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State Income Tax Examinations of S Corporations, Partnerships, and Their Owners

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I. Taxing Nonresident Owners of Resident Pass Through Entities

A. The Nexus Quandry as to Nonresident Owners of Resident Pass Through Entities.

1. **Risk.** The Nonresident Owner ("NRO") has no nexus with the state in which the Resident Pass Through Entity ("RPT") is operating. Therefore, the states have often encountered difficulty subjecting the income of RPT to state income tax since it lacks jurisdiction and nexus over the NRO.[1]

2. **Results.**

   (a) **Alabama** – ***Court Reverses Anti-Taxpayer Lanzi Case on Nonresident Limited Partner On Due Process Grounds***

   Lanzi v. Department, Ala. Civ. App. (6/30/06). The Alabama Court of Civil Appeals reversed a circuit court decision to hold that Alabama lacked statutory authority to tax the income of a Georgia limited partner of a partnership doing business in Alabama for the tax years at issue (1998 and 2000).

   The Court explained that the Due Process Clause requires that the partner have more than a minimal contact with the state to have his income subject to Alabama personal income taxation. Under the facts, the individual's only contact with Alabama was his passive investment in the Alabama limited partnership, which invested in stocks/bonds and was managed solely by the individual's parents in consultation with financial consultants located in Alabama.

   (b) **Kentucky** – ***Corporate Partner in Kentucky Resident Partnership Not Subject to Kentucky Tax on Partnership Income***

   Asworth Corporation v. Kentucky Revenue Cabinet (1/27/06). Kentucky Board of Tax Appeals held that corporate partners, whose sole connection to the state were their respective interests in resident limited partnerships, were not taxable on their share of distributive income under Kentucky law because the partners themselves did not own or lease property or have employees in the state.

   (c) **Louisiana** – ***Nonresident REIT Shareholder Taxed Under Personal Jurisdiction***

   Bridges v. Autozone Properties, Inc. (3/24/05). The Louisiana Supreme Court reversed the two lower courts to hold that Louisiana has personal jurisdiction over a nonresident REIT shareholder to tax the investment (dividend) income received from a resident corporate REIT that received rent from Autozone stores in Louisiana.

[1] An NRO typically lacks any contact with the RPT state.

Noting that a Commerce Clause physical presence issue had not been raised on appeal, the court found that the taxation power withstood Due Process clause scrutiny as it was asserted in relationship to the benefits, opportunities, and protections provided by the state that contributed to the profitability of the in-state activities. The court noted in *dicta* that "although states have asserted their rights tax nonresident investors in partnerships and S corporations, there are no reported cases where a state has asserted their rights to tax nonresident investors in REITs."

A rehearing of the matter was denied because the application was not timely. While concurring in the denial, Louisiana Supreme Court Justice Bridges suggested that the case may have been decided inconsistent with long-standing jurisprudential authority. Justice Bridges stated that : "to my knowledge, no court has ever before held that a nonresident shareholder's simple receipt of dividends from a corporation doing business in the state constitutes sufficient minimum contacts to allow that state's courts to exercise personal jurisdiction over that nonresident shareholder."

(d) **Ohio** – ***Nonresident Shareholders of Ohio Sub S Corporation Held Liable for Ohio Tax***

Agley v. Tracy, 719 N.E. 2d 951 (Ohio 1999)

(e) **New York** – ***D.C. Partners of NY Law (General) Partnership Taxable On Partnership's New York Income***

Weil v. Chu, 120 A.D. 2d 781, 501 N.Y. S. 2d 515 (N.Y. App. Div. 1986), aff'd, 515 N.E. 2d 908 (N.Y. 1987)

(f) **Oregon** – ***Nonresident Shareholder of Ohio Sub S Corporation Held Liable for Oregon Tax***

Kulick v. Dept. of Rev., 626 P.2d 93 (Or. 1981)

3. **Virginia:**

In P.D. 06-85 (August 25, 2006), the Department of Taxation ruled that a nonresident member of an LLC with active business operations in Virginia (as well as income from intangibles in the form of a lawsuit settlement) had nexus in Virginia with no other contacts in the Commonwealth. Both the Due Process and Commerce Clause objections of the taxpayer were rejected out of hand:

In this case, VALLC is headquartered in Virginia and conducts all of its operations in Virginia. Accordingly, the Department is well within its

> jurisdictional rights [under the Due Process Clause] to impose tax on the income of VALLC.
>
> * * * *
>
> For federal income tax purposes, the members were considered the owners of all VALLC's assets and liabilities. Consequently, *the Department regards the members, including the Taxpayer, as having the attributes and conducting the activities of VALLC. Because this election was made at the discretion of the members of VALLC,* the Department's imposition of tax on VALLC's income on the returns of its members is not prohibited by the Commerce Clause.

Comment: Note the Department's reliance on the notion of attributional nexus which has worked when an instate agent, affiliate or independent contractor is acting for an out of state principal to subject the principal to taxation in the state, but is untried as a theory of taxation when the out of state principal is mere passive owner akin to a shareholder.

4. **District of Columbia:** ***Unincorporated Business Tax on Limited Partnership Made Up of Nonresidents Held Valid***

   Bender v. District of Columbia, Court of Appeals (8/24/06). In March a District of Columbia Superior Court Judge held that the District's Unincorporated Business (UB) Tax, which is an income tax, as it applied to four nonresident individuals' ownership in four unincorporated businesses (real estate limited partnerships) violated District statutes to the extent it imposed a "*personal income tax*" on the personal income of a nonresidents (prohibited pursuant to the District's Home Rule charter). Under the minimum franchise tax on limited partnerships and LLC facts, the UB tax was imposed on D.C. source profits of real estate investors that resided outside the District and used limited partnerships as their vehicle of choice. .

   The D.C. Court of Appeals (the District's highest court) reversed on August 24, 2006 not surprisingly given the statutory language and revenue loss potential.

B. <u>"Withholding at the Source" To the Rescue of the States</u>

1. **<u>Sidestepping Nexus.</u>** Premised upon the obvious nexus of the RPT, by mandating that the RPT carry out income tax withholding ("ITW") the state, through the RPT, collects state income tax from the NRO. Via the time honored mechanism of tax withholding, state income tax is collected that would otherwise not be taxable in state by virtue of two factors: (i) the RPT's choice to operate as pass through making the RPT partners its national taxpayer(s) and (ii) the NRO's lack of nexus.

(a) Different Levels of Tax Avoidance. ITW, but for rate arbitrage and the compliance burden, may have little additional impact on individual NRO's who pay tax in their home state on taxable income from all sources offset only by credits for actual tax properly paid elsewhere. Corporate NRO's have more to lose to an ITW regime since income from the RPT state would per apportionment often escape taxation anywhere.

2. **Enacting Withholding Regimes.**

   (a) Multistate Tax Commission Model Act was introduced in 2003 and has been followed with a myriad of tailored state specific variations by most of the states.

   (b) Today 30 to 35 states have enacted withholding regimes to capture income that otherwise might escape tax in the state by the convergence of a resident taxpayer in pass through form with nonresident owner. 16 states and the District of Columbia (AK, AZ, DE (w/h on 'S' corps only), FL, HI, ID, IL, MA, NV, SD, TN, TX, UT, VA, WA) have no ITW regime as of yet.

3. **An NRO's Response to ITW:** The NRO has a series of choices to the withheld tax including filing a return (on its own or on a composite basis with other NRO's), or various ways to opt out of the withholding regime by agreeing to file in the state of the RPT and pay the tax due on its own or possibly claiming exemption from the withholding. See below.

C. **Alternatives to ITW.** The states also use other methods to extract state tax on RPT's. Most notably, entity level taxes imposed on the RPT without regard to whether its owners are resident or non residents including:

1. **Entity Level Taxation of the RPT. See e.g.:**

   (a) California imposes a reduced-rate corporation franchise tax (1.5%; 3.5% if a financial corporation) on S corporations. Cal. Rev. & Tax. Code §§23186, and 23802(b) and (c). California also imposes a minimum franchise tax on limited partnerships and LLCs (recently held unconstitutional), and a gross-receipts-based annual fee (maximum $11,790) on LLCs. Cal. Rev. & Tax. Code §§17935(a), 17941, 17942.

   (b) Illinois imposes a 1.5% personal property tax replacement income tax on partnerships and S corporations. 35 ILCS 5/201(c) and (d), 5/205(b) and (c).

   (c) New Jersey imposes its corporation business tax on S corporations (with entire net incomes exceeding $100,000) at a rate of 1.33%. N.J. Rev. Stat. §§54:10A-4(o) and (p), 54:10A-5(c)(2).

(d) Texas imposes its franchise tax, which includes a 4.5% tax on earned surplus (i.e., net income), on S corporations and all LLCs, including those treated as partnerships for federal income tax purposes. Tex. Tax. Code §§171.001(a) and (b)(3), 171.002; Texas continues such treatment with its new Margins Tax.

(e) Minnesota imposes a tax (maximum $5,000) on a partnership or S corporation based on the extent of the entity's Minnesota property, payroll, and sales. Minn. Stat. §290.0922, subd. 1(b).

(f) New York imposes its fixed-dollar minimum tax on S corporations. N.Y. Tax Law §210.1(g).

(g) District of Columbia imposes a net-income-based tax on every unincorporated business, including those conducted or engaged in by an LLC. Exceptions are made for, among others, certain personal services businesses, and any trade or business that, by law, customs, or ethics, cannot be incorporated. D.C. Code Ann. §§47-1808.03(a), 47-1808.01.

(h) New Hampshire imposes its business profits tax on the taxable business profits of every business organization, including LLCs.

(i) Tennessee also generally imposes its excise tax on an LLC that is disregarded for federal income tax purposes. An exception applies, however, if the single member is a corporation. Tenn. Code Ann. §§67-4-2007(a) and (d), 67-4-2004(27).

2. **Information Returns Required for the RPT.** Information reporting does not collect the tax (as is the case with withholding) and therefore leaves the burden on the state to pursue the NRO.

3. **A Rose by Any Other Name...** NY and VT package their ITW regimes as estimated taxes which the RPT must withhold for its NRO's.

D. **ITW Vulnerabilities**

1. Is It Constitutional? Is Due Process Due for a Comeback? Given the obvious nexus of the RPT, a constitutional challenge of ITW is problematic on either Commerce Clause or Due Process grounds. Lanzi is instructive as to the possible federal Due Process limits to an ITW regime that overreaches. Hence, all of the state ITW statutes and the MTC Model Act provide numerous exceptions and exclusions discussed below to ameliorate possible constitutional objections.

II. The Relevant Parties in ITW

A. The Source – The Resident Pass Through Entity

1. Partnerships of all kinds (general, limited, LLP's).

2. Limited liability companies (LLC's) taxed as partnerships.

3. Sub S Corporations treated by the state as pass throughs.

4. Single member LLC's. Since most states regard these as disregarded entities, the NRO is deemed to have nexus and therefore there is no need for ITW.

5. Other:

   (a) Publicly Traded Partnerships. But see e.g., PA and RI which exempt PTD's as a source.

   (b) Investment Partnerships. But see CA, KY and NJ (which includes "hedgefunds by name") from being a source.

   (c) States may impose withholding a resident REIT. See the *Autozone* litigation and statutory response in Louisiana.

B. The Withheld - On Nonresident Owner

1. Nonresident Individuals.

2. Nonresident Corporations. But a surprising number of states continue to exclude or until recently excluded nonresident corporate owners from their ITW regimes. See e.g., MI, MO, NB, Conn (recently intended to reach corporate NRO's), LA.

3. Tiered Partnerships. Most states require withholding without regard to whether the NRO is itself another pass-through. Each partnership in the tier pays the tax required for its nonresident partners (by direct payment or withholding) and the upper tier partners claim a credit for withholding or payments made at the lower levels of the tiered structure.

4. Non U.S. Partners. CA expressly does not reach such partners. Most states implicitly require withholding as to even non U.S. partners.

C. NRO's Excepted Out of ITW

1. IRC 501(c)-type and ERISA-type Tax Exempt Entities. Virtually all the states carve out tax exempt entities from their ITW regimes.

2. Publicly Traded Partnerships. See e.g., AR, ND, OR, PA, WI.

3. Other Non Taxable Entities. Other sorts of NRO's that for other reasons are not subject to a state's income tax regime may still be withheld upon and have difficulty retrieving the withheld funds without further jeopardy to their status in the state.

   (a) Out of state Insurers. Several states provide that NRO's that are out of state insurers (who generally do not pay income tax in the states) can be excluded from ITW but only if the insurer files a certification in the state that it is an insurance company (GA); filed as doing business certificate (e.g. MD); or pays the states own gross premium tax for domestic insurers (GA). However, but for ITW, such out of state insurers would never have had to consider subjecting themselves to a state for tax purposes (thereby acquiring nexus by filing paperwork or paying tax with state) or in personan jurisdiction for other purposes (state insurance regulation of domestic insurance companies)

4. Tiered Partnerships. See above.

III. Opting Out of ITW – Directly Paying the Tax Due

A. **NRO may opt out of the ITW in most states (to the extent permitted by the individual states) by:**

1. Composite Returns. NRO files a composite return with other NRO's in the RPT although some states require both.

2. Tax Agreement. NRO files its own tax returns in the RPT home state or in 15 to 20 states files a "Nonresident Tax Agreement" (e.g., AL, MT, NB, NM) agreeing with the RPT or the state or both to file a return. Compare NC where the NRO may merely file "affirmation" with the RPT that the NRO will pay NC tax. A tax agreement from the NRO avoids altogether the still unresolved if somewhat less than persuasive concerns about the constitutionality of nonresident withholding.

IV. Determining the Amount to be Withheld

A. **Nonresident Individual Owners.** Withheld at the highest state income tax rate to a base of the NRO's share of the RPT's income from sources in that state. California is one of the very few states that allows with permission of its FTB an adjustment to the withholding mandate. The high rate is often the "stick" that motivates the NRO to file a return in the RPT state.

B. **Nonresident Corporate Owners.** Withheld at the highest corporate rate on a base equal to the NRO's distributive share of the RPT's income apportionable (or allocable if relevant) to that state. In other words, distributions by the RPT to the NRO are ignored.

1. Rare exception. At least two states (GA and OK) limit the withholding base to the actual distribution made by the RPT to the NRO. (See also MI which limits the base to "income available for distribution").

C. **No Withholding If the Character of the Distributive or Distributed Share is Extraordinary or De Minimis.**

1. Extraordinary Transactions. Many of the state do not require withholding if the distributive share of income resulted from a complete liquidation or termination of the RPT See e.g., MN, MO, CA and GA do not require withholding if the distribution is shown to be a return of capital.

2. Minimum Threshold Amount. Many states require no withholding if the NRO's share of income is less than $1,000 (AR, ND, OR, RI, WI); in GA, none required if the distribution to the NRO is less than $1,000.

V. Handling State Tax Audits of Pass Through Entities

A. Introduction

1. Rule of Thumb: Most U.S. Businesses pay 50% more in state taxes (income, franchise, GRT, sales/use, property) then they do in federal tax.

2. Second Rule of Thumb: Sale/Use Tax Revenue is roughly twice the size of state income/franchise and state/local property tax revenues are roughly twice the size of state sales/use tax. [Property Tax>Sales and Use Tax>Income Tax]

3. Who is the Auditor?

– state (or local) resident employee

– "interstate" auditor

– contract auditor

– level of experience (e.g., former IRS)

– Why does it matter?
  – out of town auditor plopping down at your place of business
  – whether they have view of issue across different states
  – level of competency
  – the economic of their audit

4. Who Is The Taxpayer When Pass Throughs Are Being Audited

- The Pass Through Entity is the taxpayer in sale and use tax and in property tax cases and in many gross receipt type taxes.

VI. Common Audit Issues Today Involving Pass Through Entities

A. Income Taxes

1. Intercompany Royalty and Interest Payments.

2. Inclusion of Loss Corporations (often through a SMLLC pass-through) in Nexus Consolidated Returns where Loss Corporation(s) can show no positive factor in the state.

    a. Va. Department's reliance on the dubious relevance of VEC filings and "acceptance" by VEC. See P.D. 06-75. (August 23, 2006); P.D. 06-76 (August 23, 2006).

3. Forced Combination of Out of State Profitable Corporations into a Combined or Consolidated Group.

4. Nexus and P.L. 86-272.

    A Distinction to Federal Audits: The U.S. Constitution is all but irrelevant in federal taxation. In state taxation the Quill requirement of "physical presence" for nexus and Complete Auto requirement of "fair" apportionment are the cornerstones of multistate taxation.

B. Sales/Use Taxes: Sales Tax and Use Tax are Different

1. The Pass Through, Unrecognized for Income Tax, is the Taxpayer in Sales and Use Tax.

2. Unreported use tax on corporate infrastructure purchases.

    a. E.g., "first use" issue; interstate sales; credit derived from sales tax previously paid elsewhere erroneously; sloppy sales/use tax compliance; nexus audits

3. "True Object" Audits: Is the taxpayer performing a service – therefore taxable on all of its purchase of tangible personal property used to perform the service – or is it a mere reseller of the property it buys?

4. "Directly Used" Audits for taxpayers who routinely purchase and consume manufacturing and processing equipment.

5. Audits with Statistical Sampling Problems. Know what you are asking for and the consequences of your choices.

6. Drop Shipment (i.e. the "Bill to/Ship To" addresses are different) Audits

    a. Distinction to Federal: A typical sales/use audit can be huge in scope (million + invoices) and sales/use tax is very formalistic and very state specific re: the arcane rules. Cf., SSTP.

C. Taxpayer As Tax Collector – The Shameful Use State Tax Amnesties By States

1. The Addicted and Their Enablers. The states are addicted to state tax Amnesties and now routinely impose such heavy penalties for non participation that many taxpayers grossly overpay their amnesty remittance. See California ($3B), Maryland ($300M), Virginia.

D. Property Tax

1. Auditor: Local or State Auditor depending on the state, type of property and/or the type of taxpayer

2. Property Tax As Target for Audit. Property Tax despite its size is a tax revenue source draws less audit coverage for several reasons: (a) SALY credo (b) sloppy compliance causes many taxpayers to overpay ("ghost assets") (c) low volatility of PT vs. income or use tax.

VII. State Audit Areas You Should Expect To See More Activity But (So Far) Do Not ...

A. Use of State NOL Carryforwards

1. Most states (not Virginia) have restrictions on use of out-of-state generated NOL's.

2. Many loss corporations have lost their NOL carryforwards due to a bankruptcy, change in owner (IRC § 382) or reorganization/liquidation. Many states expressly bar carryover of NOL's to a successor corporation.

B. State (And Federal) Gains Triggered in "Slimming Down" the corporate organized chart

1. Classic IRC § 1001 state gain or loss will occur in separate return-states where insolvent. Subsidiary filing separate returns in a state liquidates into a parent. Intercompany debt, even debt of dubious character as debt, treated as debt for insolvency testing.

2. Avoiding cancellation of Indebtedness Income at the state level via the state's adoption-through federal conformity of IRC § 108 may not work at the subsidiary level or NOL's may be limited due to § 382 limitations.

3. Corporate reorganization may also greatly impact (increase) net worth based franchise taxes at the corporate level.

C. Sales/Use Tax Aspects of "Lease Co's"

Rationale: These areas of audit scrutiny require detailed knowledge of the Internal Revenue Code which most state tax auditors (even former IRS) lack.

D. Apportionment Factor Rollups

Rule of Thumb. Pass Through entities' factors (sales, property, payroll) typically are supposed to flow up and be included in the owners' factors.

VIII. Giving the State Tax Collector Free Roadmaps

A. Publicly Traded Corporations. The adoption by the federal government and affiliated accounting bodies of broad measures such as Sarbanes-Oxley, reformed FAS 109 and new FIN 48 for uncertain tax positions require taxpayers who file with SEC and others audited financial statement to make detailed disclosures of their state tax exposures and benefit typically on an entity-by-entity, state-by-state, year-by-year and level of comfort (more likely than not … or not) basis.

1. Result: The publicly traded taxpayer's own tax department, its attest audit firm and its attorneys are now the surrogate auditors for states.

2. And Not Just Income Tax: FAS 5 require disclosure of gain and loss contingencies around taxes other than income tax, e.g. property, GRT (Washington State B+O, Ohio CAT), sales/use taxes.

B. FIN 48 Reach Beyond Publicly Traded Corporations.

1. Many Private Corporations and Pass Through Entities have to file GAAP compliant financials to obtain bank credit.

IX. Conflict Resolution In State and Local Tax

A. Compare With the IRS. IRS has a robust and well understood Appeals process that is not uncommonly more generous in resolving audits and a generally fair and unbiased court system reserved for resolution of conflicts via the U.S. Tax Court and/or the federal district courts and the federal Courts of Appeal.

B. State Tax Conflict Resolution – at the Administrative Level

1. Sometimes "pay to play" still.

2. Hearing officers with No Discretion. Witness the Maryland system where the Appeals process is a mere rubber stamp of the auditor's findings.

3. Long drawn out Ruling Processes. Witness the Virginia Department of Taxation where a 4 year ruling cycle has not been uncommon.

C. State Tax Conflict Resolution – Litigation

1. Almost always "pay to play".

2. No jury. Probably not a big factor since federal court juries tend to be anti-taxpayer.

3. Is The Trier of Fact A Tax Expert? Some states have Tax Courts with Tax Court judges (e.g. California, Indiana, Maryland); others do not (e.g., Virginia). Trying tax cases to judge who try car wrecks and divorces for a living can be challenging. Some Virginia Circuit courts have tax specialist judges (Fairfax and Richmond).

4. Bias of state judges in favor of the state is generally a concern. An out of state corporate taxpayer seeking to avoid state or local tax by reliance on the more arcane parts of the federal constitution are not typically well received. A judge's own lack of experience in tax cases will cause them to rely heavily on the pronouncement and rulings of state tax authorities. Such predilections by the judges even if more perception than reality tend to incent tax authorities at the administrative audit and appeals level to be more rigid.

X. Conclusion: State vs. Federal

A. More Issues – Income/Franchise, Sales/Use, Property, Gross Receipts Taxes

B. One Very Big Difference – the U.S. Constitution matters!

C. More Information Becoming Available To The States Due to Federal Financial Regulation of American Business

D. Less Flexibility in Conflict Resolution

XI. Concluding Remarks