21st Century State Taxation of the Closely Held Business

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Duane Dobson
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I. **Nexus** - When and Where is the Business subject to a state or local tax?

II. **Apportionment** - How is the National Income of the Business divvied up among its Nexus States?

III. **Non-Resident Withholding** - What the states are doing now to keep more tax money in their state.

IV. **State Tax Planning** - Reducing the State Tax Burden on the Business and its Owners.

V. **“PTE’s”**- Be a Power User of Pass-Through Entities in State Taxation.
Nexus – When is the Business Subject to a State or Local Income Tax?
Nexus Who, What, Where, When, How

• **Who** is the Business, its choice of entity ("C" Corp or PTE) and who are its Owners, Affiliates and Agents?
• **What** does it sells (Goods or Services or Both)? See P.L. 86-272 (1959) may shield Goods from state tax.
• **Where** are the states it operates in or sells into?
• **When** did the Business trigger having nexus or stop having nexus in state? “Trailing” nexus……..
• **How** are the Nonresident Owners and Affiliates affected by the Business having Nexus in a State?
• “C” Corp is the State’s taxpayer but a PTE may or may not be the Taxpayer.
Nexus- The Law is based on the U.S. Constitution

- Nexus typically determined by State Courts consistent with Nexus standards crafted by the U.S. Supreme Court:
  - The Commerce Clause (States cannot interfere with interstate commerce). Quill v. North Dakota (1992)
  - Generally, any state tax must satisfy both provisions.
Nexus Standards

• **Due Process Clause** requires for Nexus:
  - Purposeful direction not minimal connection with a state
  - Tax based on reasonableness and fair notice
  - May be attained by attribution from an agent or affiliate

• **Commerce Clause** requires for Nexus:
  - Physical presence
    ▪ By the Taxpayer in the Taxing State
    ▪ Or by attribution from agent or "Affiliate Nexus"
  - "Economic Nexus"
    ▪ Emerging trend since 1992 in State Courts but not by USSC
    ▪ No Physical Presence needed if TP is "exploiting the market"
Nexus at the Pass-Through Entity Level Triggers Tax on the PTE Itself

- Numerous jurisdictions impose income and/or franchise tax directly on any PTE with Nexus:
  - *For example:* AL (BPT), CA (S corps), DC (UBT), IL (replacement tax), KS (franchise tax), KY (LLET), MI (MBT, now repealed), NH (BPT/BET), NYC (UBT), TN, TX, WV (franchise tax)

- Others impose fees, a minimum tax or similar assessments on PTE’s:
  - *For example:* CA, CT, MN, NJ, NY, OR, RI, VT, WI

- State taxes (sales/use, property, real estate transfer tax, etc.) typically imposed directly on the PTE with Nexus.

- PTE can be required to be included in a combined return
  - *For example:* DC, MI MBT, NH, TX
Does P.L. 86-272 apply to a PTE or its owner?

- P.L. 86-272 provides that "No State ... shall have power to impose ... a net income tax on the income derived within such State by any person ... if the only business activities within such State by or on behalf of such person" are solicitation, etc.
  - Does only the PTE have protection (i.e., the protection only applies to the PTE "person" deriving the "income") or does the PTE owner (i.e., the protection applies to the "income" derived by "any person")?

- Ariz. Dep't of Rev. v. Central Newspapers, Inc., 218 P3d 1083 (Ariz. Ct. App. 2009), held that the Arizona sales, property and payroll flowing up from partnership qualifying for P.L. 86-272 protection in Arizona had to be included in numerators of corporate owner's Arizona apportionment formula. Not Good...
Does P.L. 86-272 apply to PTE or Owner?

- New York Advisory Opinion TSB-A-08(7)C (2008) held that income from a partnership qualifying for P.L. 86-272 protection in New York was taxable to corporate owner already having New York nexus, but was not income from New York sources for a nonresident individual owner.

- Several state regulations provide that “unprotected activity” includes:
  - “Owning an interest in any ... pass-through entity whose activities, if conducted directly by a foreign corporation, would give [state] jurisdiction over the foreign corporation, unless the activities of the pass-through entity are limited to solicitation protected by P.L. 86-272” (emphasis added).
Economic Nexus – Nexus Without a Physical Presence

- Not based on the physical presence from Quill
- Sufficient nexus based on mere exploitation of, or purposeful direction to, a state’s marketplace
  - In past, E/N targeted intangibles (e.g., trademarks, trade names, patents) used as State Tax Shelters. Geoffrey (1992) involving Toys R Us.
  - E/N expanded to financial services related intangibles (e.g., credit cards, loans). MBNA (0000)
  - Recent trend targets all industries with a nexus standard based on factor-presence (E/N triggered once Business reaches a threshold amount of sales, property, or payroll in the state. See CA, CO, CT, OH.
Economic Nexus – Map as of 1/1/2015

- No tax
- No specific authority (incl. AK, DC, HI, RI) or unofficial administrative guidance (AZ, IN, ME)
- Intangible licensing or general E/N authority
- Financial institution E/N authority (IN, KY, MA, MN, NY, PA, TN, WI, WV)
- Factor presence E/N authority (CA, CO, CT, MI, OH, WA)

OH: adopted factor presence E/N for B&O purposes.

IN and MA: IHC nexus and FI economic nexus rules.
• Growing trend of bright-line economic nexus standards keeps it simple:
  - For example: IN, KY, NC, MN, PA, TN (financial institutions)
  - For example: CA, CO, MI, WA (factor-presence)
• BUT most Economic Nexus states adopt broad statutory language requiring taxpayer to make a judgment call as to its Nexus exposure risk.
• U.S. Supreme Court has not opined on economic nexus but getting closer. See Justice Kennedy 2015 Brohl concurrence calling for reconsideration of Quill.
# Economic Nexus Exposure on Purchased Loans: Where Do You Draw the Line?

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Less Nexus Exposure

More Nexus Exposure

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Nexus – Aiming at Nonresident Owners of PTEs

• States generally view Nexus as a flow-through item to the PTE owner and assert tax on the Nonresident Owner
  – Attributional or “Affiliate” Nexus theory (GP vs. LP; managing member vs. non-managing member)
  – But caselaw blocks nonresident taxation where Owner contact in state is limited.

• Theoretically, PTE owner nexus should be governed by same principles as PTE nexus
  – Constitutional principles (Physical Presence req’d) at conflict with tax fiction of pass thru income by PTE to its Nonresident Owner. States lose $$$ if they don’t get a piece of that passed thru income headed out of state.
  – Therefore Nexus of the Owner by attribution from the PTE remains an important enforcement tool of the states.
Nexus – Aiming at Nonresident Owners of PTEs

PTE Withholding:

- States new weapon of choice is Withholding at the PTE level.

- States with PTE Withholding Now Collect the Owner’s State Tax directly from the PTE.

- A state’s right to require an instate PTE to withhold tax is not blocked by owner’s lack of instate nexus.

- Thus, Withholding renders moot the uncertainty of whether the Nonresident Owner has Nexus.

- Think of PTE Withholding as if PTE had “C” Corp status (thereby remitting itself any tax due in-state) but PTE Withholding rates etc. are often more onerous.
Sourcing Income by Factor Apportionment

- Nexus told us in what States the Business and/or its Nonresident Business Owner by attribution (or withholding) may owe tax.
- How much of the Business is Apportioned? "Unitary" states take the entire Business regardless of structure ala a Federal Consolidated Group. "Separate" return states allow the Business to file on its entities with nexus or elect to file consolidated (except MD).
- Apportionment tells how much the Business income can be taxed by the Nexus states, i.e., what is each state's Fair Share?
- Apportionment was traditionally done by averaging the three "factors" - Property, Payroll and Sales with each state getting the average of:
  - Instate Property FMV divided by National Property
  - Instate Payroll divided by National Payroll
  - Instate Sales divided by National Sales
- States have moved away from this model to many variations noted infra.
Using Apportionment to Source Business Income of the Unitary Group to the States

- U.S. Constitution has been interpreted to require a "fair" apportionment of business income by use of factor formulas based on property, payroll, sales or combination thereof.

- If "formulary" apportionment is used to source income of a unitary business, all the related entities making up the unitary business group must be included in the calculation.

- "Line of Business" Unitary is where not all related affiliates in the same unitary business with each other but file unitary with their own LOB, e.g., Members A and B operate TV Stations while C and D publish newspapers.
Using Allocation to Source Non Business Income to Domicile

- **Business** Income generated by different activities may only be combined and taxed by formulary apportionment if those activities are part of the same unitary business.

- **Nonbusiness** Income is not "apportioned" but is "allocated" 100% to the Commercial Domicile of the Seller. As rule of thumb, "apportioned" business income (taxed by multiple states) is typically taxed more than nonbusiness income "allocated" to a single state.

- The recent California FTB case re **Comcast**'s sale of its 57% stake in **QVC** shows just how valuable achieving Nonbusiness income status for sale proceeds can be.
Allocation, Apportionment, and Sourcing-Unitary Business Principle treat C Corps and PTE’s alike

- Constitutional unitary principles apply without regard to legal form or choice of entity
  - Unitary cases generally have involved “C” Corp affiliates
  - Practical effect of flow-up of PTE factors and income is similar to apportionment by a unitary corporate group.

- But to apportion income across multiple states, unitary business relationship must exist between the activities at issue whether undertaken by “C” Corps or PTEs.
  - See, e.g., In re Imperial Rental Invs., Inc. (NYC Tax 2009)
Allocation, Apportionment, and Sourcing—
“To Be…. or Not to Be… Unitary”

- **Unitary Business tests:**
  - “The 3 Unities” of Ownership, Operation and Use.
  - Contribution or Dependency: segments of the business contribute to or depend upon each other.
  - Functional integration, centralized management, economies of scale.

- **Issues and implications**
  - What does it take for a group investing in diverse businesses to be unitary or not unitary?
  - FTB held Comcast nonunitary with QVC when it sold the Retailer (Thus sale was Nonbusiness income 100% “allocated” to Comcast’s commercial domicile of PA).
• Involves two concepts:
  - How should the ultimate Taxpayer (i.e., a corporation, individual, estate or trust at the top of the PTE tiers) source income from a PTE?
  - How should the PTE source income for purposes of the information statement to be provided to its PTE owners, which may or may not be taxpayers (i.e., the PTE owner is often just another PTE)?
    - Sourcing by the PTE also factors into the determination of a PTE’s required Nonresident withholding payments

• Should the sourcing results for both be consistent? Is it even possible for them to be consistent?
Owner Level v. Entity Level Apportionment - "C" Corp Owner with PTE Income Flow-up

Some States require share of PTE income and apportionment factors to flow-up to Owner like a slice of pie ("Owner-level apportionment")

- Constitutionally suspect when Owner and PTE NOT engaged in unitary business.
- Owner adds the PTE income and app factors to its other income and factors from elsewhere-Complex Method.

A few states permit apportionment at PTE level ("Entity-level apportionment")

- Only allocable state source income (no apportionment factors) flows-up to owner (For example: AR, LA, MS, OK). Owner gets a post-apportionment State K-1: Easier Method.

Other states provide for Owner-level apportionment only when unitary relationship exists (i.e., otherwise entity-level apportionment typically is utilized)

- Constitutionally supportable (For example: CA, IL, IN, MA (sort of), NJ, NY (limited), WV)
State Source Income—Nonresident Individual, Estate or Trust with PTE Income

- For Nonresident individuals, estates and trusts, state source income from a “business, trade, profession, or occupation” generally is determined by application of allocation/apportionment rules.
- Income such as dividends and interest generally sourced to the PTE’s state only if associated with “business, trade, profession, or occupation” carried on in the state.
  - Otherwise, investment income typically is sourced to the Nonresident Owner’s home state.
- Income from real property and tangible personal property (e.g., rental income) generally sourced to property location.
State Source Income—Nonresident Individual, Estate or Trust with PTE Income (Cont’d)

- Income from “business, trade, profession, or occupation” carried on in PTE generally allocated/apportioned at PTE level
  - The Default methodology typically is entity level apportionment (i.e., the state does not provide or require for the combination of income and apportionment factors from multiple PTEs).
  - Sourcing on a unitary combined basis with (a) other owner activities, or (b) other affiliated PTEs, still may apply in certain states and under certain circumstances.
Allocation/apportionment provisions used by Nonresident individuals, estates and trusts are not always the same as those used by “C” Corporations (e.g., NY)

- Beware that certain classes of “business income” may require allocation, either
  (a) under normal allocation/apportionment rules, or
  (b) from application of special nonresident individual sourcing rules (e.g., rental real estate income in NY)
State Source Income—Owner that is a PTE

- Methodology to source income for Owner that itself is a PTE often difficult to determine
  - Some states provide that a PTE Owner sources its income consistent with Nonresident Individual Sourcing rules (e.g., CA, NY)
    ✷ Best practice—provide a consistent methodology that a PTE can use to determine its Nonresident Withholding payments
    ✷ May require additional reporting to ultimate “C” Corp owners
  - Some states, especially for Nonresident Withholding purposes, appear to provide that a PTE sources its income based upon how its various types of owners must source their income:
    ✷ Limited functionality if an owner is another PTE
    ✷ What if sourcing methodology differs based on type of ultimate owner?
    ✷ What if this is a middle-tier PTE—is entity-level or owner-level apportionment used if unitary with the lower-tier PTE? Does that differ based on type of owner?
    ✷ Are nonresident individual exceptions ever applicable to “C” Corp owners?
Allocation and Apportionment—Sale of Owner’s Interest

- Sale of PTE interest
  - Does Nonresident Owner have nexus with state in question? Does it matter?
  - Does sale create business or non-business income/loss?
    - “Asset unity” (nonbusiness income) versus “enterprise unity” (business income)
    - Sales by intermediate entities/holding companies
  - Treatment as sale of an Intangible asset
    - If “C” Corp Seller:
      - If business income, generally source as sale other than sale of TPP (i.e., costs of performance, or market sourcing, possible “throw-out,” etc.)
        » Some exceptions (such as Texas Margin Tax “location of the payor”)
      - If nonbusiness income, generally “allocate” 100% to commercial domicile
    - Individual Seller—generally source to Resident state of the seller
    - PTE Seller—is it operating a trade or business or mere asset holder?
  - Emerging trend: Sourcing based on location of the underlying PTE’s assets (in theory, only should apply if nonbusiness income)

- Combined Reporting (2003) East v. West

- No Corporate Income Tax
- Separate Return States
- Combined Reporting Required (AK, HI)

- Combined Reporting (2014)

- No Corporate Income Tax
- Separate Return States
- Combined Reporting Required (AK, HI, DC)
- Combined Reporting Under Limited Circumstances

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Sales Factor Weighting as of 2015

UT SSF only for “sales factor weighted taxpayers”

CA Prop 39 generally requires SSF

No income-based tax

Equally weighted (AK, HI)

Double-weighted allowed or required (DC)

SSF phasing in (NYC; elective in AZ)

SSF generally required

* SSF allowed or required for certain taxpayers

NOTE: Based upon general sourcing rules.

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The Sales Factor for Services in 2015: Market-Based Sourcing outpaces Costs-of-Performance

- WA – Benefit of service sourcing for B&O purposes
- IPA/COP (AK, DC, HI)
- Benefit/Market (AZ, NE and PA)
- Service Performed in State (%)
- IPA/Market/Other (FL, MO)

NOTE: Different sourcing rules may apply to intangibles

AZ – Eff. for 2014, an election is available to phase-in market sourcing for multistate service providers

FL – IPA/COP rule is not supported by a statute, thus rule is invalid and Florida should be interpreted to be a market-based sourcing state
Filing/Payment Issues in Nonresident Withholding
PTE Filing Issues

- While PTE may lack Nexus with certain states, certain states still impose a filing obligation if the PTE has owners that are Residents of those states:
  - *For example:* GA, MO, NJ, NY, OR, PA, WV
  - Can be burdensome for PTEs with large numbers of owners in multiple jurisdictions
  - Failure to comply can result in penalty imposition (for example, NY imposes a $50 penalty per partner per month for the failure to timely file a partnership report)
  - Constitutionally suspect, but worth risk of noncompliance?
PTE Nonresident Owner Filing Issues

• Generally file in jurisdictions where PTE Business itself has Nexus
  - Be mindful of situations where PTE Owner does not have nexus and filing would have a significant tax impact.
  - Know the jurisdictions that exempt a PTE owner from filing when tax liability has been fully paid from withholding.
  - Filing exceptions for participation in a composite return.
  - Other exceptions (investment p/s, etc.)

• What if de minimis income is sourced to a jurisdiction from a PTE?
  - The PTE’s Nonresident Owners that are individuals, estates or trusts may have filing thresholds that may avoid the need to file instate.
  - PTE Owners that are corporations/PTEs generally do not have filing thresholds-failure to file penalties may apply to noncompliance.
Several methods are used by states to ensure receipt of taxes from Nonresident PTE Owners

- **Withholding at the PTE Level on Nonresident Owner**
  - PTE required to withhold tax on behalf of Nonresident Owner and remit it to the state

- **Nonresident Owner Agreement to File**
  - Nonresident Owner agrees to be subject to state’s taxing jurisdiction and to file return in exchange for PTE not withholding tax on owner’s behalf

- **Composite return**
  - Generally, Nonresident Owner elects to have PTE pay tax on their behalf, e.g. Law Firms and Accounting Firms.
PTE Withholding is Street Legal and the New Normal

- Permitted under *International Harvester Co. v. Wisconsin*, 322 U.S. 435 (1944)
- The Best Vehicle yet for collecting tax from Nonresidents versus a tax on the Business.
- Withholding was needed when the Business was in a C Corp and had PTE Nonresident Owners
- Numerous issues to consider, which vary significantly by state.
- FWIW, Virginia has the most draconian withholding regime in the US today.
For which Nonresident Owners must a PTE withhold?

- Can vary significantly by state
- May include Nonresident:
  - Individuals
  - Trusts and estates
  - Other PTEs (i.e., multi-tiered)
  - "C" Corps
  - Tax-exempt entities
  - Foreign Investors
Exceptions to Withholding vary by state
- Nonresident owner agreements
- Member of composite return
- De minimis amounts/thresholds
- Statutory exemptions (e.g., publicly traded partnerships, insurance companies, tax exempt entities, etc.)
- Waivers obtained directly from the state
Withholding- The Tax Base

- What is the Withholding Tax Base?
  - Share of state source income (majority of states)
    - How is that determined?
      - Does type of Owner matter or does a single sourcing methodology apply for all?
      - Apportionment vs. Allocation (Business v. Nonbusiness)
      - State specific modifications
  - What about multi-tiered PTEs?
    - Some states provide specific rules, others do not
  - Distributions of state source income (California and a few others)
  - Tax-exempt entities (UBTI) and foreign investors (ECI). Often use “C” Corps as “Blockers”.

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Withholding - Rate and Payments

• What is the Withholding rate?
  - Varies by state, but generally either:
    ▪ Flat rate, or
    ▪ Highest marginal tax rate for the owner in question

• Compliance/timing of withholding remittances
  - Varies greatly by state; examples include:
    ▪ Annually only
    ▪ Quarterly estimates required
    ▪ Remittances required on a schedule that is similar to wage withholding due dates
While many PTEs are part of multi-tier structures, states generally do not provide explicit rules for apportioning income in such a structure.

Issues
- Sourcing
  - Flow-up income and factors from lower-tier PTE to upper-tier PTE vs. flow-up state source income
  - Applicability of unitary methodology
- Withholding
  - Withhold at upper-tier PTE, lower-tier PTE, or both?
  - What if tax-exempt entities are owners at highest tier?
- Reporting
  - If reporting to upper-tier PTE and ultimate owners unknown, possibly should report state source income as if both corporate and individual owners (if different) may exist
Withholding Issues - Parting Shots

- Under-withholding/over-withholding Issues
- Investor (Owner) Relations
- PTE's with multiple outside investors can be particularly demanding of certainty in a tax area that is notorious for its lack of clarity.
- One state admitted they had no opinion on the "right way" to do X so "just do the right thing".
Composite Returns

- Owner elects to have entity makes tax payment on owner’s behalf
  - Several states require composite returns (e.g., AL, IN)
- Generally relieves nonresident owner of requirement to file return with jurisdiction
- Owners’ state source income generally limited to PTE income
- Rules vary significantly by state
  - Election requirements (consents; state approval; forms to file; minimum number of electing owners)
  - Includible owners (non-resident; resident; corporation; individual; etc.)
  - Applicable tax rate (generally highest marginal individual tax rate)
  - Computation of tax base (deductions allowed; availability of credits; etc.)
• Considerations
  - Obtaining elections from, tracking appropriate information for, and communicating with owners can be a formidable administrative task
  - What if PTE has losses?
  - What if owner unknowingly has income/losses from other sources in state after electing composite return participation?
  - What if owner has de minimis income/losses from other sources in state after electing composite return participation?
# K-1 Reporting—2013 State Summary

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Indirect (Non-Income) and Direct (Income) Tax Opportunities
Indirect Tax – BPOL Tax

**BPOL Tax In Virginia**

- Review the Company’s Virginia Business, Professional, Occupational, License Tax (BPOL) Tax filings and data to see if the Company has overpaid BPOL tax.
- The War of 1812 was 200 years ago but its BPOL Tax survives.
Indirect Tax – Reverse Audit Services

- **Reverse Audit Services**

- **What It Is:** Audit of sales and use tax filings and support data to see if the Company’s has overpaid sales or use taxes in one or more states.

- **Type of Companies That Benefit Are:** Companies with:
  - Large tax accrual activity and exemptions (e.g., Manufacturers);
  - If Company is currently undergoing audits; and
  - An audit history of net assessments or no change.
  - Where Stock or Asset Sale likely
• **What They Are:** Review of Company’s state income tax data to help them identify and obtain refunds, spot current savings, and utilize tax planning such as restructuring or income concentration techniques to save future taxes, e.g. Apportionment studies.

• **Service providers typically benefit as there are more complexities associated with proper sourcing receipts from services (Market Sourcing v. COP) than from the sale of tangible personal property (Remote Sellers v. Sellers with Nexus Risk).**
Income Tax Credits

What They Are: A dizzying array of statutory credits available to Taxpayers in many states, many of which may be overlooked in the course of busy season.

For example, a number of states allow an income tax credit for property taxes paid on personal property, such as inventory that is stored in the state. A number of states offer hiring and investment credits, as well.

Many companies may not have taken advantage of these credits and are potentially missing out on significant benefits, e.g., Virginia Jobs Credit.

Annual Compliance can be costly and complex so consider staffing or outsourcing.
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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Your Questions

Ask

Question

Answer

Apply

Who

Why

Understand

Where

What

Query

How

When

Answers

Questions
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