana Court of Appeal upheld the taxpayer's challenge that its contacts with the state were insufficient to establish nexus under the Due Process Clause of the U.S. Constitution.

In addition to Louisiana, other states are continuing to push the edges of what constitutes nexus as a way to generate additional revenue from out-of-state businesses. In addition to aggressively asserting nexus on audit, some states are enacting questionable statutory and regulatory provisions laying out what kind of presence is required to establish income tax nexus. These new nexus tests presumably rest on the premise that Quill Corp. v. North Dakota[2] only applies to sales and use taxes, not other types of taxes. California, Connecticut, and Michigan are the most recent states to jump onto the factor-presence nexus bandwagon. While physical presence in a state is generally sufficient to create nexus, a state arguably should not be able to assert that a business is subject to a state's taxing jurisdiction solely based on the fact that the business makes sales into the state.

The jurisdictional issues pass-through entities and their owners face are not confined to the area of federal constitutional nexus. Questions still arise regarding the applicability of Public Law 86-272 to pass-through entities. For example, Michigan's new factor-presence nexus test might very well conflict with Public Law 86-272. Discussed below are several recent state developments addressing various aspects of the jurisdictional issues faced by pass-through entities and their nonresident owners.

### California

Effective for taxable years beginning on or after January 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.[3] Beginning in 2011, a taxpayer is considered to be "doing business" in California if it meets any of the following thresholds: (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 exceed 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; (5) 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 (partnerships, S corporations, LLCs treated as partnership) factors.*

In January 2011, the California Franchise Tax Board (the "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.[4] Thus, the in-state activities of a SMLLC or Q-Sub 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.[5] 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

[2] 504 U.S. 298 (1992).

[3] Cal. Rev. & Tax'n Code § 23101.

[4] California Franchise Tax Board, Legal Ruling 2011-01 (Jan. 11, 2011).

[5] "New Rules for Doing Business in California," FTB Taxnews (Mar. 4, 2011).

corporation business tax and personal income tax.[6] The legislation,[7] enacted on September 5, 2010, became effective for all tax years beginning on or after January 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 will be 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, Public Law 86-272 will continue 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; and (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 will not be considered a basis for a finding of economic nexus.

## 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.[8] Petitioners, UTELCOM, Inc. and UCOM, Inc., were foreign corporations maintaining their 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 to or for any 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; or (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 of Appeal 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 March 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.[9] 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 were not disputed by the petitioners, however. 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, in 2004, Maryland enacted the SNRT to subject nonresident income to a tax equal to the lowest county income tax rate set by any Maryland county.[10] 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,[11] the court found that the SNRT did not violate the Commerce Clause because: (1) the SNRT is compensating for the burden of the county income tax on intrastate commerce

[6] Connecticut Dep't. of Rev., Informational Publication IP 2010(29) (Sept. 23, 2010); See also Connecticut Dep't of Rev., Informational Publication IP 2010(29.1) (Dec. 28, 2010).

[7] Conn. Gen. Stat. § 12-216a.

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

[9] Frey v. Compt. of the Treas., 29 A.3d 475 (Md. 2011), cert. denied, U. S. S. Ct., Dkt. No. 11-825 (Mar. 26, 2012).

[10] 2004 Md. Laws Ch. 430 § 30.

[11] 516 U.S. 325 (1996).

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; and (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 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 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 (the "CIT") that largely parallels the federal corporate income tax, effective January 1, 2012.[12] The CIT is comprised of three separate taxes: (1) a corporate income tax; (2) a premiums tax on insurance companies; and (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 checks-the-box to be taxed as a corporation). Individuals and pass-through[13] entities, 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: (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; or (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").[14] 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.

## 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 the discharge of indebtedness resulting from the foreclosure on commercial property located in Pittsburgh.[15] 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.

The 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

[12] Act No. 38, Public Acts of 2011, Michigan H.B. No. 4361 (May 25, 2011); Act No. 39, Public Acts of 2011, Michigan H.B. 4362 (May 25, 2011).

[13] 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.

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

[15] Wirth v. Pennsylvania, 424 F.R. 2008 (Pa. Commw. Ct., Jan. 3, 2012); Marshall v. Pennsylvania, 933 F.R. 2008 (Pa. Commw. Ct., Jan. 3, 2012)(appeal pending).

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.

Lastly, the taxpayers argued that the differing treatment of residents and nonresidents violated the Equal Protection Clause of both the U.S. Constitution 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 REQUIREMENTS FOR NONRESIDENT OWNERS OF PASS-THROUGH ENTITIES

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 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. Also, some states have enacted composite filing requirements for pass-through entities that may or may not require withholding. 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.

### Georgia

Effective May 1, 2012, Georgia requires pass-through entities to withhold income tax from distributions to nonresident individuals, *regardless* of whether the income is actually distributed.[16] The amount to be withheld shall be determined by multiplying the nonresident owner's share of the taxable income of the pass-through entity that is sourced to Georgia by four percent.

### Idaho

Effective retroactively to January 1, 2012, if a corporation, partnership, trust, or estate transacting business in Idaho does not comply with the provisions of Idaho Code § 63-3036B (withholding for nonresident members or partners), and fails to file an Idaho income tax return reporting the share of any income, loss, deduction, or credit of a pass-through entity required to be included on such individual's Idaho return; that corporation, partnership, or trust shall be liable for tax on such items at the rate applicable to corporations. Additionally, a pass-through entity that files a composite return shall include a statement with the return showing each individual's share of the income reported on the return and the tax paid by the pass-through entity on each individual's share of the income reported on the return.[17]

Last year, the Idaho legislature passed a bill, retroactively effective to January 1, 2011, which prohibited 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.[18] Interestingly, this session, the Idaho Legislature yet again amended the state's composite return and withholding requirements, retroactively effective to January 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.[19]

### Kentucky

The Kentucky Department of Revenue issued guidance summarizing recent changes in Kentucky's income tax laws.[20] For tax years beginning after December 31, 2011, every pass-through entity in Kentucky required to withhold Kentucky income tax is required to 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.

[16] H.B. 965, Laws 2012.

[17] Idaho House Bill No. 582 (effective Jan. 1, 2012).

[18] Idaho Code § 63-3022L.

[19] H.B. 582, Second Regular Session – 2012, amending Idaho Code § 63-3022L.

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

## Michigan

As mentioned above, a new Michigan law imposes a number of changes on pass-through entities.[21] For instance, pass-through entities that withhold income tax on their member's distributive shares will be 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 upon the failure or refusal of the entity to provide certain information.

## New Mexico

Effective January 1, 2011, pass-through entities were required to make quarterly withholding tax payments on net income distributed to their nonresident owners.[22] Thankfully, effective January 1, 2012, amounts withheld by a pass-through entity will be due at the end of the calendar year, rather than quarterly.[23]

## 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.[24] 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

In March 2012, the Wisconsin Department of Revenue issued a fact sheet providing a general overview of pass-through entity withholding and the use of composite returns by pass-through entities.[25] Since 2005, a partnership, including an LLC treated as a partnership, having Wisconsin income allocable to a nonresident owner over $1,000, is required to pay a withholding tax. A nonresident owner includes: (1) an individual who is not domiciled in the state; (2) a partnership, LLC, or corporation with a commercial domicile outside the state; and (3) a nonresident estate or a trust. The tax to be withheld for each nonresident owner is equal to the highest income tax rate for a single individual (for an individual, estate or trust) or the highest corporate income/franchise tax rate (for a partnership, LLC, or corporation) multiplied by the nonresident owner's share of income attributable to Wisconsin. A pass-through entity, such as a partnership, that is an owner of another pass-through entity is required to withhold and remit tax on the distributable share of income of each of the entity's nonresident owners. An entity is not required to withhold tax on behalf of its nonresident owners if: (1) the owner is exempt from taxation in Wisconsin; (2) the owner's distributable share of the entity's Wisconsin income is less than $1,000 and the owner has no other Wisconsin source income; (3) the entity is a joint venture that has elected not to be treated as a partnership for federal income tax purposes; (4) the entity is a publicly-traded partnership that files an annual information return; or (5) the nonresident owner files with the Department of Revenue an affidavit in which it agrees to file a Wisconsin return, pay any taxes including estimated taxes, interest and penalties, and agrees to be subject to the jurisdiction of the Department, the Wisconsin Tax Appeals Commission, and the courts of Wisconsin for income tax-related matters. Nonresidents having Wisconsin gross income of $2,000 or more are required to file an individual income tax return. A nonresident owner may claim the withheld tax as a credit on its own Wisconsin income tax return.[26]

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

[21] Act No. 193, Public Acts of 2011, Michigan S.B. 679 (Oct. 17, 2011).

[22] N.M. Stat. § 7-7A-3; New Mexico Dep't of Taxation and Rev., New Mexico Bulletin, B.200-25 (Mar. 2011).

[23] N.M. Stat. § 7-7A-3, amended by N.M. L. 2012, S.B. 212, c. 40, § 2 (eff. Jan. 1, 2012).

[24] Utah Informational Pub. 68 (Oct. 1, 2011).

[25] Wisconsin Dep't of Rev., Pass-Through Withholding and Composite Return – Fact Sheet (Mar. 8, 2012).

[26] Wis. Stat. § 71.775.

[27] United Wisconsin Grain Producers, LLC v. Wisconsin Dep't of Rev., Doc. No. 10-W-244 (Aug. 24, 2011).

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.

## TRANSFERS 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. Because the taxpayer did not fall within any of the four exemptions, the recording tax applied and the refund claim was denied.

### Florida

The Florida Department of Revenue adopted a rule[29] governing the tax on transfers of a grantor's ownership interest in a conduit entity after the grantor has conveyed Florida real property to the conduit entity without having paid tax on the full consideration of the property. Under the new rule, when there is a transfer of an ownership interest in a conduit entity for consideration within 3 years after a transfer of real property to the conduit entity, the transfer of such ownership interest is subject to tax if the conduit entity continues to own property. The rule provides a number of examples that illustrate how it operates in various circumstances.

### New Hampshire

In Say Pease IV, LLC v. New Hampshire Department of Rev. Admin.,[30] Two International Group ("TIG") sought to obtain a $10 million mortgage loan using land it owned as collateral. The lender required the majority owner and managing member of TIG, Say Pease, LLC, to form a new "single purpose bankruptcy remote entity." To comply with the lender's request, Say Pease formed Say Pease I, LLC to be the managing member of TIG. Say Pease's interest in TIG was then transferred to Say Pease IV, LLC. Based upon this transfer, the Department assessed a real estate transfer tax. The trial court ruled that the transfer was not a "contractual transfer" because the transaction lacked a bargained-for exchange and the real estate tax did not apply. The Department appealed to the Supreme Court of New Hampshire.

Finding in favor of the taxpayer, the Supreme Court refused to apply First Berkshire Business Trust v. Comm'r, which "held that if a transaction directly benefits the owner of a subsidiary transferor company, the benefit may constitute consideration, and the Department of Revenue Administration can tax the transfer." Rather, the Court modified its prior holding by announcing that "if there is no direct benefit to the party controlling a transferor entity, the transfer tax does not apply."

## ENTITY-LEVEL TAXES IMPOSED 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 and Philadelphia, also impose a substantial 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.

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

[29] Fla. Admin. Code Ann. r. 12B-4.060.

[30] Say Pease IV, LLC v. New Hampshire Dept. of Rev. Admin., Dkt. No. 2011-174 (N.H. 2012).

## 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.[31] The so-called "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

Last spring, the Multistate Tax Commission (the "MTC") proposed a model statute that imposes the state's corporate income tax on a partnership or disregarded entity in that state if at least 50 percent 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. At the time, it was 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. The draft model statute was almost adopted, but the states agreed to hold the proposal until state insurance regulators were given sufficient time to analyze the issue.

In what appears to be an effort to gain support for its model statute, the MTC recently released findings from a study it conducted of certain SEC filings. The study determined that some retail mutual funds are being converted to pass-through entities with insurance company parents, thereby preventing the funds' management fees from being subject to state income tax because insurance companies generally are not subject to state income tax. The study is widely seen as an expression of the MTC's concern over the increasingly widespread use of pass-through entities.

# APPLICATION OF CREDITS AND DEDUCTIONS TO PASS-THROUGH ENTITIES/OWNERS

Generally speaking, most states allow the credits earned by a pass-through entity to be allocated to its owners. However, there are still many questions that 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.

## Alabama

This spring, the Alabama Legislature passed Act 2012-427, the "Gross Income Regulation Fix," which amends the definition of "gross income" so that resident individuals who are owners of pass-through entities must include their proportionate share of income from the pass-through entity, regardless of where the income is earned. Resident owners of these pass-through entities now receive an income tax credit for certain income and modified gross receipts-based taxes paid by the entity to other states or foreign countries on behalf of the individual owner because the other jurisdiction imposes an income tax withholding obligation or an entity-level tax on the pass-through entity. Although this act is retroactively effective for all tax years beginning after December 31, ***2010***, the ADOR cannot assess penalties for any understatement of income tax resulting from this retroactive application. The portions of the bill related to the foreign tax credit are not effective until tax years beginning after December 31, 2011.

## California

In April 2011, the FTB released a memorandum[32] 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 (the "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

[31] In re Allcat Claims Service LP, Tex., No. 11-0589 (Nov. 28, 2011).

[32] Cal. Franchise Tax Bd., Tech. Advice Memo, No. 2001-03 (Apr. 13, 2011).

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.

## Idaho

Idaho H. 634 amends Idaho Code § 63-3029 to clarify that resident individuals are allowed a credit for taxes paid to other states that was either made directly by the resident or by a pass-through entity on the resident's behalf. The amendment expands the scope of the excise or franchise taxes available for the credit to include those taxes based on income, which permit a deduction for one or both of the following: "(i) The cost of goods, inventory or products with respect to revenue from sales; and (ii) The cost of services rendered with respect to revenue from services rendered." The change is effective for tax years beginning on or after January 1, 2012.

## Kentucky

The Kentucky Board of Tax Appeals ruled that an LLC may not use its members' net operating losses to offset its income because the LLC did not have a vested right to use the NOLs.[33] 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.,[34] 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 December 31, 2004 – its members did. The NOLs were not eliminated, however; but they were left with the members who could have used the NOLs in 2005 and 2006 if they had taxable income in those years.

## Missouri

In a recent letter ruling, the Missouri Department of Revenue stated that individual partners of a limited partnership will be allowed a credit on their Missouri individual income tax returns for their proportionate share of Texas margin tax paid directly by the limited partnership.[35] In allowing the credit, the Department looked to the "based on" and "object" test set forth in Herschend v. Missouri Dir. of Rev., 896 S.W.2d 458 (Mo. 1995). Concluding that the Texas margin tax operated as an income tax similar to the federal income tax, the Department allowed the credit to be claimed on the Missouri individual income tax return.

The Department also looked at the Business and Occupation Tax paid to the State of Washington by the same limited partnership. Concluding that a credit would not be allowed for that tax, the Department found the B&O tax is based on the gross income of businesses which operate in Washington and not their federal taxable income.

## Tennessee

In November 2011, the Tennessee Court of Appeals concluded that shareholders in two S corporations are not entitled to the Hall Income Tax Credit for income tax paid to South Carolina.[36] 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

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.[37] The Commissioner explained that the Kentucky LLE tax is not a tax based on net income because it excludes almost all business expenses normally

[33] HPCKAL, LLC v. Commonwealth of Kentucky Finance and Admin. Cabinet, File No. K09-R-27, Order No. K-21182 (Aug. 25, 2011).

[34] 296 S.W.3d 392 (Ky. 2009).

[35] Missouri Dep't of Rev., Priv. Ltr. Rul. LR 7030 (Feb. 3, 2012).

[36] Boone, et al. v. Chumley, Dkt. No. E2010-0162-COA-R3-CV (Tenn. Ct. App. Nov. 30, 2011); see also B. Carter, Court Finds Individual is Not Entitled to Tennessee Resident Credit for Tax Paid to South Carolina, 21 J. Multistate Tax'n 10 (Feb. 2012).

[37] Virginia Dep't of Tax., Rulings of the Tax Comm'r, Doc. No. 11-147 (Aug. 10, 2011).

permitted in determining net income. Corporations and limited liability pass-through entities must pay the Kentucky LLE tax. The Commissioner also stated that Virginia will consider 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.

### 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.[38] This ruling reversed the 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, 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 percent.[39]

### West Virginia

In a recent decision, the West Virginia Office of Tax Appeals ruled that "a person who is elected or appointed as an officer without his knowledge or consent, or who does not act as an officer and does not assume the character, duties, or responsibility of an officer, is not liable as an officer" for the LLC's state sales tax liability.[40] The individual in the case, who the West Virginia Department of Revenue determined was a responsible person, did not sign either the LLC's Articles of Organization or its business license application, although his name appeared on both. The petitioner's testimony claimed he was never employed by the company, shared in any gains or losses, or had any other dealings with the company. Ultimately, the Administrative Law Judge concluded by finding that, "while it appears from the evidence that Petitioner was a member of the business, it is likewise clear that he did not take part in the management of the business, nor in any way assume the character, duties, or responsibilities of an officer."[41]

## SERIES LLCs

Businesses and investors are beginning to turn to series LLCs as a viable answer to choice-of-entity questions. In recognition of this fact, Kansas, Kentucky, and the District of Columbia have all adopted series LLC statutes within the last year. One of the main issues surrounding series LLCs is whether each individual series will be treated as a single taxpayer, requiring separate filings from each series, or if the series as a whole will be 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 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.

[38] 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. (May 26, 2011).

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

[40] W. Va. Code R. § 110-15-4a.5.1 (1993).

[41] West Virginia Office of Tax Appeals, Admin. Decision, Dkt. No. 09-464 C (Feb. 15, 2012).

## California

While California law does not explicitly allow series LLCs to be formed in the state, it does, at least informally, recognize them.[42] 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 will take the position that each unit will be treated as a separate entity for California filing and tax purposes. Thus, the same filing guidelines and estimated taxes that apply to LLCs will apply to each series of a series LLC. For example, if the LLC has elected to be taxed as a corporation, the LLC will be required to follow California corporate filing guidelines and estimated tax requirements, and will be subject to the minimum franchise tax.

## Texas

For purposes of the Texas margin tax, taxable entities include an LLC; in contrast to the California FTB, however, the 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.[43] Also, the entity pays one filing fee and registers as one entity with the Texas Secretary of State.

## 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.[44] 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.

## CONCLUSION

As the above discussion shows, there have been numerous recent developments addressing 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 case law and statutory and regulatory changes, it's very important for the owners of pass-through entities and their advisers to closely monitor these 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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[42] California Franchise Tax Board Tax News (Oct. 1, 2011).

[43] Texas Policy Letter Ruling 201005184L (May 5, 2010) (released Sep. 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).

[44] Tennessee Dep't of Rev., Letter Ruling 11-42, (Sept. 6, 2011); see also B. Carter and J. Long, State Issues Significant Guidance on the Tax Treatment of Series LLCs, 21 J. Multistate Tax'n 10 (Feb. 2012).

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