Mastering Multi-State Taxation of S Corporations: State Variances in Recognition of S Elections and QSSS

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Mastering Multi-State Taxation of S Corporations

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Mastering Multi-State Taxation of S Corporations: State Variances in Recognition of S Elections and QSSS

Karen Harriger Currie
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Agenda

- Current landscape of state treatment of S corporations and qualified subchapter S subsidiaries
- S corporations with nonresident shareholders
- Taxation of nonresident shareholders
- Composite return requirements
- Other issues
Federal S Corporation Election

- Under subchapter S of the Internal Revenue Code a “small business corporation” may elect to become a nontaxable entity.

- A corporation that has made a valid S election pursuant to IRC Section 1362(a) receives tax treatment that is similar to a flow through entity; the shareholders must include their pro rata share of S Corporation income and loss on their individual income tax returns.
Current State Tax Landscape

- Full conformity to federal S election
- Partial conformity to federal S election
  - States that require a separate S corporation election
  - States that depart from federal tax treatment
- Nonconformity to federal S election
- Other issues
Federal Conformity

- Many states expressly follow the federal S election for state tax purposes

- See *e.g.*, Alaska, Arizona, Delaware, Florida, Idaho, Indiana, Iowa, Kansas, Maryland, North Dakota, Virginia, Utah
Partial Conformity – Separate Elections

- Some states require that a separate state S election be made

- See *e.g.*, Arkansas, Mississippi, New Jersey, and New York

- What if the S corporation was not aware of the fact that it was doing business in a particular state?
Partial Conformity – Elections

- Nonresident shareholders in Georgia must consent to pay Georgia income tax
  - Failure to consent will result in taxation as a C corporation

- Wisconsin provides the option to elect out of S corporation treatment and be taxed as a C corporation
Partial Conformity – Other Taxes

- Franchise or license taxes
  - See e.g., Mississippi, Missouri, New Mexico, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Carolina, West Virginia

- Minimum taxes

- Other taxes
  - Alabama business privilege tax
  - Illinois personal property replacement tax
  - Ohio commercial activity tax
Partial Conformity – Income Taxes

- California: subject to a 1.5 percent tax on net income

- Massachusetts: S corporations with total gross receipts > $6M subject to the income measure of the corporate excise tax at varied rates depending on receipts

- New Jersey: subject to a reduced corporate tax rate based on the difference between the highest personal income tax rate and the corporation business tax rate
Nonconformity

- District of Columbia
- New Hampshire
- New York City
- Tennessee
- Texas
- Washington
Nonconformity

- Louisiana requires that a subchapter S corporation doing business in the state file in the same manner as C corporation.

- However, exclusion is available for taxable income of an S corporation based on the ratio of issued and outstanding shares owned by Louisiana resident individuals to total.
Unique Issues

- Election may be revoked for failure to file returns
  - See *e.g.*, Arkansas

- Election may be forced if sufficient investment income
  - See *e.g.*, New York
Timing Considerations

- **Kentucky**
  - For tax years beginning on or after January 1, 2005 and before January 1, 2007, S corporations were subject to income tax

- **Oklahoma**
  - S corporation is not subject to tax for tax years beginning after December 31, 1996

- **Pennsylvania**
  - For tax years prior to 2006, separate state election was required
Qualified Subchapter S Subsidiaries

A “qualified subchapter S subsidiary” (QSub) is a subsidiary of an S corporation that is not treated as a separate corporation.

All of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as the assets, liabilities, and items of income, deduction, and credit of the S corporation.

The American Jobs Creation Act of 2004 (2004 Jobs Act) gave the IRS the authority to require a QSub to file an information return.
Qualified Subchapter S Subsidiaries

- Generally states that recognize the federal subchapter S election also recognize the federal QSub election

- A limited number of states require a QSub to make a separate state election
  - See *e.g.*, New Jersey and New York

- A number of states are silent regarding treatment of a QSub
QUESTIONS?

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State Taxation of Nonresident S-Corporation Shareholders

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Strafford CPE, August 13, 2015
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Agenda

- Nexus for Nonresident Shareholders
- Taxation of Nonresident Shareholders
- Special Issues
Nexus for Nonresident Shareholder

- S-corporations are legally formed under state law as corporations (i.e., they are formed under a state’s corporations (or similar) code)
- There is no such thing as an S-corporation under state law
- S-corporations are solely an income tax classification, and their treatment as pass-through entities where the shareholders are taxable instead of the entity is set forth in the IRC
- This is different from entities formed as partnerships under state law
- State law partnerships (which are typically treated as partnerships under the tax law) are viewed as conducting the business of the partnership on behalf of the partners, and partners have the ability to legally bind and obligate the partnership
  - This is referred to as the aggregate theory of partnerships (i.e., the partnership and its partners are together conducting business)
  - Example: A shareholder of a corporation can not sign a note with a bank in the name of the corporation; however, a partner may sign a note with a bank in the name of the partnership
Nexus for Nonresident Shareholder

- So what does all of this have to do with nexus?
- States have generally been successful at arguing that under the aggregate theory of partnerships, a nonresident partner has nexus in all of the states in which the partnership does business.
- Certain states have ruled that nexus did not exist for nonresident limited partners whose only connection with the state was that it owned a limited partnership interest in a partnership that did business in the state.

- See *DiBelardino v. Virginia Dep’t of Taxation*, Case No. CL06-5696 (June 22, 2007) and *Dutton v. Virginia Dep’t of Taxation*, Case No. CL06-6291 (June 22, 2007) – both were Virginia Circuit Court cases addressing nonresident members of LLCs.
Nexus for Nonresident Shareholder

- For S-corporations, because they are formed legally as corporations, it appears that states have not applied nexus to nonresident shareholders based on the same theories as with partnerships.

- In essence, owning stock in an S-corporation is legally – and for nexus purposes – the same as owning stock in Coca-Cola – individual shareholders don’t have nexus in the states where Coca-Cola does business solely due to their stock ownership.

- So, if the S-corporation is not a taxable entity, and the states can’t tax nonresident shareholders, what options do the states have to make sure that all of the S-corporation income is taxed.

  - **Example:** S-corporation does 100% of its business in GA and its sole shareholder is a Tennessee resident – if the S-corporation is not a taxable entity, and GA can’t tax the nonresident shareholder, how does the S-corporation income ultimately get taxed at the state level?

  - It seems reasonable that GA should be able to collect income tax on 100% of the income earned by the S-corporation and/or its shareholder.
Options for Taxation of S-corporation Income

- Directly tax the S-corporation on its income/revenues (i.e., tax the entity like a C-corporation)
  - There are several states that do this, such as Texas (margin tax), California (1.5% tax), and Ohio (CAT)
  - Not going to focus on these – our focus is going to be on how states have chosen to economically extract the tax from the nonresident shareholder

- Nonresident Shareholder Agreements
- Withholding on income of nonresidents
- Composite Returns

- States vary in how they utilize these options
Nonresident Shareholder Agreement

- These are forms filed by each nonresident shareholder that are typically filed with the state S-corporation return
- The forms state that the nonresident agrees to be subject to the taxing jurisdiction of the state (i.e., that the state has nexus over the nonresident), and agrees to comply with all filing and income tax payment requirements of the state
- In some states, the agreement is required to establish the S-corporation status (i.e., without these agreements, the entity will be taxed as a C-corporation)
- In some states, the agreement is required to join in the filing of a composite return
- In some states, the agreement is not required, but can be executed in order to relieve the S-corporation of other tax requirements, such as nonresident withholding/estimated payment, or the filing of a composite return
- Depending on the state, the form must be filed annually or in the first year that the S-corporation/nonresident shareholder has a filing requirement in the state
Nonresident Withholding

- This is really the main tool that states have at their disposal to tax the income of nonresidents in respect of their ownership interest in the S-corporation
  - Both Alabama and Virginia, in response to losing the nexus cases mentioned above, enacted nonresident member withholding statutes

- While the economic impact of withholding is on the nonresident shareholder, the withholding tax is legally imposed on the entity (i.e., the taxpayer that the state clearly has jurisdiction to tax)

- For example, if the S-corporation fails to withhold but the nonresident shareholder files a return and pays income tax, the state may still go after the entity for failing to comply with the withholding requirements

- In those cases, while the state may agree to forgive the actual tax owed, penalties are often imposed and can be onerous (e.g., Georgia’s penalty used to be 100% but was reduced to 25% in 2008)

- In some states, the liability for the penalty may be “joint and several” meaning that members may be liable for the penalty as well
Nonresident Withholding (cont’d)

- Withholding may be required on amounts “distributed or credit” or on “amounts of taxable income sourced to the state, whether distributed or not”
- In other words, withholding may be required even if the money is not distributed to the nonresident shareholder
- Possible exceptions to withholding requirement
  - Signing of nonresident shareholder agreement consenting to jurisdiction
  - Electing to participate in composite return
  - *De minimis* – typically be based on distributive share of income or on amount of tax to be withheld
- Withholding due dates differ – some on date of S-corporation return, some tied to composite due date or individual return due date, and some are required quarterly (may be referred to as estimated tax payments)
Composite/Group Returns

- A composite return is a return filed by the S-corporation on behalf of its electing nonresident members that relieves such nonresidents from having to file an individual nonresident tax return in each of the states in which the S-corporation files a tax return.

- Most states allow for a composite return to be filed:
  - State approval may be required
  - A minimum number of participants may be required

- Participating in a composite return may except the nonresident member from having the entity withhold

- Estimated composite payments may be required
Composite/Group Returns

- Typical requirements for a nonresident member to participate in a composite return:
  - Nonresident for entire taxable year
  - Does not maintain a permanent place of abode at any time during the tax year
  - The member’s and spouse’s only source of income from the state must be from the S-corporation (if other income from state is also attributable to a pass-through entity, then multiple composite returns may be allowed)
  - Waive right to claim state itemized deductions, personal exemptions, credits, and loss carryovers
  - Have same tax year as other members (generally not an issue for S-corporations since all members are usually calendar year taxpayers)
Composite/Group Returns

- In most states, the tax is computed by multiplying the member’s share of income apportioned to the state by the highest marginal individual tax rate.

- Some states may provide alternative calculation options.

- Often participating in a composite results in more tax being paid to the nonresident state.

- In most states, participating in a composite return is considered as meeting the individual filing requirements, so “true ups” are not allowed – there are exceptions to this.

- Typically, once the composite is filed, it can not be amended to remove a member unless it is later determined that the member did not qualify; alternatively, the individual is directed to file a return and take a credit for the tax paid on the composite.
Special Issues – Resident State Credit

- S-corporation shareholders who pay tax to multiple states due to the multi-state business of the S-corporation may not always get full credit on their individual resident state income tax return.

- *Criticare, Inc. and Marina Shakour Haber v. Director, Division of Taxation*, Docket No. 008253-2013, N.J. Tax Court, (July 8, 2014)

  - Taxpayer, a NJ resident, was sole shareholder of S-corporation doing business in NY and NJ
  - The S-corporation filed in NY and apportioned 80% of its income to the state; thus, the taxpayer paid income taxes to NY as a nonresident on 80% of S-corporation’s income.
  - On her NJ resident income tax return, taxpayer reported all income from the S-corporation, computed tax on that amount and then proceeded to take a credit for the tax paid to NY.
  - NJ denied a portion of the credit based on statute that limits the amount of the credit in the case of a resident S-corporation shareholder.
Special Issues – Resident State Credit

- *Criticare, Inc. and Marina Shakour Haber v. Director, Division of Taxation*, Docket No. 008253-2013, N.J. Tax Court, (July 8, 2014) (cont’d)

  - NJ statute (§ 54A:4-1(c)) provides that “no credit shall be allowed against the tax otherwise due . . . for the amount of any income tax . . . imposed for the taxable year on S corporation income allocated to this State”

  - “S corporation income allocated to the state” is defined by reference to NJ’s allocation statutes

  - Therefore, since under NJ allocation rules, more income would have been allocated to NJ, the credit was reduced

  - Example: S-corporation does business in NJ and NY and has income of $100,000 (assume individual tax rate in each state is 10% and that sole shareholder is a NJ resident). Under NY apportionment rules, NY source income is $80,000, and shareholder pays NY nonresident tax of $8,000. Under NJ allocation rules, NJ source income is $40,000. On NJ resident return, shareholder reports income of $100,000, owes $10,000 and would like to take credit of $8,000 for taxes paid to NY. However, under this case, NJ will only allow a credit of $6,000 ($100,000 x 60% allocation to NY under NJ rule x 10% tax rate). Therefore, taxpayer ends up paying a total tax of $12,000 ($8,000 to NY and $4,000 to NJ) instead of $10,000.
Special Issues – Resident Adjustment

- In some states, S-corporations will be required to pay entity-level taxes. Will the shareholder’s resident state provide an adjustment for individual income tax purposes so that the income is not taxed twice at the state level?


  - Taxpayer, a GA resident, owned an interest in an LLC that did business in Texas
  - LLC paid Texas Franchise Tax, based on amount of taxable margin apportioned to Texas
  - GA statute (§ 48-7-27(d)(1)(C)) provides that a GA individual resident who is a partner or member of a partnership or LLC (treated either as a partnership or disregarded entity) is allowed to make an adjustment to federal AGI “for the entity’s income taxed in another state which imposes on the entity a tax on or measured by income”

  - Issues for GA Tax Tribunal: Is Texas Franchise Tax “a tax on or measured by income” and how should the adjustment be calculated?
Special Issues – Resident Adjustment

- **H. Alan Rosenberg v. Douglas J. Macginnittie, Commissioner, Georgia Department of Revenue**, No. 1414626 (GA Tax Tribunal, Nov. 25, 2014) (cont’d)

  - State ruled for the taxpayer, rejecting the state’s interpretation of the term “income” to mean “net income”
  
  - The Tribunal concluded that the term “income” and “gross income” are synonymous and include all sources of income without regard to deductions or expenses
  
  - Since Texas’ Franchise Tax includes in its total revenue calculation basically all items of income that make up gross income under the IRC, the Tribunal concluded that the tax was measured by income
  
  - This is significant since it raises the possibility that other entity-based taxes (Washington B&O, Ohio CAT, etc.) may be viewed as measured by income, thus allowing residents an adjustment
  
  - Even though this was a partnership/LLC case, GA’s statute (§ 48-7-27(d)(1)(B)) provides that “Georgia resident shareholders of Subchapter “S” corporations may make an adjustment to federal adjusted gross income for Subchapter “S” income where another state does not recognize a Subchapter “S” corporation”
  
  - Consider whether similar adjustment are available – what does it mean for a state to not recognize a Subchapter “S” corporation? Does any income tax on the entity qualify?
Special Issues – Resident Adjustment

- On July 13, 2015, the GA Tax Tribunal issued a final consent order in the case, addressing the second issue regarding the method for calculating the adjustment (this was a difficult issue since the Texas Franchise Tax’s margin base is not equivalent to Georgia’s net income base)

- The calculation of the adjustment is as follows:
  - (1) Determine the pass-through entity's Georgia taxable income before apportionment;
  - (2) Multiply the amount in (1) by the pass-through entity's apportionment ratio in the state where it paid entity level tax; and
  - (3) Multiply the amount in (2) by the Georgia resident's distributive share percentage from his or her ownership interest in the pass-through entity
Special Issues – Sale of S-corporation Stock

- Historically, the sale by an S-corporation shareholder (or other owner of an interest in a pass-through entity) of his/her interest in the entity was treated by states as the sale of an intangible that was sourced to and taxed by the shareholder’s state of residence. While that rule generally holds true today, some states have begun to apply different rules in certain cases.


  - Taxpayer was a Georgia resident shareholder of an S-corporation that owned NY real estate and derived all of its income from operating parking lots and real estate rentals
  
  - S-corporation redeemed all of Taxpayer’s stock and gave Taxpayer an installment note
  
  - Issue was whether gain from redemption of stock constituted NY source income
  
  - NY Tax Law § 631(b) provides that income from NY sources includes income from an interest in real property located in NY, which includes interest in a flow-through entity that owns New York real estate with a fair market value that is at least 50 percent of the fair market value of all the assets owned by the entity (taking into account only those assets owned by the entity for at least two years prior to the transaction giving rise to the income)
Special Issues – Sale of S-corporation Stock

  - The amount of such gain attributable to New York is equal to the gain reported for federal purposes multiplied by a fraction, the numerator of which is the fair market value of the New York real property on the date of the sale or exchange and the denominator of which is the fair market value of all of the assets of the entity on the date of the sale or exchange.

- The NY rule applies to S-corporation owners as well as owners of other pass-through entities.

- Other states, such as Massachusetts, treat the sale of an interest in a business by a nonresident as sourced to the state to the extent the entity conducted business in Massachusetts; however, the rule has not been extended to interests in S-corporations.

- Nonetheless, a nonresident owner should pay particular attention to the impact of selling his/her interest in a business, particularly if that nonresident resides in a low or no tax state.
Contact us

We look forward to working with you.

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Background:

- Federal tax election (made by both Buyer and Seller) that treats the sale of stock in an S corporation (“Target”) as a “deemed” sale of Target’s assets.
- Primary benefit is to provide Buyer with a stepped-up in basis in Target’s assets.
- Generally results in additional tax burden for Seller (ordinary income vs. capital gain treatment).
State Tax Considerations:

- Non-recognition of IRC §338(h)(10) “Election”.
- Separate Election required for state tax purposes.
- Other Apportionment Issues
- Sales Tax
- Shareholder-level credit for taxes paid to other states
Non-Recognition of IRC §338(h)(10) “Election”:

- State and local taxing jurisdictions that do not recognize “S Corporation” status.
  - Louisiana
  - D.C.
  - NYC
- Ohio CAT/Washington State B&O Tax
- New Hampshire Business Profits Tax
- Texas
Separate IRC §338(h)(10) State S Corp Election Required:

- California (opt-out election)
- Wisconsin
- Mississippi
Business v. Nonbusiness income Treatment of IRC §338(h)(10) Gain:

- Business Income is apportioned
- Nonbusiness income is allocated
- Nonbusiness income tests
  » Transactional
  » Functional
  » Operational (NJ)
  » Some state apply test to entire transaction, others on an asset-by-asset basis.

*Good luck taking nonbusiness income treatment….win some - lose a lot!*
Apportionment:

- Certain states exclude IRC §338(h)(10) gain/receipts from Target’s receipts factor.
- Certain states include gross receipts from “deemed” asset sale in Target’s receipts factor.
- Certain states include net gain from “deemed” asset sale in Target’s receipts factor.
- Goodwill is typically largest component of §338(h)(10) gain, therefore sourcing methodology is critical.
S Corporations – IRC §338(h)(10)

Sales Tax:

- Bulk sale notification
  » Required in certain states that have bulk sale reporting.
- Sales tax on “deemed” sale of assets
  » Generally, states do not subject §338(h)(10) “deemed” assets sale to sales tax. Considered a stock sale for sales tax.
S Corporations – IRC §338(h)(10)

Credit For Taxes Paid To Other States:

– Denial of credit by resident state due to difference in sourcing rules on IRC §338(h)(10) gain.
Retroactive S Corporation Election

- **New York**: Available to federal S Corps with “reasonable cause”.
- **New Jersey** – Available to foreign, unauthorized federal S Corps that:
  - Consistently filed New Jersey returns as though a timely election was made and in full effect; and
  - properly reflected the pass-through items of S corporation income on shareholders New Jersey personal income tax returns.
About Presenter

David Seiden is the partner-in-charge of Citrin Cooperman’s State and Local Tax Practice. He brings more than 25 years of expertise in all areas of State and Local Tax (SALT). Prior to joining Citrin Cooperman, Dave was the founding partner in a NY-based SALT consulting firm, SALT Link, LLC. Prior to starting his own firm, Dave spent 17 years as a SALT partner at a Big Four accounting firm where he held various leadership roles.

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Presentations and Publications:
Dave regularly writes articles and serves as a media resource on a multitude of tax-related topics. His articles and contributions have appeared in *Crain's NY Business, The Huffington Post, Law360, Retail Merchandiser,* and *State Tax Notes*. He is also regularly engaged to speak at various conferences for organizations such as Moore Stephens North America (MSNA).

Affiliations/Education
Dave is a member of the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants.

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