Recent Developments in the State Taxation of Pass-Through Entities

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This newsletter contains selected developments, organized by topic, related to the state taxation of pass-through entities (referred to, intermittently, as "PTEs") and their owners. These updates, spanning the past 12 months, cover a range of topics, including nonresident owner nexus (i.e., jurisdiction to enforce the collection of tax), apportionment, nonresident withholding, composite returns, entity-level taxes, issues unique to S corporations, and miscellaneous items.

Nonresident Owner Nexus

Alabama—Nexus over nonresident member unnecessary when enforcing composite income tax

Chief Administrative Law Judge Bill Thompson of the Alabama Department of Revenue upheld the imposition of the state's mandatory composite income tax on an Alabama LLC owned in part by a nonresident who resided abroad. In his ruling, Judge Thompson reasoned that it was irrelevant whether the state had jurisdiction over the *nonresident member*, who lived in Greece, because the statutory composite filing/payment requirement was imposed on the LLC, which clearly had a sufficient nexus with the state to permit Alabama to enforce collection of the tax through the composite filing. Citing *International Harvester Co. v. Wisconsin Dep't of Taxation*, 332 U.S. 435 (1944), Judge Thompson explained, "I agree with the Taxpayer's representative that Alabama's composite return and payment provisions were enacted … to avoid the jurisdictional problems involved in taxing a nonresident partner or member. But such provisions are clearly constitutional, and while the tax is measured by the nonresident's distributive share of the entity's income, it is levied on the in-state entity." *Tsitalia LLC v. Alabama Dep't of Rev.*, Admin. L. Div., Dkt. No. BIT. 12-492 (Feb. 1, 2013).

> ***Observation****:* In *International Harvester*, the U.S. Supreme Court upheld a Wisconsin statute that required an in-state corporation (International Harvester) to withhold and remit Wisconsin income tax on dividends it paid to out-of-state stockholders who themselves had no nexus with the state. The Court indicated that "[p]ersonal presence within the state of the stockholder-taxpayers is not

essential to the constitutional levy of a tax taken out of so much of the corporations' Wisconsin earnings as is distributed to them." This decision serves as the legal foundation for the ubiquitous state income tax withholding requirements today.

Alabama—But nonresident individual LLC member may not be personally assessed for income tax due

In another Alabama Administrative Law Division decision, however, Judge Thompson ruled that while the state had authority to collect income tax from an Alabama-based PTE, that authority did not extend to the PTE's nonresident owners. Thus, Alabama could not personally assess income tax against an individual who resided and worked in Minnesota and received income from an Alabama-based LLC because the taxpayer had no contacts in, or connections with, Alabama other than being a member of and receiving income from the LLC. Applying the Alabama Court of Civil Appeals' landmark decision in *Lanzi v. State Dep't of Rev.*, 968 So. 2d 18 (Ala. Civ. App. 2006), *cert. denied*, Ala. S.Ct., Case No. 1051475 (Apr. 13, 2007), Judge Thompson held that Alabama could have assessed the tax against the PTE but cannot assess the tax against the nonresident member personally. As such, the final assessment was voided. *Vogt v. State Dep't of Rev.*, Admin. Law Div., Dkt. No. INC. 11-660 (Jan. 3, 2013).

Alabama—Registration with Secretary of State constitutes nexus

Alabama Chief Administrative Law Judge Thompson ruled that an LLC organized in the state but inactive since December 2007, though never dissolved, was subject to the minimum annual $100 business privilege tax, along with interest, for 2007-2012. Pointing to the state's statute that imposes a privilege tax filing requirement on any corporation or LLC "doing business in Alabama, or organized, incorporated, qualified, or registered under the laws of Alabama," Judge Thompson explained that "[b]ecause the Taxpayer was registered with the Alabama Secretary of State's office from 2007 until 2012, it was qualified to do business in Alabama in those years, and thus liable for the minimum $100 business privilege tax in those years." Interestingly, Judge Thompson waived the associated penalties. *Old Lodge Catering, LLC v. Ala. Dep't of Rev.*, Admin. Law Div., Dkt. No. BPT. 12-1402 (Mar. 27, 2013).

Observation: A 50-state survey conducted by Bloomberg BNA earlier this year revealed that 13 states take the position that the mere act of registering to do business is sufficient to trigger an income tax filing/payment obligation in the state. However, not all states agree. In *Rylander v. Bandag Licensing Corporation*, 18 S.W.3d 296 (Tex. App. 2000), for example, the question arose as to whether qualification to do business in a state, without more, was a sufficient basis for a state to assert jurisdiction. The Texas appeals court held that the Commerce Clause and Due Process Clause prohibited a state from asserting franchise tax jurisdiction over a corporation that had merely qualified to do business in a state without engaging in any other activity there. *Bloomberg BNA 2013 Survey of State Tax Departments: Key Findings and Analysis*, Vol. 20, No. 4 (Apr. 26, 2013).

California—General partner deemed to be doing business in state

A California State Board of Equalization ("SBE") decision held that the taxpayer, a Nevada corporation, was liable for the state's minimum franchise tax. The taxpayer was a managing partner of Horizon, a Nevada limited partnership. One of Horizon's other general partners was USA Properties, a corporation located in California and registered with the California Secretary of State. The SBE held that Horizon was doing business in California through USA Properties because Horizon's activities were attributable to a California corporation. The SBE explained: "When a corporation (here, appellant) is a general partner of a partnership doing business in California (here, Horizon), the corporation is considered to be doing business in California." Thus, the SBE concluded that the Franchise Tax Board properly imposed late filing and demand penalties. *Appeal of SUP, Inc., SBE*, Case No. 571262 (Nov. 14, 2012, *released* March 7, 2013) (not to be cited as precedent).

> ***Observation***: Based on Bloomberg BNA's recent 50-state survey, most states currently take the position that owning an interest in a PTE is in itself sufficient to create nexus. According to the survey, only two states—Vermont and West Virginia—responded that a general partnership interest would *not* trigger nexus. In *Appeal of SUP*, however, California took the position one significant step further by attributing the in-state activities of one general partner to the other. Incredibly, the BNA survey further indicated that all but six states take the position that nexus could arise from owning a *non*-management interest in an LLC. It is difficult to square these positions with the Due Process Clause of the U.S. Constitution, which ensures that a nonresident have advance notice before being subjected to judicial jurisdiction, unlike the Commerce Clause (which was devised to preempt burdens on interstate commerce). In 2011, the Supreme Court renewed its focus on the Due Process Clause in ruling that J. McIntyre Machinery, Ltd., a Great Britain machinery manufacturer, was not subject to personal jurisdiction in the state court of New Jersey (i.e., did not have nexus), even though an individual was injured in New Jersey using a machine manufactured by the company. *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011). The *McIntyre* decision affirms earlier Supreme Court due process jurisprudence holding that an out-of-state actor must purposefully target a particular forum (i.e., state) in order for the state to properly assert jurisdiction. Phrased in tax terms, in order for a state to assert jurisdiction over an out-of-state taxpayer and enforce the collection of tax, the nonresident must have purposefully directed its activities toward that particular state. In a recent ruling, a Kentucky federal court held that an ownership interest in an LLC that was conducting business within the state alone was insufficient to establish personal jurisdiction for the individual owners under the Due Process Clause. *United States v. Bacara Partners, LLC*, 109 A.F.T.R.2d (RIA) 2357 (May 31, 2012). Although this was not a case deciding taxpayer nexus under the Due Process Clause, the holding should signal to taxpayers that a mere ownership interest in a PTE should not create a due process tax nexus with a taxing jurisdiction. On April 25, 2013, the case was dismissed with prejudice due to the taxpayer's settlement.
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> That this Due Process Clause argument was not mentioned in the SBE opinion is not surprising given the fact that the SBE does not have jurisdiction to consider

whether a California statute or regulation is invalid or unenforceable under the U.S. or California Constitutions unless a federal or California appellate court has already made such a determination.

California—60,000 LLCs expected to receive non-filing notices

Each year, the California FTB contacts over 150,000 corporations through a Delinquency Control ("DLC") program. Under the program, corporate taxpayers that are incorporated or qualified to do business in California but have not filed a return receive a notice. Annually, the program generates over $50 million in revenue for the state. The DLC Program has been expanded to include LLCs as of January 1, 2013. By expanding the DLC program to include LLCs, the FTB estimates an additional 59,000 taxpayers will be contacted per year. According to an FTB budgetary report made available to the public, "[t]he additional contacts will result in approximately $21 million in total revenue during the first 5 fiscal years and increasing to more than $7 million in annual revenue in later fiscal years." Non-filers will receive a "Request for Past Due Return" notice 60 days after the extended due date of the tax return and, if the business still fails to file, an official "Demand for Past Due Return" notice, after which the business entity's account enters the collection cycle. The FTB may also suspend a domestic entity or forfeit a foreign organization's rights and privileges for failure to file returns and pay taxes due. California FTB Tax News December 2012.

Observation: California is stepping up its enforcement of LLC tax compliance. Under the state's general filing requirement, an LLC—whether taxable as a partnership or disregarded federally—is required to file California Form 568 and pay the $800 annual tax if it is either (1) organized in California, (2) registered with the California Secretary of State to transact business in the state, or (3) doing business in the state. A taxpayer is "doing business" in the state if it actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California, or meets any of the state's apportionment factor presence tests based on property, payroll, or sales in the state. Additionally, a foreign (i.e., non-California), nonregistered LLC that is a member of an LLC doing business in California, or is a general partner in a limited partnership doing business in California, is considered to be doing business in the state. Even if an LLC is a limited partner, if it exceeds the apportionment factor threshold mentioned above, it is considered to be doing business in the state.

Separately, the LLC may also be required to pay the LLC graduated flat fee, ranging from $900 to $11,790, based on its gross receipts. LLCs must pay the fee if any of the following conditions apply: (1) the LLC is organized in California; (2) the LLC is registered with the California Secretary of State to transact business in the state; or (3) the LLC is doing business in the state. The fee is only required, however, if total California annual income is at least $250,000. The fee is based on total California-source income rather than on worldwide total income. Unlike the $800 LLC tax, an LLC owner is required to remit the LLC gross receipts fee only if it has its own independent California operations, and only to the extent of its own activities.

Note also that California requires that quarterly estimated payments generally be paid on behalf of nonresident owners who exceed a *de minimis* distribution of California-source income, as well as a nonconsenting nonresident ("NCNR") tax on the distributive share of California-source income received by nonresident LLC members.

Illinois—Nonresident partner who received guaranteed payments from Illinois partnership had nexus

The Illinois Department of Revenue ruled that an out-of-state individual taxpayer, whose only connection to the state was his receipt of guaranteed payments from a partnership operating in Illinois, had sufficient nexus with the state to be subject to Illinois income tax. The taxpayer had requested confirmation from the state that he did *not* have an Illinois filing obligation based on the fact that, in his words, he did not own property in state, had never visited the state, and did not possess an ownership interest in the PTE operating in the state. The Department rejected the taxpayer's request, pointing out that he received an Illinois K-1-P, Partner's Share of Income, Deductions, Credits, and Recapture, from the Illinois partnership indicating his receipt of guaranteed payments related to Illinois-source business income. The Department added that "guaranteed payments received by a nonresident partner from a partnership doing business in the state are subject to the state's income tax, even when the partner has no other connection with the state." The Department further explained the partnership's duty to withhold income tax on those payments. Illinois Dep't of Rev. General Information Letter No. IT 12-0028-GIL (Sept. 27, 2012).

New Jersey—Due Process Clause prohibits state from taxing resident shareholders on out-of-state income

This New Jersey Tax Court decision involved a New Jersey resident trust. Beginning in 2006, a New York resident served as the sole trustee of the trust, which he administered exclusively outside New Jersey. During 2006, the trust owned cash, bonds, and stock in four S corporations, each of which conducted business in New Jersey. The S corporations issued the trust a Schedule NJ-K-1 reporting the S corporations' share of income/loss allocated to New Jersey—around $3 million of the approximately $5 million the trust received. The trust also reported approximately $100,000 in interest income, none of which was allocated to New Jersey. Thus, the trust paid tax on its pro rata share of S corporation income allocated to New Jersey but did not pay tax on the interest income or on the net pro rata share of S corporation income allocated outside the state. The trust was then audited, following which New Jersey issued an assessment of approximately $200,000, including interest and penalties. The state maintained that the trust was taxable on 100 percent of its undistributed income, including its pro rata share of S corporation income allocation outside New Jersey. In contrast, the trustee argued that the trust entirely lacked sufficient contacts with New Jersey for the state to subject the trust to tax on its income allocated outside the state. The court agreed with the taxpayer, explaining:

> Trust A was not administered in New Jersey and the Trustee was a resident of New York. Therefore, Trust A could only be taxed on the undistributed income if it owned assets in New Jersey, thus running afoul of the precedent set by the Tax

> Court in *Pennoyer* and *Potter* and the guidance adopted by the Director. … [T]he owner of stock in an S corporation does not own or hold title to the underlying assets of the corporation. … [T]his court may not apply N.J.A.C. 18:35-1.5 as written [*which subjects a resident shareholder to tax on its income from all sources*] and subject Trust A to taxation on its out of state income because Trust A does not have sufficient contacts with New Jersey to satisfy constitutional due process requirements.

Thus, despite the language of the taxing statute, the Tax Court held that the trust was not subject to tax on its out-of-state income because it did not have sufficient contacts with the state to satisfy constitutional due process requirements. Accordingly, the trust did not owe tax on the interest income earned in the year in question. *Residuary Trust A v. Director*, N.J. Tax Ct., Dkt. No. 000364-2010 (Jan. 3, 2013).

Pennsylvania—Nonresident limited partner had income tax nexus

In *Marshall, Jr. v. Commonwealth,* 41 A.3d 67 (Jan. 3, 2012) (on appeal), the Commonwealth Court of Pennsylvania, an intermediate appellate court, affirmed an earlier decision in which it held that a Texas individual who owned a limited partnership interest in a Connecticut-based limited partnership had nexus with Pennsylvania. The partnership incurred losses from operations for financial accounting, federal income tax, and Pennsylvania income tax purposes for each year of its existence. However, in 2005 the lender foreclosed, resulting in cancellation of indebtedness income to the partnership related to discharged nonrecourse liabilities. The court acknowledged that the Texas individual was a passive investor who never participated in the management of the partnership or its underlying property, but nevertheless concluded that the individual had nexus with Pennsylvania (which could therefore assert jurisdiction over him), explaining:

> [I]mposition of the PIT on Marshall, as a limited partner of the Partnership, as a result of the disposition of the Property at foreclosure does not violate Marshall's Due Process rights. Marshall would have us focus solely on his status as a limited partner in the Partnership and, consequently, his limited, if not nonexistent, right to control the Partnership's business affairs. That, however, is a superficial analysis. Marshall did not simply passively invest in a Connecticut limited partnership, as one would trade stocks on a stock exchange. To the contrary, he invested in a specific and limited purpose Connecticut limited partnership, whose "primary purpose was ownership and management" of a substantial commercial property in the City of Pittsburgh—"a sixty-four story office tower and related site improvements, known as the United States Steel Building ... and the underlying parcel of land of approximately 2.676 acres." The investment objectives and policies of the Partnership were directed to maximizing the partners' return on their investment through the Partnership's ownership of the Property. Marshall knew all of this when he chose to invest in the Partnership as a limited partner. He purposefully availed himself of the opportunity to invest in Pennsylvania real estate through a partnership. These are sufficient minimum contacts for the imposition of a tax on Marshall and his fellow partners upon disposition by the Partnership of the Property.

As a result, the court affirmed a Board of Finance and Revenue decision that the Texas individual owed personal income tax to Pennsylvania on his distributive share of discharge of indebtedness income resulting from the foreclosure of commercial property owned by the partnership in Pittsburgh.

> ***Observation***: Many tax nexus judicial decisions to date have provided only a cursory analysis of due process considerations, focusing more on Commerce Clause nexus. In contrast, *Marshall* focuses on the due process requirement that a nonresident (here, Texan Robert Marshall), "purposefully avail" himself of the benefits and protections of a forum (here, Pennsylvania) in order for the forum to assert jurisdiction over the nonresident. In other words, the Texas individual must *consciously direct his activities toward Pennsylvania*; otherwise, it would violate his due process rights for Pennsylvania to assert jurisdiction over him. One would expect that in many, perhaps most, cases, a passive limited partner would have no specific knowledge of where the partnership in which the limited partner invests intends to operate. For that reason, the Commonwealth Court was careful to analyze the partner's knowledge of Pennsylvania activities in which the limited partnership would be involved at the time the nonresident invested in the partnership.
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> Oddly, no mention is made in the decision of nonresident withholding. Pennsylvania began requiring pass-through entities to withhold and pay quarterly personal income tax for nonresident owners that are individuals, estates, or trusts for tax years beginning on or after January 1, 1992.
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> Finally, it is also worth noting the apparent disparity in treatment of the partnership's nonresident investors compared to its Pennsylvania owners. While the Pennsylvania resident partners were permitted to offset their share of the gain on foreclosure with the loss on liquidation, the nonresident partners were not permitted to recognize the loss on liquidation for Pennsylvania tax purposes. The court's explanation was that intangible assets, such as a limited partnership interest, typically reside where the holder is domiciled, with the result that any gain or loss resulting from the disposition of a limited partnership interest owned by a nonresident would not be sourced to Pennsylvania.

Tennessee—Chancery court holds that general partner had nexus

A Tennessee Chancery Court held that Vodafone, a British company that owned a 45 percent (non-managing) general partner interest in Cellco Partnership d/b/a Verizon Wireless, a general partnership, was doing business in Tennessee (i.e., had nexus) and therefore was subject to the state's franchise/excise tax. During the relevant period, Verizon Wireless continuously and systematically engaged in the wireless voice and data business in Tennessee. According to the trial court, "a general partner of a general partnership doing business in Tennessee is present in Tennessee, is doing business in Tennessee, and meets all constitutional requirements for taxable nexus with Tennessee through the activities of the general partnership in Tennessee." *Vodafone Americas Holdings, Inc. v. Roberts,* Tenn. Chancery Ct., Case No. 07-1860-IV (Mar. 19, 2013) (on appeal).

> ***Observation***: *Vodafone* illustrates a common view among the states that the activities of a general or limited partnership or LLC may be attributed to the general partner/managing member in all events. Expressed in due process terms, if a partnership is directing its activities toward a particular state, then the general partner or managing member must be consciously directing its activities toward that forum by virtue of its management role. While this may often be the case, it is not invariably true. As the *Marshall* decision illustrates, a limited partner, though passive by nature, could nevertheless purposefully direct its activities (e.g., the deployment of capital) toward a particular jurisdiction. It is similarly possible that a general partner, though possessing limited managerial rights, does not necessarily exercise managerial rights with respect to a decision to operate within a state and may be unaware of the partnership's activities within that forum. Consequently, depending on the facts, the Due Process Clause may prohibit a state's assertion of jurisdiction over the general partner. Vodafone filed a similar refund suit in Florida but that case has been settled by the parties.

Apportionment of Multistate Income

California—State clarifies that single sales factor required for PTEs

California recently issued an administrative release clarifying that PTEs must likewise apportion income using the single sales factor. Proposition 39, which added Cal. Rev. & Tax. Cd. § 25128.7 for taxable years beginning on or after January 1, 2013, requires that business income of an apportioning trade or business (other than an apportioning trade or business described in Cal. Rev. & Tax. Cd. § 25128(b)) is apportioned to the state by multiplying the business income by the sales factor. Cal. Reg. §§ 17951 through 17954 requires such businesses to source such business income in accordance with the provisions of the corporate apportionment rules. Thus, an apportioning trade or business that carries on within and out of California is required to apportion the nonresident's business income using the single sales factor irrespective of the form of ownership. California FTB Tax News April 2013.

Idaho—Allocation and apportionment of partner's guaranteed payments

Effective retroactive to January 1, 2013, Idaho limits to $250,000 in a calendar year the amount of guaranteed payments paid by a partnership doing business in Idaho that may be attributed to the state in which the partner performed the services. Amounts paid in excess of $250,000 per year are sourced to Idaho based upon the partnership's Idaho apportionment factor. The $250,000 limit will be adjusted annually for inflation. This legislation also clarified that all guaranteed payments made to *retired partners* are sourced to the recipient partner's state of domicile. L. 2013, H139 (c. 83).

Illinois—"Read our statute"

The Illinois Department of Revenue summarily rejected a taxpayer's request for alternative apportionment because the alternative method requested appeared to be the default method provided by statute. The taxpayer was a limited partnership based in Texas whose sole source of income was derived from its investment in other partnerships, including partnerships operating in

Illinois. In its ruling request, the Texas LP explained that it did not receive apportionment information from its underlying partnership investments that operated in Illinois and therefore was unable to calculate an Illinois sales factor. The Illinois Department of Revenue referred the taxpayer to its statutory provision for the allocation of income derived from non-unitary partnerships, ILCS § 5/305, which provides that the partner allocate its share of Illinois-source income as determined by an apportionment calculation at the underlying partnership level. Illinois Dep't of Rev. General Information Letters No. IT 13-0001-GIL (Mar. 21, 2013).

> ***Observation****:* The compliance issue relayed by the taxpayer—lack of timely apportionment data from an underlying PTE investment—is not uncommon. Nevertheless, in its recitation of facts, the taxpayer appeared to describe a context where apportionment data was irrelevant; i.e., it appeared that the Texas LP was non-unitary with the underlying partnerships, in which case the Illinois statute required that the nonresident LP allocate its share of the Illinois-source income as apportioned at the underlying entity level. The Department's brusque response dodged the thornier question of how a nonresident partner should apportion its distributive share of income in the context in which the partner and partnership are unitary but the underlying partnership fails to timely provide apportionment information.

Michigan—S corporation shareholder not allowed to aggregate apportionment factors

The Michigan Supreme Court held in abeyance an appeal of a Michigan Court of Appeals case, *Winget v. Department of Treasury*, Mich. Ct. App., Dkt. No. 302190 (Oct. 16, 2012) (unpublished), that had ruled that the sole shareholder of several S corporations could not combine apportionment factors of the various S corporations. Noting that the S corporations were legally separate and distinct business entities with no common ownership at the entity level, the Court had ruled that the S corporations did not form a single business entity and therefore the taxpayer was required to apply a separate apportionment percentage to each S corporation. In its abeyance order, the Court referred to two cases pending on appeal before it, *Malpass v. Department of Treasury*, 295 Mich. App. 263, 815 N.W.2d 804 (2011), and *Wheeler Estate v. Department of Treasury*, 297 Mich. App. 411, 825 N.W.2d 588 (2012). The court noted that the decisions in those cases may resolve an issue raised in the present application for leave to appeal. Therefore, the present appeal is to be held in abeyance pending the decisions in those cases. *Winget v. Department of Treasury*, Mich. Ct. App., Dkt. No. 302190 (Oct. 16, 2012 - unpublished); *leave to appeal ordered to be held in abeyance*, Mich. S. Ct., Dkt. No. 146218 (Apr. 1, 2013).

Minnesota—LLC not unitary with corporate member

The Supreme Court of Minnesota held that there was insufficient flow of value between the taxpayer and an LLC of which it was a member and inadequate control by one over the other to establish the existence of a unitary business between the taxpayer and the LLC during the period at issue. The taxpayer, a Delaware corporation, provided pharmacy benefit management ("PBM") services and operated a mail-order pharmacy. The taxpayer and two other PBM services formed an LLC to create an electronic prescription and information routing service to facilitate prescription benefit communications. The court ruled that there was insufficient flow of value between the taxpayer and the LLC to establish a unitary business relationship between the two entities. The evidence showed that the taxpayer and the LLC conducted arm's length transactions. Moreover, the LLC had its own departments responsible for making its own operational and strategic decisions. During the period at issue, the taxpayer employed no LLC employee; none of the taxpayer's employees were employed by the LLC; and the two businesses maintained separate human resources personnel, separate legal and accounting departments, separate books and records, separate data processing systems, separate intellectual property ownership, separate purchasing offices, separate office facilities, and separate bank accounts. *Express Scripts, Inc. v. Commissioner of Revenue*, Minn. Tax Ct., Dkt. No. 8272 R (July 20, 2012).

Virginia—Pass-through income taxable

A recent Virginia ruling concerned a husband and wife who resided outside Virginia and owned a membership interest in an LLC also domiciled outside the state. The husband was also the primary shareholder of VSC, an S corporation based in Virginia that provided financial and retirement services. VSC was the LLC's only client and paid the LLC fees in exchange for investment and asset management services on behalf of the S corporation's clients. On its Virginia income tax return, the taxpayers attributed a loss received from the Virginia S corporation to Virginia while attributing income passed up from the out-of-state LLC entirely outside the state. Based on the number of days the taxpayer spent in Virginia and the nature of the business, the Commissioner ruled that the LLC and taxpayer conducted operations in Virginia and therefore had income subject to Virginia income tax. The Department noted that in future years the taxpayer should document the time worked in Virginia and elsewhere. Virginia Public Document Ruling No. 12-219 (Dec. 21, 2012).

Entity-Level Income Tax Withholding

California—Continued focus on nonresident withholding

In a 2011 budget document, the California FTB released revenue projections related to nonresident withholding that showed aggressive expected increases in withholding-related receipts: "$8 million in FY 2010/11, increasing to $15 million in FY 2011/12, $16.5 million in FY 2012/13, and ongoing revenue of $18.2 million beginning in FY 2013/14." In order to ensure this stream of revenue, the FTB requested "funding to increase compliance with nonresident withholding by pursing new outreach, education, and discovery activities." As part of this process, the FTB recently announced that beginning January 17, 2013, the "Withhold at Source and Compliance Section" ("WSCS") will automate "Withholding Information Notices" ("WIN"). WSCS administers the nonwage withholding program, which includes real estate, resident, nonresident, and backup withholding. In 2011, WSCS implemented the new automated "Withhold at Source System" ("WASS") to process withholding forms and payments. Beginning in 2013, WSCS will send WINs to taxpayers that submit FTB Form 592, 592F, or 593, resulting in a discrepancy. If the discrepancy results in an overpayment, the taxpayer should follow the instructions on the WIN to resolve it; if the discrepancy results in a balance due, the FTB will mail a separate bill. Individual taxpayers and estates and trusts will receive a Statement of Tax Due. Business entities will receive a Notice of Tax Due. The taxpayer should follow the instructions on the STD or NTD to make a payment. California FTB Public Service Bulletin No. 13-06 (Jan. 15, 2013).

California—Failure to timely withhold penalty

An LLC doing business in California failed to establish reasonable cause to abate the penalty for failing to timely file. For tax year 2008, the LLC was required to withhold taxes, file "Quarterly Nonresident Withholding Statements" (Form 592) and remit the withheld taxes to the Franchise Tax Board because some of the LLC's partners were nonresidents of California. The LLC filed Form 592 eleven days past the due date, reporting withholding for 77 nonresident partners for 2008. Penalties were not abated, however, because the LLC failed to (1) substantiate that it timely requested tax information from a withholding agent or take any other steps to determine or estimate the amount of withholding by the applicable deadline; (2) explain why it did not file the Form 592 until approximately three and a half months after it received all the necessary information; and (3) provide evidence supporting its argument that it could not file the Form 592 until after it received the last required Schedule K-1. The LLC's failure to produce the requested information suggests that the information, if produced, would have been unfavorable to its appeal. *Appeal of Cornerstone Real Estate Fund A, LLC*, SBE, Case No. 574006 (Oct. 24, 2012, *released* Feb. 26, 2013) (not to be cited as precedent).

Georgia—Legislation changes withholding frequency

Historically, nonresident withholding has been required monthly for actual distributions and annually for distributive share (i.e., distributions credited but not paid). Effective for tax years beginning on or after January 1, 2012, however, withholding is only required annually on the nonresident member's share of the taxable income sourced to Georgia—whether or not distributed. Payment is due on or before the due date, without extensions, for filing the income tax return of the entity. HB 965 (O.C.G.A. §§ 48-7-114 and 48-7-129).

Maryland—Tax rate change for nonresident owners

The Maryland Comptroller's Office updated an administrative release relating to the taxation of PTEs with nonresident members. The release conforms to the increase in the highest individual income tax rate for 2012, resulting in a tax rate imposed on PTEs that is paid on behalf of nonresident individual members for 2012 equal to 7 percent (i.e., the lowest county income tax rate of 1.25 percent plus the highest individual income tax rate of 5.75 percent). Maryland Administrative Release No. 6 (Sept. 1, 2012).

Michigan—Withholding exemption broadened

Michigan recently amended its exemption from flow-through entity withholding. Effective January 1, 2013, a flow-through entity that receives an exemption certificate from a member other than a nonresident individual (previously, more narrowly, from a corporation) is not required to withhold tax on the distributive share of business income of that member. The exemption must certify that the member will pay the required corporate income tax on the distributive share of the business income received from any flow-through entity in which the member has an ownership or beneficial interest. Finally, the law provides that the Michigan Department of Treasury may require the member to file the exemption certificate and provide a copy to the flow-through entity. Previously, the corporation had to file the exemption certificate with the Department and provide a copy to the flow-through entity. L. 2013, S65 (P.A. 15) (effective retroactive to Jan. 1, 2013).

***Observation**:* Most states that impose a withholding requirement on PTEs also provide an opt-out that is available for certain or all of the PTE's owners. North Carolina's opt out, for example, is only applicable to partners that are corporations, partnerships, trusts, or estates—not individuals or grantor trusts. Some states require the nonresident owner to sign and file the affidavit with the PTE (e.g., New Jersey, New York), though a few do not (e.g., Iowa, Missouri). Many states require that the PTE file the form with the state (e.g., North Carolina, Wisconsin), though other states do not impose this requirement (e.g., Illinois, New Jersey, New York, Pennsylvania, Ohio).

Michigan—2012 annual flow-through withholding reconciliation

Effective February 19, 2013, Michigan made significant updates and clarifications to its instructions to Form 4918, Annual Flow-Through Withholding Reconciliation Return. These changes—many of which concern apportionment calculations in tiered structures—are noted within the Flow-Through Withholding Booklet (Form 5014). Michigan 2012 Annual Flow-Through Withholding Reconciliation Instruction Updates (Feb. 22, 2013). Note that the state has also released instructions to Form 4918 and Form 4917, Flow-Through Withholding Quarterly Report.

Montana—Withholding form changes

Beginning with the 2012 tax year, Form PT-WH, Montana Income Tax Withheld for a Nonresident Individual, Foreign C Corporation, or Second Tier Pass-Through Entity, has been discontinued. In prior years, a PTE reported the amount of pass-through withholding attributable to each owner on a Form PT-WH and the owner's Montana Schedule K-1. Now, PTEs will only report each owner's distributive amount of pass-through withholding on a Montana Schedule K-1.

Additionally, beginning with tax year 2012, PTEs or their owners are required to file Form PT-AGR, Pass-Through Entity Owner Tax Agreement, separately with the Department of Revenue. Form PT-AGR is due on or before the due date of the PTE's return. If Form PT-AGR is filed on time, the PTE does not have to pay tax on behalf of its owners that are nonresidents or foreign C corporations. Beginning with tax year 2012, Form PT-AGR may be filed electronically. The form can also be filed by mail.

Beginning with tax year 2012, PTEs or their owners are required to file the Form PT-AGR separately with the department. Prior to tax year 2012, Form PT-STM, Second-Tier Pass-Through Entity Owner Statement and Waiver Request, was attached to a PTE's tax return. Form PT-STM is due 45 days before the original due date of the first-tier PTE's return. When the state receives Form PT-STM, it will notify the first-tier PTE within 30 days regarding the status of the waiver request. If the first-tier PTE receives a waiver, it does not have to pay tax on behalf of a second-tier pass-through owner with the first-tier PTE's return. Beginning with tax year 2012, Form PT-STM can be filed electronically on Taxpayer Access Point ("TAP") and can also be filed by mail.

New Mexico—Nonresident owner withholding changes

Retroactive to January 1, 2012, withholding from nonresident owners of a PTE is required annually. Previously (and only briefly), a PTE was required to remit the tax quarterly. The requirement to remit the tax annually was reinstated for tax years beginning on or after January

1, 2012. The entity files and pays the tax due when Form RPD-41367, Annual Withholding of Net Income from a Pass-Through Entity Detail Report, is submitted to the Department.

Additionally, if a PTE has more than 50 owners that receive New Mexico net income, the entity is required to electronically file Form RPD-41367, Annual Withholding of Net Income from a Pass-Through Entity Detail Report, through the Department's website. If the entity has more than 50 such owners and is unable to file electronically because a hardship exists, the entity may request Department approval to file by paper. The PTE may request approval by filing Form RPD-41350, E-File Exception Request Form. The request must be received by the Department at least 30 days before the taxpayer's electronic report is due. New Mexico Tax'n and Rev. Dep't, *New Mexico Bulletin*, B-200.25 Rev. 9/2012 (Sept. 2012).

North Dakota—Withholding/composite rules modified

Effective for tax years that begin on or after January 1, 2014, North Dakota legislation expands the definition of "pass-through entity" to include grantor trusts and entities similar to PTEs not taxed as entities for federal income tax purposes. Additionally, the definition of "nonresident" will be expanded to include a PTE that does not have its commercial domicile in North Dakota. The definition of "member" will be expanded to include a settlor of a grantor trust or a PTE.

The legislation also provides that a member that is a lower-tier PTE may make an election to be exempt from the withholding requirement. The form must include a statement that the member will file any return and pay any tax required on its distributive share of income from the source PTE and that the member is subject to North Dakota's jurisdiction for the collection of that tax and any applicable penalty and interest. The Tax Commissioner may revoke the exemption if the source PTE or member fails to comply with those rules. If the exemption is revoked, the source PTE must begin withholding from the member within 60 days of receiving notification of the revocation from the Tax Commissioner. L. 2013, S2104.

Oregon—Nonresident owner withholding required quarterly

Effective January 1, 2013, the Oregon Department of Revenue amended its withholding regulation (Rule § 150-314.781) to provide that a PTE must remit required withholdings to the Department on a quarterly basis. The due dates of these required payments are the 15th day of the 4th, 6th, 9th, and 12th month of the entity's tax year. For estimated tax payments due on or after January 1, 2013, the entity will submit an annual report. The report is due the last day of the second month following the close of the entity's tax year.

Utah—Interest waiver request denied related to failure to withhold

The Utah State Tax Commission upheld the imposition of interest against a PTE that failed to withhold income tax on behalf of a nonresident partner who had, nonetheless, pre-paid the amount of tax due to be paid on its behalf. The PTE and its nonresident owner had a different year end (December 15 and June 7, respectively). The PTE argued that it was therefore unable to calculate the amount of withholding due and should not be liable for interest due because the owner had fully prepaid the amount of tax due on its behalf. The Utah State Tax Commission disagreed, citing the state's withholding penalty/interest waiver provision, which provides for the abatement of penalties and interest if the owner files and pays its share of tax *prior* to the date on which the underlying PTE would be required to withhold. Despite the prepayments, the Commission adopting a form-over-substance approach and rejected the taxpayer's argument because the owner had not filed a return and therefore did not meet the technical requirements of the waiver provision. *Petitioner v. Taxpayer Services Division of the Utah State Tax Comm'n*, Utah State Tax Commission, Dkt. No. 11-2938 (Jun. 1, 2012, *released* Apr. 10, 2013).

> ***Observation***: This decision reflects a growing state trend of upholding penalties and/or interest imposed on a PTE for failure to withhold in contexts where the owner actually has already paid its share of tax due to the state. Other states that have upheld the imposition of penalties/interest even when the nonresident owner paid the amount of tax due include Delaware (*Visions Unlimited Inc. v. Dir. Of Rev*, 1444 (Apr. 8, 2009)) and Indiana (Indiana Letter of Finding No. 09-0241P (Aug. 1, 2009)), whose decisions also provide an example of the form-over-substance approach. Consider the language in the Indiana ruling: "[T]he issue is not whether the tax was paid, but rather whether the taxpayer complied with Indiana laws governing withholding—a statutory mechanism designed to ensure compliance and ease of enforcement of Indiana tax laws."

Utah—PTE withholding changes

Effective January 1, 2013, Utah added estates and trusts to the list of entities defined as a "pass-through entity" that are required to withhold. The legislation also clarified that retirement and pension plans structured as PTEs are exempt from withholding. Finally, the legislation established a *de minimis* threshold for collecting withholding taxes from trusts if the trust beneficiaries meet some safe harbor standards. Utah S.B. No. 143 (2012 Regular Session).

Additionally, effective February 21, 2013, the Utah State Tax Commission amended its withholding regulation, Utah Admin. Code r. § R865-9I-13. Changes include deleting the provision stating that a PTE is not required to withhold tax on behalf of a PTE taxpayer where the PTE taxpayer is an individual retirement account ("IRA"), as defined under IRC § 408(a), and the income from the PTE is not unrelated business income to the PTE taxpayer. Non-substantive technical changes were also made.

Wisconsin—LLC quarterly withholding required

The Wisconsin Department of Revenue updated its helpful LLC publication and now requires PTEs to make quarterly payments of estimated withholding tax on nonresident owners' shares of income attributable to Wisconsin. The PTE must make quarterly payments of withholding tax on or before the 15th day of the 3rd, 6th, 9th, and 12th month of the taxable year. Wisconsin Dep't Rev., Tax Publication No. 119 (Jan. 1, 2013).

Composite Returns

Arizona—New guidance on composite filing requirements

The Arizona Department of Revenue issued a 2013 informational release reiterating that if certain conditions are met it will accept a composite return of the qualifying nonresident individual owners in a PTE in lieu of each owner filing a separate Arizona individual income tax return. The new ruling sets forth in detail limitations and conditions that will apply to the owners included in the composite return; describes what the filing of the composite return will comprise; explains how to compute each member's deductions, exemptions, and liability; and covers certain other matters relating to composite returns. Arizona Individual Income Tax Ruling No. 13-2 (May 6, 2013); *superseding* Arizona Individual Income Tax Ruling No. 97-1 (July 22, 1997).

Illinois—Changes to alternative apportionment, composite return, and nonresident withholding

An income tax bill approved by the Illinois General Assembly would eliminate composite income and replacement tax returns for members of PTEs classified as partnerships for federal tax purposes and shareholders of S corporations. In addition, the bill clarifies the availability of alternative apportionment methods for tax years after 2008 if the rules under the state's single sales factor do not fairly represent the taxpayer's market for goods, services, or other sources of business income attributable to Illinois. PTEs computing the amount of income tax to withhold on behalf of nonresident owners would be required to include nonbusiness income and distributable credits in that calculation, effective for tax years beginning after 2013. H.B. 3157, as passed by the Senate on May 23, 2013, and concurred by the House of Representatives on May 28, 2013.

Montana—Changes to composite filing rules

Effective March 28, 2013, Admin. R. Mont. § 42.9.101 was amended to permit nonresident trusts and estates, whose only Montana-source income for the tax year is from a PTE, to be included in a composite tax return. Additionally, Admin. R. Mont. § 42.9.201 was amended to provide that the Department will not accept an income or corporate tax return from eligible participants in a composite tax return.

Oklahoma—Expansion in types of owners that may be included in composite filing

The Oklahoma Tax Commission amended a regulation, Okla. Admin. Code § 710:50-19-1, to allow partnerships with two or more partners to file composite returns for nonresident partners that are C corporations, S corporations, or partnerships. Previously, only individuals and trusts were generally allowed to be included in composite returns.

> ***Observation***: These updates reflect a continuing state trend of loosening limitations on the types of owners permitted to be included in a composite filing. At one end of the spectrum are states that only permit nonresident individuals to be included in a composite filing; at the other, states that allow any type of owner to be included, even if the owner is itself a PTE. Even if the state's rules do not

allow for all types of owners to be included, some may grant permission to do so, though others will not.

Entity-Level Taxes

California—Refund of LLC tax

The State Board of Equalization recently ruled that a California LLC that filed a certificate of cancellation with the Secretary of State's office within six months of filing its articles of organization and within four months of paying its annual $800 LLC tax was ineligible for a refund of the LLC tax. The SBE noted that a California LLC is liable for the tax unless its tax year was less than 15 days or if it (1) files a final annual state tax return for the preceding year; (2) does not do business in California after the end of the tax year for which the final return was filed; and (3) files a certificate of cancellation within twelve months of filing its final state tax return. Since the LLC's tax year was more than 15 days and it did not have a prior year return, the SBE concluded that neither exception applied and thus no refund was due. *Appeal of DG Resource LLC*, SBE, Case No. 575594 (Nov. 14, 2012, *released* Mar. 7, 2013) (not to be cited as precedent).

> ***Observation***: As noted previously, California is stepping up enforcement of tax payments required to be paid by PTEs, particularly LLCs.

California—15-day rule; entity conversions

A business entity is not subject to the $800 annual/minimum tax if the entity did not conduct business in the state during the tax year, or its tax year was 15 days or less. California law operates to provide relief to business entities (LPs, LLPs, LLCs, and corporations) from the general requirement to pay the annual/minimum tax. For purposes of corporations, if the rule qualifies for the short-year 15-day rule, this period of time will also be disregarded for purposes of determining the corporation's first year minimum tax waiver. A converting entity ends its tax year on the date of conversion, while the converted entity does not begin its tax year until the next day. The 15-day rule does not normally apply to entities involved in a conversion, because they are usually continuously doing business during both periods involved, so both the converting and converted entity each have a filing requirement. For newly formed LLCs, the $800 annual tax payment is due and payable by the 15th day of the fourth month after the LLC registers with the California Secretary of State or the date it begins doing business, if business begins before it registers with the California Secretary of State. Any portion of a month is considered a full month for calculating the annual tax payment due date. California FTB Tax News (Nov. 1, 2012).

Illinois—Taxpayer not investment partnership (thus, subject to replacement tax)

The Illinois Department of Revenue held that a taxpayer was not a qualified investment partnership because more than 10 percent of its income came from lottery winnings. The taxpayers created a partnership that collected and distributed Illinois lottery winnings and invested winnings and paid taxes on all winnings and investment income on an individual level. The Illinois Income Tax Act provides that partnerships are not subject to regular Illinois income tax, but that partnerships other than "investment partnerships" *are* subject to the so-called personal property tax replacement income tax. The Department noted that since more than 10 percent of the partnership's income resulted from lottery winnings, the partnership is not a qualified investment partnership and nothing in the Illinois Income Tax Act exempts lottery winnings or qualifying investment securities received by a partnership from taxation. Illinois Dep't of Rev., General Information Letter No. IT 12-0032-GIL (Dec. 3, 2012).

> ***Observation**:* A number of states, either by statute or regulation, exempt qualified investment partnerships from their nonresident partner withholding or composite return regimes, but as illustrated above, each criteria for qualification must be met. Most QIP definitions require a substantial percentage of the income to be passive, investment-type income such as interest and dividends.

Tennessee—Franchise/excise treatment of not-for-profit LLC

An LLC that was exempt from federal income tax purposes under IRC § 401(a) was considered a not-for-profit entity for Tennessee franchise and excise tax purposes and therefore generally was not subject to either tax. Nevertheless, as a not-for-profit entity, the taxpayer was subject to the Tennessee excise tax to the extent its net earnings constituted unrelated business taxable income, as defined in IRC § 512, or were otherwise subject to income taxes under IRC Subchapter A. In addition, the taxpayer was subject to the Tennessee excise tax on all net earnings attributable to any activities unrelated to, and outside, the scope of the activities that gave it exempt status. The taxpayer was also subject to Tennessee franchise tax with respect to Tennessee net worth, or real or tangible personal property owned or used, attributable to activities subject to income tax under IRC § 512 ("UBTI") or any other provision of IRC Subchapter A. The taxpayer was also subject to franchise tax attributable to activities unrelated to and outside the scope of the activities that gave the taxpayer its exempt status. Tennessee Letter Ruling No. 12-26 (Nov. 14, 2012, *released* Jan. 8, 2013).

Issues Unique to S Corporations

Arkansas—State S election required

The Department of Finance and Administration reminds taxpayers that qualifying corporations may elect to be treated as Arkansas Small Business Corporations by filing Form AR 1103 with the Corporate Tax Section. The Arkansas election may only be made if a valid S election has been made for federal income tax purposes for the same tax year and a copy of the federal Notice of Acceptance as an S corporation has been submitted. All shareholders in the corporation on the later of the first day of the corporation's tax year or the day the Arkansas S-Corporation election is made must consent to the election. Arkansas State Revenue Tax Quarterly No. 2 (Apr. 1, 2013).

> ***Observation**:* Arkansas is one of a handful of states that requires a separate state S election to be filed; otherwise, the entity will be considered an S corporation for federal income tax purposes but a C corporation for state income tax purposes—a trap for the unwary. Other examples of states that require a separate state S election include Mississippi, New York, and New Jersey. Separately, Ohio requires that an S corporation file a notice of the S election with

the Ohio Tax Commissioner between the first day of January and the thirty-first day of March every year for which the election is in effect. See Ohio Rev. Code Ann. § 5733.09(B). In Georgia, an S election is only valid for income tax purposes if all shareholders are subject to Georgia income tax or if all nonresident shareholders pay Georgia income tax on their portion of S corporation income. See Ga. Code Ann. § 48-7-21(b)(7)(B). An S corporation must file a consent form for each nonresident shareholder; failure to do so negates Georgia's recognition of the federal S election.

Kansas—S corporations with wholly owned subsidiaries subject to Kansas privilege tax not required to add back certain losses

The Kansas Department of Revenue recently issued a notice to taxpayers regarding changes to the state's statute dealing with addition and subtraction modifications to federal income for state income tax purposes. During the 2012 legislative session, the Kansas legislature passed HB 2117, which modified the adjustments statute (Kan. Stat. Ann. § 79-32, 117). Kan. Stat. Ann. § 79-32, 117 was further amended during the 2013 legislative session. As a result of the new amendment, S corporations with wholly owned subsidiaries subject to the Kansas privilege tax will not be subject to the requirement in Kan. Stat. Ann. § 79-32, 117(xix) to add back losses reported from Schedule E and on Line 17 of the taxpayer's federal Form 1040 income tax return. Kansas Dep't of Revenue, Notice 13-04 Kansas Privilege Tax – Losses (May 5, 2013).

Minnesota—Law does not recognize passive activity deduction for investors in S corporations

The Minnesota Supreme Court held that state law does not recognize a separate "passive activity deduction" for investors in an S corporation. The taxpayers, who were investors in a Minnesota S corporation, thus were not entitled to a deduction for carryover of passive activity losses incurred by the corporation. Instead the taxpayers were entitled to a carryover NOL deduction on their 2007 Minnesota individual income tax return, the amount they claimed as an NOL on their federal income tax return. *John Billion, et al. v. Comm'r of Revenue*, Minn. S. Ct., Dkt. No. A11-2337 (Mar. 20, 2013).

North Carolina—Shareholders not entitled to claim add-back depreciation deduction on individual returns upon conversion of corporation from C to S status

Individual shareholders of an S corporation were not authorized to claim a deduction on their North Carolina personal income tax returns for additional first-year depreciation previously added back (not deductible) by a C corporation on its income tax returns. For tax years 2002, 2003, and 2004, two C corporations purchased new equipment. They claimed bonus depreciation on their federal returns. Because they were not entitled to the bonus deduction for state tax purposes, however, they added back the amount of bonus deduction to their North Carolina corporate tax returns. After doing so, the corporations were entitled under North Carolina law to deduct the amount added back as depreciation over the next five taxable years. However, before they could use the entire balance of their added-back depreciation deduction, they each converted from C corporations to S corporations. As a result, a balance of the deduction remained unused. The taxpayers claimed on their individual state tax returns the balance of the add-back depreciation deduction to which the C corporations were entitled at the time each converted. The court upheld the state's disallowance of the taxpayer's use of the remaining balance of added-back depreciation as a deduction on their individual returns. *Bodford, et al. v. N.C. Dep't of Rev.*, N.C. Super. Ct., Dkt. No. 11 CVS 464 (Apr. 10, 2013).

Miscellaneous Issues

Arizona— Members not entitled to deduct payment of LLC's expenses

The taxpayers, members of an LLC, filed their Arizona resident individual income tax return for tax year 2006 claiming Schedule C expenses they paid on behalf of the LLC. The Arizona Department of Revenue disallowed the total deduction claimed, permitting a lesser deduction of 16.67 percent (the taxpayers' membership interest in Class A, one of the two classes of interests) of the verified expenses originally claimed on Schedule C. Generally, a taxpayer may deduct unreimbursed ordinary and necessary partnership expenses he or she paid on behalf of the partnership on Schedule E if the taxpayer is required to pay those expenses under the partnership agreement. In this case, however, the LLC operating agreement did not require that the taxpayers pay expenses or categories of expenses on behalf of the LLC. Because there was no indication in the record that the taxpayers were required to pay certain expenses, the taxpayers were not entitled to a deduction of the LLC expenses they paid. Arizona Dep't of Rev. Hearing Office Decision No. 201200088-I (Sept. 28, 2012, *released* Oct. 30, 2012).

California—Real estate withholding increase in optional tax rates

The passage of Proposition 30 resulted in an increase to the tax rates on optional gains on sales of real estate for individuals, non-California partnerships, S corporations, and financial S corporations, effective January 1, 2012. As a result of the tax increases, the new rates are as follows: 12.3 percent for individuals and non-California partnerships; 13.8 percent for S corporations; and 15.8 percent for financial S corporations. However, California's revised forms did not reflect the increased rates until late 2012. If the lower rate was used during 2012, California has announced that it will find reasonable cause and not impose penalties on any underpayment due to the Proposition 30 rate increase. California FTB Public Service Bulletin No. 13-09 (Feb. 2, 2013).

Colorado—No capital gain subtraction on sale of LLC's assets

In a recent private letter ruling, the Colorado Department of Revenue held that an LLC and its members could not reduce their Colorado taxable income by the amount of net capital gain resulting from the sale of the LLC's business assets. Colorado statutorily provides that taxpayers may reduce Colorado taxable income by the amount of income treated at the federal level as capital gain derived either from (1) the sale of real or tangible personal property located in Colorado, or (2) the sale of stock or an ownership interest in a Colorado company. However, the Department rejected the taxpayer's argument that it should receive the reduction because goodwill, which accounted for approximately 94 percent of the purchase price, was neither "real" nor "tangible" personal property and the transaction was an asset sale rather than the sale of an LLC membership interest. Colorado Private Letter Ruling No. PLR-12-008 (Dec. 31, 2012, *released* April 2013).

Illinois—Aircraft transfer from individuals to LLC subject to use tax

Four individuals who owned an aircraft together formed an LLC and inquired as to whether transferring the aircraft title to their LLC would constitute a taxable sale for sales/use tax purposes. The taxpayers noted that they paid sales tax at the time they originally purchased the aircraft. The Department responded that aircraft use tax is imposed on any aircraft acquired by gift, transfer, or purchase, though the tax is not applicable if the use is otherwise taxed under the Use Tax Act. Thus, the transfer of an aircraft from individual owners to the LLC would be a taxable event because the aircraft is being transferred from one legal entity to another. Illinois Dep't of Rev. General Information Letter No. ST 12-0062-GIL (Dec. 20, 2012).

Indiana—Intangibles expense add-back

In response to a taxpayer's protest, the Indiana Department of Revenue ruled that an LLC did not meet the statutory definition of an "includable corporation" and was not a member of an affiliated group. Thus, the intangible expenses paid, accrued, and incurred by the LLC could not be included in the add-back calculations provided by the statute. Ind. Code § 6-3-2-20(b) requires a corporation subject to the adjusted gross income tax to add back to its taxable income intangible expenses and any directly related intangible interest expenses paid, accrued, or incurred with one or more members of the same affiliated group. The LLC is treated at the federal level as a partnership, not as a corporation, and thus is neither an "includable corporation" nor a member of the "affiliated group" as defined by IRC § 1504. Because it was not a member of the affiliated group, the intangible expenses paid, accrued, or incurred by the LLC are not included in the add-back calculations under Ind. Code§ 6-3-2-20. Indiana Dep't of State Rev. Letter of Finding No. 02-20110459 (Sept. 1, 2012).

Maine—Vehicle transferred from majority owner to LLC exempt from sales/use tax

The Maine Superior Court held that the transfer of a motor vehicle from a majority owner of an LLC to the LLC was exempt from use tax. Me. Rev. Stat. Ann.§ 1764 provides that tax must be levied upon all casual sales involving motor vehicles except those sold for resale at retail sale or sold to an LLC when the seller is the owner of a majority of the ownership interests in the LLC. In this instance, a husband and wife jointly owned 51 percent of the membership interests in the LLC as joint tenants. Because the husband was the owner of the vehicle and then transferred it to the LLC of which he was deemed a majority owner, the transfer was exempt. *Welch Oil Company v. State Tax Assessor*, Superior Court of Maine, Dkt. No. AP-10-43 (Sept. 28, 2012).

Maryland—Legislation expands transfer and recordation tax exemption to LLCs

Recent legislation extends the real property transfer and recordation tax exemption to certain transfers among affiliated LLCs. Historically, the exemption only applied to transfers between affiliated corporations (e.g., parents and wholly-owned subsidiaries), but the new legislation changed the term "corporation" to "business entity," which is defined to include LLCs and corporations, though not partnerships. Maryland, H.B. 372, 2013 Regular Session.

Maryland—Tax credit found to favor intrastate over interest state commerce in violation of the Commerce Clause

In January 2013, the Maryland Court of Appeals held that Maryland's law that provided a credit for income taxes paid to other states against Maryland state income tax violated the U.S. Commerce Clause because the credit was not available to offset county-level income taxes in Maryland. *Wynne v. Comptroller of the Treasury*, Md. Ct. App., Dkt. No. 107 (Jan. 28, 2013). Maryland's state individual income tax is divided into two parts: a state portion and a county portion. The state portion is uniformly applied to all Maryland residents, but the county portion varies by county. Maryland law provides a credit to residents to offset taxes paid to nonresident states. The credit, however, does not extend to the county portion of the Maryland individual income tax. The taxpayers in *Wynne* claimed a credit for taxes paid in other states against both the state and county portions of the Maryland individual income tax. The Maryland Court of Appeals, applying the internal consistency test of *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995), found that if each state imposed a county tax without a credit as Maryland does, intrastate commerce would be favored over interstate commerce. This type of discrimination against interstate commerce was found impermissible by the Maryland Court of Appeals. On May 17, 2013, the Maryland Court of Appeals denied the Comptroller's motion for reconsideration of the case. Thus, the ruling still stands, but the effective date of the ruling is still on hold to give Maryland time to petition the U.S. Supreme Court for certiorari. *Comptroller of the Treasury v. Wynne*, Md. Ct. App., Dkt. No. 107 (May 17, 2013).

Multistate Tax Commission ("MTC") Shelves Model Statute to Tax Certain PTEs

Over the last few years, the MTC has been developing a model statute that would impose an entity-level tax on certain disregarded entities or PTEs if the entity is owned 50 percent or more by an entity not subject to state income tax (e.g., an insurance company or financial institution). On December 6, 2012, the MTC voted to continue working on its model statute, despite requests from the National Conference of State Legislatures ("NCSL") to drop the initiative. The MTC's Executive Committee agreed to refer a revised proposal concerning the tax treatment of LLCs receiving revenues from insurance businesses and passive investment activity to its Uniformity Committee. On March 6, 2013, the Uniformity Committee voted to forward the proposal to the Executive Committee. Surprisingly, the EC voted on May 9, 2013, to discontinue the project, instead deciding to issue a white paper explaining the issues and possible solutions.

Nebraska—New Markets Job Growth Investment Act

PTEs are eligible to earn a nonrefundable, nontransferable credit for an investment in a qualified community development entity. The credit may be distributed to partners to be used against their liability for state income tax, the premium tax imposed on insurance companies, or the franchise tax imposed on financial institutions. New Markets Job Growth Investment Tax Credit, Nebraska Dep't of Rev. (updated Feb. 4, 2013).

New York—Empire Zone tax benefit eligibility

The Department of Taxation and Finance ruled that the taxpayer, a New York State LLC, will be eligible to claim Empire Zone ("EZ") tax benefits after the proposed change in its ownership structure for the remainder of its benefit period, provided it continues to be certified as eligible for EZ tax benefits (i.e., obtains a certificate of eligibility and an EZ Retention Certificate ("EZRC")) by the Department of Economic Development ("DED") and meets the requirements provided in the law. Under the proposed change, a foreign corporation's 50 percent interest in the LLC will be transferred to the remaining member, a New York State resident individual, who will then own 100 percent of the LLC. The LLC's business will continue to operate after the proposed transfer in the same manner as it did before the transfer. The Department stated that if the LLC continues to be certified by DED after the transfer and meets the employment test under N.Y. Tax Law § 14(b)(4), it will be eligible to claim the qualified EZ enterprise tax credits for the remainder of its benefit period, provided it meets the other credit requirements in the tax law. New York Advisory Opinion No. TSB-A-13(1)C, (Jan. 8, 2013); New York Advisory Opinion No. TSB-A-13(2)I (Jan.8, 2013).

New York—Nonresident partner's loss on disposition of partnership interest not included in New York source income

A New York State administrative law judge recently held that a nonresident partner improperly included a loss from the disposition of a partnership interest as New York source income, while gain from the partnership's sale of New York real estate was properly included as New York source income. The nonresident partner, Craig A. Olsheim, was a limited partner in a partnership whose only asset was a New York City office building. There was a disparity in Mr. Olsheim's inside and outside bases because he had recently inherited his partnership interest. In addition to reporting his pro rata share of the gain from the sale of the office building, Mr. Olsheim also claimed a capital loss resulting from the difference between his outside and inside bases. While current New York law would allow Mr. Olsheim to properly allocate the loss to New York, the law that existed at the time of the sale and liquidation of the partnership did not. The provision in the law that currently allows the sourcing of these types of losses to New York was not added until 2009 and was not made retroactive. Thus, the ALJ held that the loss was improperly sourced to New York. *In re Craig A. Olsheim*, DTA No. 824218 (May 9, 2013).

Washington—Sale of LLC controlling interest subject to real estate excise tax

The Wisconsin Court of Appeals affirmed the Department of Revenue's denial of the taxpayers' request for refund of real estate excise tax ("REET") paid in connection with the sale of a controlling interest in an LLC. The taxpayers owned 50.01 percent of an LLC that owned 19,400 acres of farm land. In 2008, the taxpayers sold their interest in the LLC, paid REET based on the fair market value of all the farm property owned by the LLC, and filed for a refund, contending that they should pay tax on only 50.01 percent of the property owned by the LLC. The court rejected the taxpayers' argument that the REET violated the Uniformity Clause of the Washington Constitution because the Uniformity Clause applied only to property taxes, and the REET was imposed on the *transfer* of property, making it an excise tax. The taxpayers also argued that the REET was invalid because the taxpayers did not voluntarily act to transfer the minority portion of the property. The court noted, however, that the taxpayers voluntarily transferred their controlling interest and the tax applied to their voluntary act of selling property rather than mere ownership. *Watts v. Wash. Dep't of Rev.*, Wash. Ct. App., Dkt. No. 42159-3-II (June 29, 2012) (unpublished opinion).

Wisconsin—Manufacturing and agricultural credit

The Wisconsin Department of Revenue updated its fact sheet concerning the manufacturing and agricultural credit. The revised fact sheet clarifies that an individual, estate, trust, partnership, LLC, or corporation can compute the credit, but that a partnership, LLC treated as partnerships, or S corporation may not claim the credit. The credit computed by a partnership, LLC treated as a partnership, or S corporation, however, can pass through to the partners, members, or shareholders. Wisconsin Manufacturing and Agriculture Credit - Fact Sheet 1107, Wisconsin Dep't of Rev. (Oct. 31, 2012).

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