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In this installment of A Pinch of SALT, the authors illustrate important state tax implications that should be considered when making a federal check-the-box election.

Introduction

The Internal Revenue Code and Treasury regulations allow business entities that are not treated as corporations under state law to choose their classification for federal income tax purposes.[1] Many noncorporate entities choose to be treated as partnerships or disregarded entities under the federal income tax regime unless they affirmatively elect to check-the-box (CTB) to be classified as corporate taxpayers. Unsurprisingly, some states do not conform to the federal election for state tax purposes.

There are numerous implications of state nonconformity to CTB elections and classifications. In this installment of A Pinch of SALT, we review recent cases that highlight some of these implications. We discuss how a CTB election may affect the composition of a taxpayer's unitary combined group in one state but not in another. A CTB election may also modify the applicable method for sourcing income to a state. And the timing of making a CTB election may materially impact a taxpayer's state taxable income. Although not exhaustive, these issues illustrate important state tax implications that should be considered when making a federal CTB election.

CTB Election Overview

The federal rules and complex issues associated with making the CTB election for federal income tax purposes are beyond the scope of this article. But to appreciate the potentially significant state tax implications associated with the election, we provide a high-level overview of those federal rules.

[1] Section 7701; reg. section 301.7701-3.

A CTB election allows an entity to be classified differently from its default classification for federal income tax purposes. Under the Treasury regulations, an entity that is formed as a corporation under state law is automatically classified as a corporation for federal tax purposes.[2] The default classification for all other entities depends on the number of members or owners.[3] For example, the default classification for a domestic entity with two or more members is a partnership.[4] A noncorporate entity with a single owner is classified by default as a disregarded entity.[5] The default classification of an entity may be changed by filing federal Form 8832 "Entity Classification Election."[6] An election is treated as occurring at the start of the day the election is effective.[7]

The possible election type depends on whether the entity has one or more members. An eligible entity with at least two members may elect to be treated as an association (taxable as a corporation[8]) or a partnership.[9] A single-member limited liability company (SMLLC) may elect to be classified as an association taxable as a corporation or as a disregarded entity.[10] For federal income tax purposes, a disregarded entity's business activities are treated as a branch or division of its owner. In other words, the disregarded entity and its owner are treated collectively as one taxpayer filing a single federal corporate income tax return.

CTB Elections and the Impact on State Tax

The extent to which states recognize and apply CTB elections is filled with nuances and variations that may lead to unexpected or unintended results. For example, SMLLCs that are disregarded entities generally do not file separate state corporate income tax returns. However, the appropriateness of including or excluding disregarded entities when analyzing state tax nexus or sourcing issues is not clear cut. Moreover, identifying who the taxpayer is can have a significant effect on the analysis. And the timing of a CTB election may affect a taxpayer's state taxable income because the classification change is treated as occurring at the start of the day that the election is effective. We explore these nuances by looking at three different cases.

Composition of a Filing Group

CTB elections may affect the composition of a taxpayer's filing group in a particular state. In *Ashland*,[11] the Minnesota Supreme Court held that a foreign entity's federal CTB election must be respected for determining which entities were included in the Minnesota combined franchise tax reports. Under Minnesota's water's-edge rules in effect before 2013, unitary "foreign corporations or foreign entities" were excluded from the unitary business's combined report. In *Ashland*, the taxpayer's foreign affiliate elected to be treated as a disregarded entity for federal income tax purposes. The Department of Revenue refused to recognize this election. The court held that the foreign affiliate was disregarded for Minnesota franchise tax purposes because net income was defined in the state statutes as "federal taxable income . . . incorporating . . . *any* elections made by the taxpayer in accordance with the Internal Revenue Code in determining federal taxable income for federal income tax purposes."[12] Thus, the foreign affiliate was not a foreign corporation or foreign entity but a part of its domestic parent, and its income and apportionment factors were properly includable in the parent's water's-edge report.[13] The court rejected the DOR's argument that treating the foreign affiliate as a disregarded entity violated Minnesota's water's-edge rule that prohibits including the net income and apportionment factors of foreign entities on a combined report.

[2] Reg. section 301.7701-3.

[3] Reg. section 301.7701-3(b)(2).

[4] Reg. section 301.7701-3(b)(1).

[5] *Id.*

[6] Reg. section 301.7701-3(c)(1)(i).

[7] Reg. section 301.7701-3(g)(3)(i).

[8] Reg. section 301.7701-2(b)(2).

[9] *Id.*

[10] *Id.*

[11] *Ashland Inc. v. Minnesota Commissioner of Revenue*, 899 N.W.2d 812 (Minn. 2017).

[12] *Id.* at 817, citing Minn. Stat. section 290.01, subd. 19 (2012) (emphasis added).

[13] In making its determination, the court found that the plain language of Minnesota's net income definition unambiguously incorporates a taxpayer's federal elections.

The court explained that because the foreign entity "ceased to exist as a separate entity," its income and apportionment factors could not be said to have been included in a combined report.

The Colorado Court of Appeals reached the opposite conclusion in *Agilent Technologies*.[14] The issue before the court, and ultimately the Colorado Supreme Court, was whether a domestic corporation formed as a holding company to own the taxpayer's foreign affiliates was an "includable C corporation" that must be included in the taxpayer's Colorado water's-edge return. The supreme court held that because the holding company did not have at least 20 percent of its property and payroll assigned to U.S. locations, it was not an includable C corporation under the controlling Colorado statute. Notably, the taxpayer argued in the alternative that because the holding company and its foreign subsidiaries made the CTB election to be treated as a single C corporation for federal income tax purposes, they should also be treated as a single corporation under Colorado law so that the property and payroll of the foreign affiliates entirely outside the United States would be viewed as property and payroll of the holding companies.

The appeals court refused to be bound by the taxpayer's federal CTB election to treat its foreign subsidiaries as disregarded entities (and therefore as divisions of the taxpayer) in determining the composition of the taxpayer's filing group. The court held that the fact that the parent's federal CTB election to include its foreign subsidiaries in one C corporation did not mandate the same result in determining whether foreign entities are includable in the parent's Colorado combined report.[15] Although the state appears to conform to the CTB rules generally, in the court's view, doing so here would render its rules for including or excluding foreign entities in the state combined report meaningless. The Colorado Supreme Court did not have to address this argument because it decided that the holding company did not satisfy the statutory definition of an includable C corporation.

These cases demonstrate that to avoid unintended consequences when determining a taxpayer's filing group in a particular state, it is critical to understand how an entity that has made a federal CTB election would be treated for state income tax purposes. A taxpayer should confirm whether a particular state conforms to the CTB election rules and determine how that conformity, or lack thereof, will affect the composition of the taxpayer's reporting group and the computation of its apportionment factors in the jurisdiction.

Receipt Sourcing

Over the last two decades or so, courts, state revenue agencies, taxpayers, and commentators have grappled with diverging and ever-changing interpretations of state sourcing rules. CTB elections may add another wrinkle of complexity in determining the proper method for sourcing a taxpayer's receipts. In *BTG Pactual*,[16] the New York appellate division concluded that the federal CTB election rules did not dictate the application of New York's special sourcing rules for broker-dealers.[17]

For the tax years at issue (2012 and 2013), New York generally requires sourcing receipts based on a cost-of-performance method.[18] Registered brokers and dealers were allowed a different method, based on their customers' location.[19] The taxpayer in *BTG Pactual* was the owner of two disregarded entities — one was a registered broker-dealer, and the other was a registered investment adviser.[20] Because both the broker-dealer entity and the investment adviser entity were otherwise disregarded for federal and state income tax purposes, receipts from both were

[14] *Agilent Technologies Inc. v. Department of Revenue of Colorado*, 442 P.3d 938 (Colo. Ct. App. 2017), *aff'd* 441 P.3d 1012 (Colo. 2019).

[15] *Department of Revenue v. Agilent Technologies*, No. 2019 C.O. 41 (Colo. 2019).

[16] *Matter of BTG Pactual NY Corp. v. New York State Tax Appeals Tribunal*, 165 N.Y.S.3d 149 (N.Y. App. Div. 2022).

[17] Under New York's sourcing rules before its 2015 tax reform, corporate franchise taxpayers generally assigned service receipts to the location where the service was performed. N.Y. Tax Law section 210(a)(2)(b). But registered broker-dealers were exempt from this general rule. *Id.* at section 210(a)(3)(9). Instead, a taxpayer who was a registered broker-dealer would assign receipts to the location of the broker-dealer's *customer*. *Id.*

[18] *Matter of BTG Pactual*, 165 N.Y.S.3d at 152.

[19] *Id.*

[20] *Id.* at 150-151.

included on the parent's tax returns. On BTG's original New York corporation franchise tax returns, only the broker-dealer's receipts were sourced using the broker-dealer sourcing rules. The investment adviser's receipts were sourced using the generally applicable cost-of-performance sourcing method. The taxpayer later amended its returns to reflect that all receipts, both those generated by the broker-dealer entity and the investment adviser entity, should be sourced using the broker-dealer sourcing rules. The taxpayer argued that since the SMLLCs were disregarded entities, it and its members were collectively one taxpayer for purposes of the application of the broker-dealer sourcing rules.[21]

The Department of Taxation and Finance rejected the taxpayer's application of the broker-dealer sourcing. The department's position was upheld by the Division of Tax Appeals, the Tax Appeals Tribunal, and the appellate division. The latter reasoned that registered broker-dealers and investment advisers perform different services and are subject to different regulatory requirements. Thus, it held that the broker-dealer sourcing rules unambiguously applied solely to entities that were, in fact, registered as broker-dealers.[22] Although New York generally conforms to the CTB election rules, the appellate division explained that "the doctrine of federal conformity did not require a different conclusion" because "federal tax law has no counterpart to New York's receipt sourcing rules."[23] It noted that the taxpayer chose to structure itself as separate legal entities from itself and from each other and it is bound by the tax consequences of that choice of corporate form.[24]

BTG Pactual shows that to avoid being caught by surprise when making a CTB election, taxpayers should consider how entity classification may affect the method for sourcing of receipts in a state. An entity that has made the CTB election to be treated as a disregarded entity for federal tax purposes may forfeit special apportionment rules or other unique state tax provisions. Many states have sourcing rules applicable to specific industries. The categorization of industries that are subject to special rules and the resulting sourcing methods vary among states. Moreover, many states have industry-specific tax regimes. While these regimes are often created for regulated industries such as financial services, insurance, utilities, and transportation, each state's rules have their own requirements. Taxpayers should consider the effect of an entity's CTB election and classification across this broad scope of possibilities.

CTB Election Timing

Another consideration that may impact a taxpayer's state taxable income is the timing of a CTB election. In *Matter of the Appeal of B. Housman and B. Pena*,[25] the California Office of Tax Appeals rejected the Franchise Tax Board's argument that in determining whether a taxpayer was entitled to a stepped-up basis in computing the gain realized from the sale of the taxpayer's company, the taxpayer's valid CTB election that applied retroactively for federal tax purposes under the IRS's late classification relief guidance was not binding for California income tax purposes. The OTA explained that California law required that an entity's classification for California income and franchise tax purposes must be the same as the classification for federal tax purposes, including under Treasury's CTB regulations. Therefore, the timing of the taxpayer's valid election to be reclassified from an association to a partnership on a retroactive basis, resulting in a stepped-up basis for federal tax purposes, was binding in determining the taxpayer's stock basis for

[21] *Id.* at 151.

[22] New York amended the franchise tax on business corporations for tax years beginning on or after January 1, 2015. 2015 Sess. Law News of N.Y., ch. 59, pt. T, sections 10-20 (A.3009-B). The department drafted corresponding regulations and began the State Administrative Procedure Act process in July 2023. The proposed apportionment regulations address the arguments made in *BTG Pactual*. Prop. regs. section 4-1.1(e). The draft regulations state that a "corporation that itself is not a registered broker or dealer will not be deemed to be a registered broker or dealer because it is a partner in a partnership that is a registered broker or dealer or a member of a limited liability company that is a registered broker or dealer. Business receipts from such registered broker or dealer that are described in section 210-A(5)(b) and are passed through to the corporation because it is a partner in or member of a registered broker or dealer are apportioned using the rules in such section." *Id.* at section 4-1.1(e).

[23] *Matter of BTG Pactual*, 165 N.Y.S.3d at 153.

[24] *Id.* at 154.

[25] *Matter of the Appeal of B. Housman and B. Pena*, Cal. Office of Tax App. No. 18010300 (Aug. 31, 2022).

California income and franchise tax purposes.[26] The OTA noted that the IRS's late classification relief guidance, although not binding, was persuasive because it interpreted the CTB election to which California conformed.

Not all states conform to Treasury's regulations, even if they conform to the CTB rules, and different states give different weight to the IRS's guidance construing those regulations and rules. Therefore, it is important to evaluate the effect an election's timing under the federal CTB regulations might have on a taxpayer's state taxable income.

Conclusion

The impact of whether a state will recognize a federal CTB election and the effect recognition has on the entity's state income tax obligations will vary and may depend on the taxpayer's attributes and income and losses, the taxpayer's group composition, and the attributes and income and losses of the other taxpayer group members. Thus, before making a federal CTB election, taxpayers should review their state tax footprint and liabilities to evaluate the potential pitfalls. *BTG Pactual* is a good reminder that this evaluation is more than comparing states with income taxes and gross receipts taxes, or states with industry-specific tax regimes or apportionment provisions for the *filing* taxpayer. Similarly, *Housman* is a good example of the importance of reviewing CTB elections regularly to ensure efficient tax compliance. Taxpayers should evaluate these considerations for *all* taxpayers in the filing group, including disregarded entities. Diligent taxpayers may identify substantial costs that are far greater than the compliance headache of filing another tax return. ■

[26] *Id.* at 15; *see also* Cal. Code Regs. tit. 18, section 23038(b).