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Multistate Tax Treatment of Multi-Tier Partnerships: Navigating State Rules For Nonresident Tiered Pass-Through Entities

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Michael Hirsch, JD, LLM, Senior Manager of Tax Services
Berkowitz Pollack Brant Advisors and Accountants, Ft. Lauderdale, Fla.
mhirsch@bpbcpa.com

Karen A. Lake, CPA, Associate Director of Tax Services
Berkowitz Pollack Brant Advisors and Accountants, Ft. Lauderdale, Fla.
klake@bpbcpa.com

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Multistate Tax Treatment of Multi-Tier Partnerships:

Navigating State Rules for Non-Resident Tiered Pass-Through Entities

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Speaker Panel

- Karen Lake, CPA
  - Associate Director of Tax Services
  - Berkowitz Pollack Brant Advisors and Accountants
  - Ft. Lauderdale, FL
  - klake@bpbcpa.com
  - (305) 960-1202

- Michael Hirsch, JD, LLM
  - Senior Manager of Tax Services
  - Berkowitz Pollack Brant Advisors and Accountants
  - Ft. Lauderdale, FL
  - mhirsch@bpbcpa.com
  - (954) 712-7083

Agenda

- Nexus Issue for Pass-Through Entities and Their Corporate Owners
- State Sourcing of Partnership Income
- Determining Treatment of Lower-Tier Apportionment Factors
- Pass-Through Entity Owner Considerations
- Entity-Level Taxes

Nexus Issues for Pass-Through Entities and Their Corporate Owners

Physical Presence

Any of the following activities conducted within a state may result in nexus:

- Traveling employees and partners
- Telecommuters
- Visiting potential investments and portfolio companies
- Visiting investors and road shows
- Visiting governmental agencies

Economic Presence / Factor Based Nexus

Growing trend among states to enact an additional nexus trigger based on a certain amount of sales to an in-state customer

Does merely holding an interest in a pass-through entity create nexus for the owner with the state in which the pass-through entity does business?

- For corporations, merely holding shares of stock in a subsidiary is not enough to create nexus
- For pass-through entities, the U.S. Supreme Court has never addressed the situation
- Conclusion varies depending upon whether the corporate partner is a Limited Partner or General Partner

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Emergence of “bright line” or economic nexus standards draw in members of pass-through entities doing business in the state

Some recent cases call into question whether a state has nexus over corporate partners at all

- Louisiana – franchise tax
- New Jersey – income tax
- Missouri – holding corporation found to be engaged in the same business as predecessor taxpayer after restructuring even though business operating through an LP

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California

- Traditionally, a foreign corporation is not transacting intrastate business just because it is a LP or member manager of an LLC

- But the Franchise Tax Board asserts that the activities of a SMLLC doing business in CA will be attributed to the corporate owner

  - California economic nexus standards (first enacted January 1, 2011) make this ruling even more important (effective January 1, 2016):
    - Commercial domicile in CA; or
    - $547,711 or 25% of sales to CA; or
    - $54,771 or 25% of property to CA; or
    - $54,771 or 25% of payroll to CA

California

- FTB Amendments to Market-Based Sourcing Regulations (Cal. Code Regs. tit. 18, § 25136-2 (September 15, 2016)

- Changes the state to which revenues derived from dividends, interest, securities and other intangible property are assigned for purposes of determining the California sales factor
  - Assigned to California based on the location of legal entity sold or distributing income

- Coupled with California’s bright-line nexus standards, companies that are not currently filing tax returns in California may not find out they are subject to California taxation, including the state’s $800 minimum tax

- Partners of partnerships “doing business” in California to the extent the partnership is doing business

Pennsylvania

- 72 P.S. 7402.2 61 Pa. Code § 153.29(a)(1)
  - A corporate taxpayer's interest in a partnership is considered a direct interest in the assets of the partnership rather than an intangible interest
  - The taxpayer's share of the partnership's property, payroll, and sales shall be included in the apportionment factors of the taxpayer unless otherwise excluded

Rhode Island

When a partnership or other pass-through entity is directly or indirectly held by a corporation, the business conducted by such a partnership or pass-through entity is considered the business of the corporation to the extent of the corporation's distributive share of the partnership and pass-through entity net income

Illinois

Gen. Inf. Ltr. IT 12-0028-GIL (September 27, 2012)

- Individual nonresident without any personal physical presence in Illinois is subject to Illinois tax because limited liability partnership of which he was a partner conducted business in Illinois
- K-1 showed partner received guaranteed payments and Illinois-sourced partnership business income
- Ruling does not specify whether the type of partnership mattered (e.g., General Partnership or Limited Partnership)

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State Sourcing of Partnership Income

Does owning an interest in a pass-through entity operating in a state create nexus for that partner?

- Yes, if the activity of the pass-through is treated as the activity of its partners.
  - For example, in CA business entities that own a membership interest in a multi-member LLC that has elected to be taxed as a partnership will be treated as doing business in the state if the LLC is doing business in the state (Letter Ruling 2014-01).
  - However, *Swart Enterprises* found that an out-of-state company whose in-state interests were limited to investment in a managed LLC investment fund may not have a CA filing responsibility for purposes of the $800 annual corporate franchise tax.

Two general methods used by the states

- No apportionment factor flow-up (Allocation or Non-Unitary Method)
  - Apportionment at the pass-through entity level
  - Business income is apportioned to the state by the partnership
  - Partners treat the partnership business income as allocable

Apportionment Factor Flow-Up (Aggregate or Unitary Method)

- Apportionment at the owner level
- Partner includes its share of the partnership's apportionment factors in computing its own apportionment factor
- Partnership business income is apportioned using the partner’s apportionment factor

Apportionment Factor Flow-Up (Aggregate or Unitary Method)

- The partner's share of the partnership's factors flow through and are combined with the partner's other factors
- The state tax base equals the partner's apportionable income, including the distributive share of the partnership income, multiplied by the partner's apportionment percentage, including the partner's share of the partnership's factors

Apportionment at the Pass-Through Level (Allocation or Non-Unitary Method)

– The partnership's activities are treated as a separate trade or business of the partner
– The distributive share of the partnership income is apportioned to the nexus state, based on the partnership's factors
– The state tax base equals the partner's distributive share of the partnership income multiplied by the partnership's apportionment percentage
– The apportioned partnership income is combined with any other income that the partner apportions to the state

Federal and State Conformity of Partner's Distributive Share

– Flow-through of the pass-through entity's apportionment factors and income/loss based on the partner's interest in the pass-through entity

  - Under IRC § 704(b), a partner's distributive share of income, loss, or credit is determined by the partnership agreement

Federal and State Conformity of Partner's Distributive Share

- The regulations related to IRC § 704(b) outline the requirements that must be met for the method of distribution to be upheld on federal audit
- The method of distribution must have substantial economic effect:
  - The partnership must maintain capital accounts
  - Upon liquidation the proceeds are distributed based on positive capital account balances
  - The agreement must contain a Qualified Income Offset (QIO) to restore negative capital account balances

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Federal and State Conformity of Partner’s Distributive Share

- Federal and state conformity of partner’s distributive share
  - Generally, state apportionment follows the percentage flow-through of partner’s distributive share used for federal tax purposes

Federal and State Conformity of Partner's Distributive Share

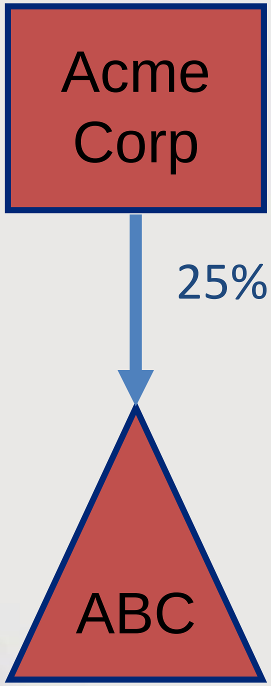
- It should be noted that the distribution of income and loss do not have to align with the partner's ownership interests
  - Under a partnership agreement, income, loss and credits can be distributed under an alternative method – not necessarily based on ownership percentages
  - The distribution of income can be calculated based upon the profitability of the pass-through entity or the value of property contributed by a partner
  - Additionally, the partnership agreement can distribute income and losses under different percentages from year to year based upon various criteria and measurement
  - However, on a yearly basis apportionment and income flow-through should be consistent with the partner's percentage distribution

Determining Treatment of Lower-Tier Apportionment Factors

Pass-Through Entity Apportionment Examples

Apportionment Example 1

Income = $500
(before ABC)



- Nexus in State X
- Income = $400

Acme Corp is 25% partner in ABC Partnership.

ABC has nexus in State X, but Acme has no presence in State X except as partner in ABC.

Acme has $500 of income before its $100 distributive share of ABC's income (ABC's total income is $400).

State X uses sales-only apportionment formula.

	ABC Partnership	Acme's Other Operations
State X sales	$1,000	$0
Sales everywhere	$2,000	$4,500

Apportionment Example 1 (cont.)

Partner-level apportionment (aggregate or unitary method)

	Acme's combined apportionable income ($500 + $100)	$600
×	Acme's combined apportionment % ($250* / $5,000**)	× 5%
=	Acme's taxable income in State X	**$30**

* Acme's sales factor numerator ($0 + [25%][$1,000]) = $250

** Acme's sales factor denominator ($4,500 + [25%][$2,000])=$5,000

Partnership-level apportionment (entity or allocation method)

	Acme's distributive share	$100
×	ABC's apportionment % ($1,000 / $2,000)	× 50%
=	Acme's taxable income in State X	**$50**

Example 2 – Facts

•Corporation A is doing business in Alabama and Illinois
$5,000,000 of apportionable income
Corporations A's apportionment factors are:

	IL	AL	Total
Sales	6,000,000	14,000,000	20,000,000
Property	17,000,000	39,666,667	56,666,667
Payroll	3,000,000	7,000,000	10,000,000

Example 2 – Illinois

Corporation A Income		5,000,000
IL Sales Numerator	6,000,000	
IL Sales Denominator	20,000,000	
IL Sales Factor		30.00%
Total Illinois Taxable Income		1,500,000
IL Tax Rate		9.5%
IL Tax		142,500

Example 2 – Alabama

Corporation A Income		5,000,000
AL Sales Numerator	14,000,000	
AL Sales Denominator	20,000,000	
AL Sales Factor		70.00%
AL Property Numerator	39,666,667	
AL Property Denominator	56,666,667	
AL Property Factor		70.00%
AL Payroll Numerator	7,000,000	
AL Payroll Denominator	10,000,000	
		70.00%
AL Payroll Factor		70.00%
Corporation A Apportioned Income		3,500,000
AL Tax Rate		6.5%
AL Tax		227,500

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Example 2 – Facts

Corporation A invests in Partnership B for a 50% ownership interest

Partnership B has $(200,000) of apportionable loss

	IL	Total
Sales	800,000	800,000
Property	6,000,000	6,000,000
Payroll	300,000	300,000

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Example 2 – Illinois No Factor Flow Up

Federal Taxable Income (5,000,000 - 100,000)		4,900,000
Less Non Unitary Partnership Business Income (Loss)		(100,000)
Corporation A Apportionable Income		5,000,000
IL Sales Numerator	6,000,000	
IL Sales Denominator	20,000,000	
IL Sales Factor		30.00%
Corporation A Apportioned Income		1,500,000
Non Unitary Partnership Business Income (Loss) Apportionable to Illinois		(100,000)
Total Unitary Taxable Income		1,400,000
IL Tax Rate		9.5%
IL Tax		**133,000**

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Example 2 – Alabama Factor Flow Up

Alabama Apportionment Factors

	Co. A	Ptnshp B	Total
AL Sales Numerator	14,000,000		14,000,000
AL Sales Denominator	20,000,000	400,000	20,400,000
AL Sales Factor			68.6%
AL Property Numerator	39,666,667		39,666,667
AL Property Denominator	56,666,667	3,000,000	59,666,667
AL Property Factor			66.5%
AL Payroll Numerator	7,000,000		7,000,000
AL Payroll Denominator	10,000,000	150,000	10,150,000
AL Payroll Factor			69.0%
AL Apportionment Factor			**68.2%**

Example 2 – Alabama Factor Flow Up

Total Apportionable Income	4,900,000
AL Apportionment Factor	68.2%
AL Taxable Income	3,341,800
AL Tax Rate	6.5%
AL Tax	**217,217**

Example 2 Summary

	Illinois	Alabama	Total
Tax Before Partnership Investment	142,500	227,500	370,000
Tax After Partnership Investment	133,000	217,217	350,217
Savings	9,500	10,283	**19,783**

Pass-Through Entity Owner Considerations

States in which pass-through entities have nexus will tax nonresident owners on the portion of federal pro rata share of pass-through income (subject to state modifications) apportioned to the state as reported on state K-1s.

Mechanisms by which states tax nonresident owners at pass-through entity level:

– Nonresident withholding
– Composite filings

Pass-Through Entity Owner Considerations – Nonresident Withholding

- Revenue generator for the state and a means to ensure compliance by pass-through owners
- Pass-through entity is subject to the requirement and it is not considered a tax
  - Pass-through entity is a withholding agent of the partners (similar to payroll tax)
  - May have to register with the state as a withholding agent and receive a nonresident withholding number

Pass-Through Entity Owner Considerations – Nonresident Withholding

- Potential penalties on pass-through entity for failure to comply
- Depending on entity classification, a nonresident partner not included in a composite return may be subject to income tax withholding

Pass-Through Entity Owner Considerations – Nonresident Withholding

- The nonresident partner receives credit for all taxes withheld and paid by the partnership on its behalf
- Varies by state if nonresident withholding on behalf of the partner satisfies the filing requirement of the partner in the state
- In most states the partner must file a return to get a refund of any amounts over-withheld

Pass-Through Entity Owner Considerations – Nonresident Withholding

Amount to withhold

- Generally based on distributable share of income sourced to the state
- Certain states base the amount withheld on the distribution sourced to the state

Pass-Through Entity Owner Considerations – Nonresident Withholding

Withholding tax rates

- Generally based on owner entity type (individual, estate, trust, S corp, C corp, pass-through)
- Withholding rates are often times lower than marginal rates (e.g., California nonresident partner withholding rate is 7%, while the highest marginal individual tax rate is 13.3%)

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Pass-Through Entity Owner Considerations – Nonresident Withholding

- Withholding remittance due dates
  - Annual, quarterly, monthly
  - Due on the original due date of the partnership return
- Exemptions
  - Some states exempt a partner if they submit an affidavit affirming that the partner will file a return (and consent to personal jurisdiction)
  - De minimus thresholds
  - Tax-exempt partners
  - State specific waivers
  - Publicly traded partnerships
  - Qualified investment partnerships
  - Inclusion in composite return filing

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Pass-Through Entity Owner Considerations – Nonresident Withholding

- How does a partnership handle reserves for potential withholding issues (certain and uncertain)?
- How does a partnership account for withholding payments going to its partners?
- When is withholding treated as a federal itemized deduction and how is that communicated to partners?

Pass-Through Entity Owner Considerations – Nonresident Withholding

- Issues related to state refunds of withholding overpayments
- Tiered partnership withholding issues
  - States where operating partnership must or can withhold
  - States where withholding does not tier up (operating partnership cannot withhold)
  - Accounting for withholding payments from underlying investments

Pass-Through Entity Owner Considerations – Composite Returns

- Composite return is a single return filed to satisfy the state filing obligations for the entire group of nonresident taxpayers.
- A partner may or may not have to be a nonresident individual to participate in a composite filing
- A means for the state to ensure tax compliance by taxpayers by providing a simplified tax filing process
- Tax compliance considerations

Pass-Through Entity Owner Considerations – Composite Returns

- Most states permit a partnership to file a composite return on behalf of its nonresident partners
- Composite returns typically satisfy the nonresident filing obligation of partners who elect to be included in the composite return
- Partnership remits the composite tax due
- Composite tax is not an entity level tax and gets charged to the partners (either by treating it as a distribution to its partners or reimbursement by the partners)

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Pass-Through Entity Owner Considerations – Composite Returns

- Many states allow only individual taxpayers to participate. However, some states also allow other entity types to participate as well

- Eligibility criteria – general information:
  - Individuals
    - Non-resident of the state
    - Did not have any income from the state other than the income from the pass-through entity (several states provide exceptions)
    - Individual did not make estimated tax payments to the state

Pass-Through Entity Owner Considerations – Composite Returns

Eligibility criteria – general information:

- Trusts
  - Inclusion in a composite return is only allowed where a given state expressly authorizes inclusion and may vary between classification of trusts (for example, grantor trusts)
  - Inclusion in the composite return impacts the credit to the beneficiary
  - Inclusion in the composite return is only a benefit if the trust does not have to file a separate return

Pass-Through Entity Owner Considerations – Composite Returns

Eligibility criteria – general information:

- Corporation and pass-through entities
  - Inclusion in a composite return is only allowed where a given state expressly authorizes inclusion
  - Inclusion in the composite return is only a benefit if the corporation or pass-through entity does not have to file a separate return

Pass-Through Entity Owner Considerations – Composite Returns

- Partners may be required to make an annual election or confirmation that they can be included in the composite return
- In most states, each partner can elect to be included or not, but a few states require all partners to be included in the composite return
- The partner will need to file a separate return in each state where they are not included in the composite
- Many states require the partnership to withhold tax (nonresident withholding) for partners who are not included in the composite return

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Pass-Through Entity Owner Considerations – Composite Returns

- Composite tax return considerations
- Advantages
  - Simplified tax compliance process for nonresident partners
  - Reduction of tax preparation fees due to fewer returns to prepare
- Disadvantages
  - Partner’s income is generally taxed at the highest rate
  - Losses, personal exemptions, standard deductions and itemized deductions may not be allowed
  - Credits may be disallowed

Pass-Through Entity Owner Considerations – Composite Tax Payments

- Composite tax payments are treated as distributions for partners/shareholders
  - Composite tax payments reduce the partner/shareholder's basis
  - This can create issues with respect to S Corporation shareholders and the need for proportionate distributions
- Payments made on behalf of individual taxpayers are treated as itemized deductions on their income tax returns

Entity-Level Taxes

- Several states impose an entity-level tax and for most of these states the entity-level tax is in addition to imposing an owner/partner-level income tax

- Some states also impose entity-level filing fees

Entity-Level Taxes

- Alabama: A "business privilege" (net worth-based) tax is imposed on all corporations and limited liability entities (including SMLLCs if the member-owner is not itself subject to the tax) that are doing business in Alabama or have qualified with the Alabama Secretary of State to do business in the state

- California: Imposes an LLC tax and fee – Annual Limited Liability Tax ($800) plus LLC fee if total California income is greater than $250K (ranges from $900 to a maximum of $11,790)

- Connecticut: LLCs, LPs, and LLPs formed under Connecticut law or required to register with or obtain a certificate of authority from the Secretary of State are subject to a Business Entity Tax of $250 that is payable every other taxable year

Entity-Level Taxes

- District of Columbia: Imposes a 9.4% franchise (income) tax on D.C.-source income earned by unincorporated businesses with gross income over $12,000. Minimum tax of $250 or $1,000, depending on gross receipts

- Illinois: Pass-through businesses are subject to a 1.5% personal property replacement tax, based on net income

- Kentucky: Imposes a limited liability entity tax (LLET) on pass-through entities. Minimum tax of $175 must be paid at all levels

Entity-Level Taxes

- Minnesota: Annual fee based on amount of MN apportionment factors. The fee is up to $9,500 and applies to entities with payroll, property, and sales over $950,000 in the state
- Nevada: Effective July 1, 2015, the state imposed a new "commerce tax" on each business entity engaged in business in Nevada with Nevada-sitused gross revenue exceeding $4 Million in a taxable year
- New Hampshire: Imposed an 8.5% tax on business taxable profits on every business organization having gross income in excess of $50,000
- New Jersey: Filing fee of $150 multiplied by the number of NJ resident partners plus $150 multiplied by the number of non-resident partners and an allocation factor

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Entity-Level Taxes

- New York: Imposes a partnership, LLC and LLP annual filing fee based on New York-source gross receipts. Amount of filing fee is based on the New York-source gross income for the tax year immediately preceding the tax year for which the fee is due.
  - Filing fee of an LLC or LLP ranges from $25 to $4,500 depending on the entity's New York-source income
  - Filing fee of a regular partnership with New York-source income in excess of $1 million ranges from $500 to $4,500 depending on the entity's New York-source income

- New York City: Unincorporated business tax is imposed at a rate of 4% on any unincorporated entity engaged in business within NYC

- Ohio: Partnerships, LLCs, and S Corps are subject to the Ohio Commercial Activity Tax (CAT), which is on gross receipts

Entity-Level Taxes

- Rhode Island: LLCs that are treated as partnerships for purposes of federal income taxation and LPs and LLPs are subject to a fee equal to a minimum tax of $500
- Texas: Franchise tax, also referred to as the business margin tax, which is calculated on an entity's gross receipts after limited deductions (compensation, COGS, etc.)
- Vermont: Annual entity tax of $250

Entity-Level Taxes

- Washington: Subjects all business entities to its business and occupation (B&O) tax, which is on gross receipts

- West Virginia: Partnerships owning or leasing real or tangible property, or doing business in the state, are subject to a business franchise tax of the greater of $50 or .10% of the business franchise tax base

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Questions

- Karen Lake, CPA
  - Associate Director of Tax Services
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  - Ft. Lauderdale, FL
  - klake@bpbcpa.com
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  - Senior Manager of Tax Services
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  - mhirsch@bpbcpa.com
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