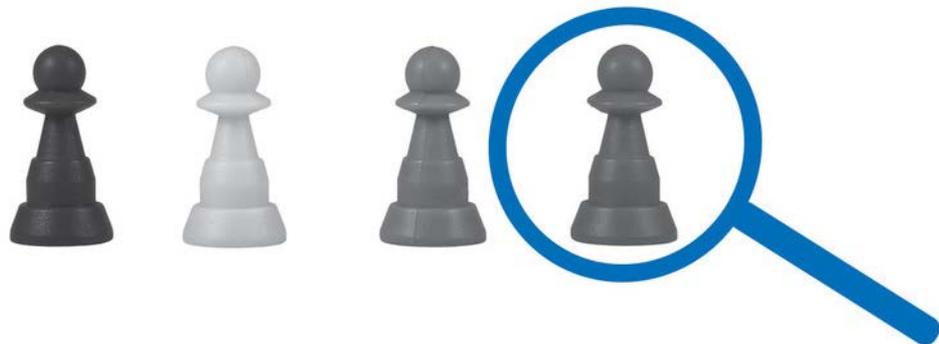


Just Passing Through: State Tax Liabilities Incurred by Pass-Through Entities

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Agenda



- PTE Background
- TCJA SALT Deduction Cap
 - IRS Notice 2020-75
- TCJA Aftermath: Proliferation of PTE State Tax Regimes
 - Non-elective PTE state taxes
 - Elective PTE state taxes
 - Considerations for elective PTE state tax regimes
- Other PTE State Tax Issues and Developments

PTE Background



PTE Background

- For federal income tax purposes, pass-through entities, including partnerships, LLCs, and S corps, (“PTEs”) do not pay tax at the entity level
 - Income flows through to owners
- States vary in their treatment of PTEs and their owners
 - Many follow federal tax treatment
 - Some treat PTEs as separate taxable entities
 - Some allow PTEs to elect to be treated as separate entities
- Most states require PTEs to withhold income tax on behalf of nonresident owners (unless notified otherwise)

PTE Background: Entity Level Taxes & Fees

- In states that impose taxes directly on PTEs, taxes come in many different flavors: income, net worth, gross receipts, etc.
- Examples:
 - California (\$800 tax on LPs, LLCs treated as P'ships, LLPs)
 - D.C. Unincorporated Business Franchise Tax, Ballpark Fee
 - New Hampshire Business Profits Tax, Business Enterprise Tax
 - New York City Unincorporated Business Tax
 - Ohio Commercial Activity Tax
 - Tennessee Excise Tax, Franchise Tax
 - Texas Margins Tax
 - Washington Business & Occupation Tax
- The list is growing!
 - Recent new tax: Oregon Commercial Activity Tax

PTE Background: Issues

- Lack of uniformity among states!
 - What type of PTE, who are the owners, where does it do business?
 - Conformity (or lack thereof) with federal tax treatment (and complexity of federal PTE regime)?
 - What taxes are imposed at entity level? Application to PTEs?
 - State tax nexus and jurisdiction to tax PTE and/or its nonresident partners/owners
 - Computation of PTE taxable income (apportionment, business/non-business classification, combined reporting (D.C.), etc.)
 - PTE required to withhold or file return for nonresident partners?

TCJA SALT Deduction Cap



TCJA SALT Deduction Cap: Background

- Effective in 2018, the Tax Cuts and Jobs Act (TCJA) limited an individual's deduction under to \$10,000 for the aggregate amount of state and local taxes paid during the calendar year
 - However—the SALT cap did not impact deduction for taxes incurred in a “trade or business”
- Immediately perceived potential workaround—New taxes directly imposed on pass-through entities

TCJA SALT Deduction Cap: IRS Notice 2020-75

- Last month, the IRS confirmed that “Specified Income Tax Payments” (i.e., taxes directly imposed on a partnership or S corporation by a state or locality) will not be “taken into account in applying the [SALT deduction cap] to any individual who is a partner in [a] partnership or shareholder of [an] S corporation”
- Guidance applies regardless of whether:
 - The state/local regime is elective; or
 - The partners/shareholders receive a deduction/credit in the jurisdiction imposing the tax on PTEs

TCJA Aftermath: Proliferation of PTE State Tax Regimes



TCJA Aftermath: Proliferation of PTE Tax Regimes

- In the aftermath of the TCJA, numerous states instituted pass-through entity tax regimes
 - Non-elective
 - Connecticut
 - Elective
 - Maryland, Louisiana, New Jersey, Oklahoma, Rhode Island, & Wisconsin
- Will there be more momentum for these regimes post-Notice 2020-75?

TCJA Aftermath: Non-Elective PTE State Taxes

— Connecticut

- Effective for taxable years beginning on or after Jan. 1, 2018.
- PTEs are subject to an entity-level tax on their own income (i.e., no election).
 - Applies to partnerships (including LLCs treated as partnerships) and S corps (including LLCs treated as S corps).
- Tax rate at entity level is 6.99% (applied to the applicable base)
- A partner can claim a credit against corporate business tax and income tax.
 - 93.01% for taxable year 2018
 - 87.5% for taxable year 2019 and thereafter

TCJA Aftermath: Elective PTE State Taxes

— New Jersey

- Elective regime effective Jan. 1, 2020
- Annual election must be made by all owners of the pass-through entity or by an officer or member who is designated with the authority to make election for all members.
- Credit is equal to member's tax on the share of distributive proceeds paid by the pass-through entity.
- For corporate members, the credit may not reduce liability below statutory minimum tax, but excess credits may be carried forward for 20 years.

TCJA Aftermath: Elective PTE State Taxes

— Maryland

- Elective regime eff. for tax years beginning after Dec. 31, 2019.
- Beginning in 1991, MD imposed tax on PTEs based on each PTE's non-resident owners share of taxable income.
- Under the new regime, PTEs may elect to pay tax with respect to the distributive or pro rata shares **of resident members**.
 - Impact of special allocations?
- Credit mechanism is modified to allow residents to claim a credit for taxes paid by the PTE.

TCJA Aftermath: Elective PTE State Taxes

— Louisiana

- Effective 1/1/2019
- Election causes partnership or S-corp to be taxed as a C-corp.
- Election requires consent of more than half of ownership interest in the electing entity.
 - Once election is made, it generally remains effective until revoked.

— Wisconsin

- Effective 1/1/2018 for S-corps; 1/1/2019 for partnerships
- Annual election requires consent of majority of capital/profits interest in partnership, or majority of shares in S corporation.

TCJA Aftermath: Considerations for Elective PTE State Tax Regimes

- Lack of uniformity in regimes.
 - Does regime require election by all partners or majority of partners?
 - Does election apply to all partners or only certain partners?
- Potentially less beneficial to corporate, tax exempt partners/shareholders
- Some related PTEs may have gains, while others have losses
- Potential repeal (or eventual expiration) of SALT cap

Other PTE State Tax Issues & Developments



Other PTE State Tax Issues & Developments

— Nexus

- California

- *Arizona v. California*, U.S. S. Ct. Case No. 220150 (Motion for Leave to File Bill of Complaint denied Feb. 24, 2020).
 - Arizona challenged California's policy of extraterritorial assessment and enforcement of its \$800 annual LLC tax and \$800 minimum corporate franchise tax.
- *In the Matter of the Appeal of Aroya Inv. I, LLC*, 2020-OTA-255P (Cal. Office of Tax Appeals Jul. 7, 2020).
 - California Office of Tax Appeals (OTA) held that a foreign LLC was subject to the state's \$800 LLC tax because it held a 0.7830849% ownership interest in an LLC that owned property in San Diego.



Other PTE State Tax Issues & Developments

— Nexus

• New Jersey

- *Preserve II, Inc. v. Director, Div. of Taxation*, No. A-1331-17T3, 15 (N.J. Super. Ct. App. Div. Sept. 9, 2020).
 - On its face, the decision looks like a disappointing taxpayer loss because the court upheld the determination that a corporation was subject to the New Jersey Corporation Business Tax (CBT) based upon its limited partnership interest in a partnership conducting business in New Jersey.
 - However, in what could be good news for other taxpayers, the appellate court also interpreted the CBT imposition statute to require more than simply deriving receipts from New Jersey sources before a taxpayer can be subject to the CBT.

Other PTE State Tax Issues & Developments

— Taxability of Gain on Sale of Interest

- Massachusetts

- *Vas Holdings & Investments LLC v. Commissioner*, No. C332269, C332270 (Mass. App. Tax. Bd. Oct. 23, 2020).
 - Massachusetts Appellate Tax Board sustained corporate income tax assessments on the gain realized by a nonresident S corporation that sold its 50% interest in a Massachusetts LLC (that was treated as a partnership).
 - ATB rejected appellant's argument that the gain did not have the requisite minimum connection to Massachusetts or availment of the protections and benefits of Massachusetts law as required by the Due Process and Commerce Clauses of the U.S. Constitution.
 - "[T]he capital gain income at issue... was dependent upon Massachusetts business operations, without which much of the additional value that gave rise to the [gain] would not have existed."

Other PTE State Tax Issues & Developments



– Taxability of Gain on Sale of Interest

- New York City

- *In the Matter of Mars Holdings, Inc.*, TAT(H)16-14(GC) (NYC Tax Trib., ALJ Div. June 26, 2020).

- A New York City Administrative Law Judge held that a New Jersey S corporation was subject to New York City general corporation tax (“GCT”) on its gain from the sale of a minority limited partner interest in a limited partnership that leased and managed New York City real estate.
 - The Taxpayer argued that the gain was from an intangible not used in its trade or business, and the gain should therefore be sourced to its domicile and excluded from its taxable income for GCT purposes.
 - The ALJ disagreed, citing a City regulation that says a corporation will be treated as “doing business” in the City for GCT purposes if it holds a limited partner interest in a limited partnership that does business in the City.

Other PTE State Tax Issues & Developments

– Taxability of Gain on Sale of Interest

- Idaho

- *Noell Indus., Inc. v. Idaho Tax Comm'n*, 167 Idaho 367 (2020)

- The Idaho Supreme Court held that the gain realized by a holding company on the sale of its ownership interest in an LLC was nonbusiness income not subject to apportionment in Idaho.
 - The gain did not satisfy the transactional test for business income because:
 - The holding company was not in the business of buying and selling companies; a one-time sale over a seven-year span does not constitute a “regular” trade or business.
 - The gain did not satisfy the functional test for business income because:
 - The sale of the LLC interest did not serve an operational function, but was instead a passive investment.
 - The holding company and the LLC were not unitary.

Other PTE State Tax Issues & Developments

— Oregon Corporate Activity Tax (CAT)

- The Oregon CAT—a quasi-gross receipts tax—went into effect on January 1, 2020
- Taxpayer is defined as “any person or unitary group” required to register, file or pay the CAT
 - “Person” includes individuals, combinations of individuals of any form, receivers, assignees, trustees in bankruptcy, firms, companies, joint-stock companies, business trusts, estates, partnerships, limited liability partnerships, limited liability companies, associations, joint ventures, clubs, societies, entities organized as for-profit corporations under ORS chapter 60, C corporations, S corporations, qualified subchapter S subsidiaries, qualified subchapter S trusts, trusts, entities that are disregarded for federal income tax purposes and any other entities.
- Combined reporting:
 - “Unitary group” is “a group of persons with more than 50% common ownership, either direct or indirect, that is engaged in business activities that constitute a unitary business”
 - Pass-through entities required to be included in the unitary group

Other PTE State Tax Issues & Developments

— Portland-Metro Area Business Profits Tax

- In May 2020, Portland-metro area (Multnomah, Clackamas and Washington counties) voters approved a 1% tax on business profits
 - “Beginning tax year 2021, a tax of one percent is imposed on the net income of each person doing business within Metro”
 - Includes a small business exemption for person’s with gross receipts of \$5 million or less
- The Metro Council is working with the Portland Revenue Division to administer this new tax
 - Portland and Multnomah County impose entity-level income taxes on pass-through entities, which Metro seems to be set on
- Metro’s authority to impose an entity-level is questionable
 - Although all three local jurisdictions have home rule authority, Metro is statutorily required to follow Oregon income tax laws

Other PTE State Tax Issues & Developments



- Potential Sourcing Issues Related to New York City’s Unincorporated Business Tax (UBT)
 - Background: Imposed on unincorporated businesses, including partnerships and limited liability companies
 - A 4% tax rate is charged for taxable income allocated to NYC
 - Receipts from services:
 - NYC Admin. Code §11-508(c)(3)(C) provides that, for taxable years beginning on or after July 1, 2007, certain “charges for services performed shall be allocated to the city to the extent that the services are performed within the city.”
 - Interplay with WFM mandates / convenience of the employer rule?



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