Composite Returns and Nonresident Withholding for Pass-Through Entities: Multistate Complexities

TUESDAY, MAY 12, 2020, 1:00-2:50 pm Eastern

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Composite Returns and Nonresident Withholding for Pass-Through Entities: Multistate Complexities

May 12, 2020

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Agenda

I. The landscape of withholding requirements, composite returns, and partnership audit rules

II. Withholding requirements on nonresident shareholders/partners

III. Measures to enforce nonresident filing and payment of taxes

IV. Mechanics of electing and filing composite returns

V. Elections and strategies

VI. Taxation of the disposition of interest by nonresident shareholders/partners

VII. Tax reporting and planning issues specific to S corporations

VIII. States pass-through entity taxation

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Landscape of multistate requirements

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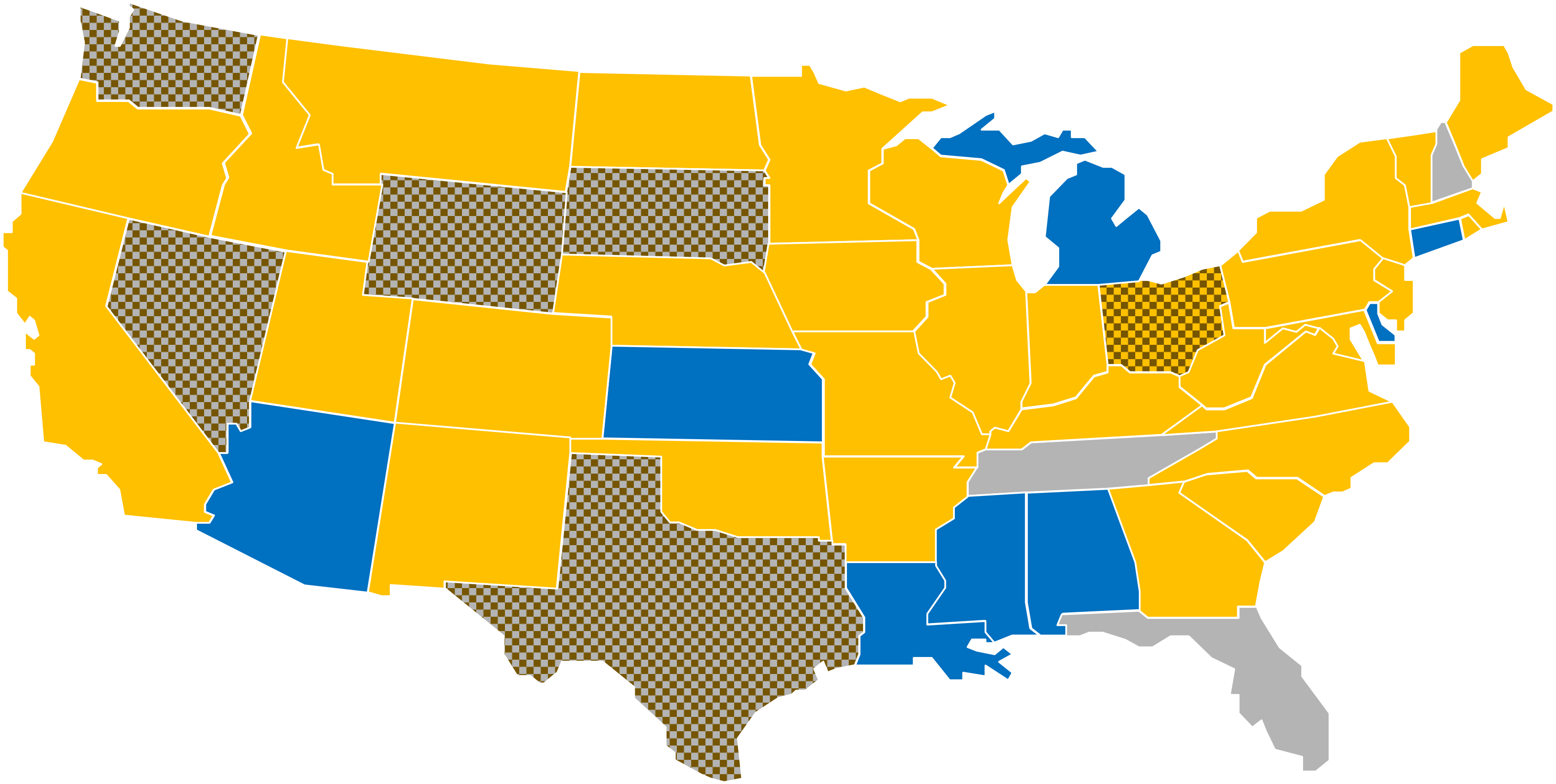
Nonresident partner withholding



Nonresident withholding required

Nonresident withholding not required (CT entity tax)

No Personal Income Tax (incl. NH/TN; no withholding)

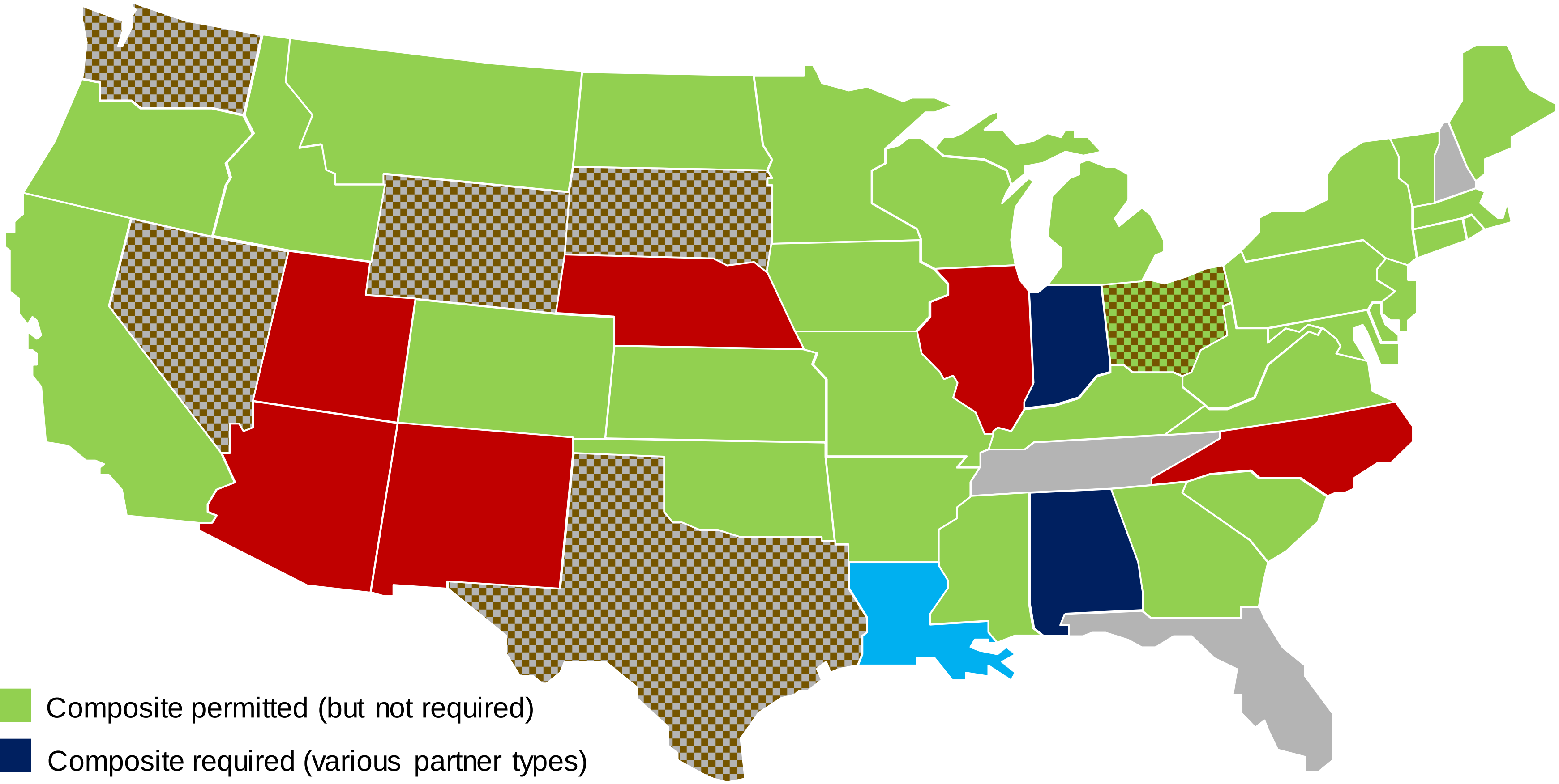
No Corporate Income Tax

Alaska

D.C. *No income tax on nonresidents*

Hawaii *For TY19 effective date was delayed*

Nonresident composite returns



- Composite permitted (but not required)
- Composite required (various partner types)
- Composite required (individuals/certain trusts only)
- No composite permitted
- No Personal Income Tax (incl. NH/TN; no composite)
- No Corporate Income Tax

Alaska
D.C.
Hawaii

State Partnership Audit Legislation

Bipartisan Budget Act of 2015

— Effective for TYB after 12/31/2017

Enacted state partnership rules
BBA-related / post-TEFRA rules

— Kentucky (4/15/20)

— Virginia (4/10/20)

— Indiana (3/21/20)

— Ohio (7/18/19)

— Rhode Island (7/5/19)

— West Virginia (3/25/19)

— Maine (6/18/19)

— Oregon (5/24/19)

— California (9/23/18)

- "Cleanup" Bill SB790 (9/20/19)

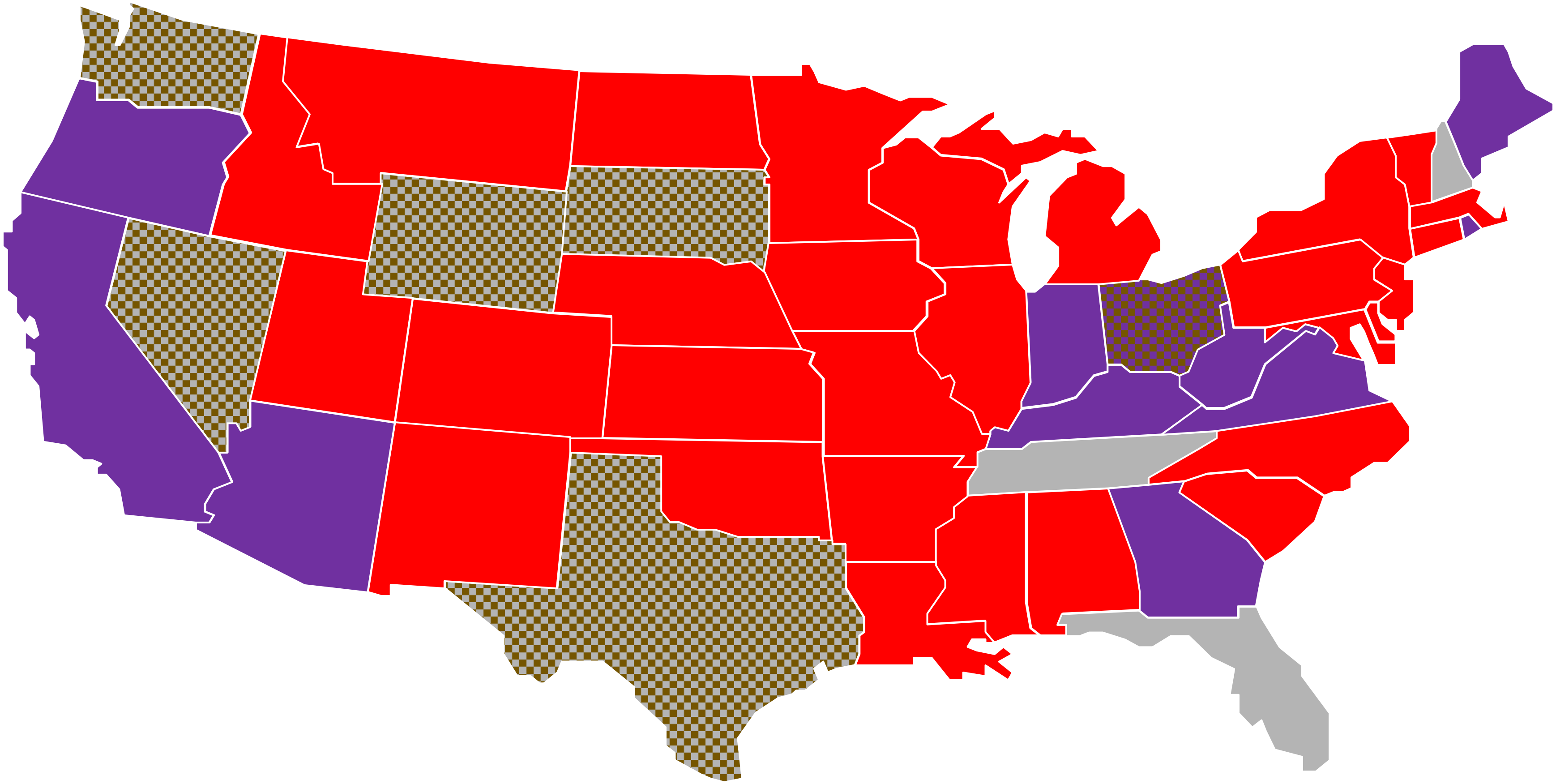
— Hawaii (6/13/18)

— Georgia (5/3/18)

- Regulations adopted in Jan. 2019

— Arizona (5/11/16)

Post-BBA 2015 partnership rules



New legislation since BBA of 2015 was enacted

Has not had new legislation (yet)

No Personal Income Tax (incl. NH/TN; no withholding)

No Corporate Income Tax

Alaska

D.C. *No income tax on nonresidents*

Hawaii

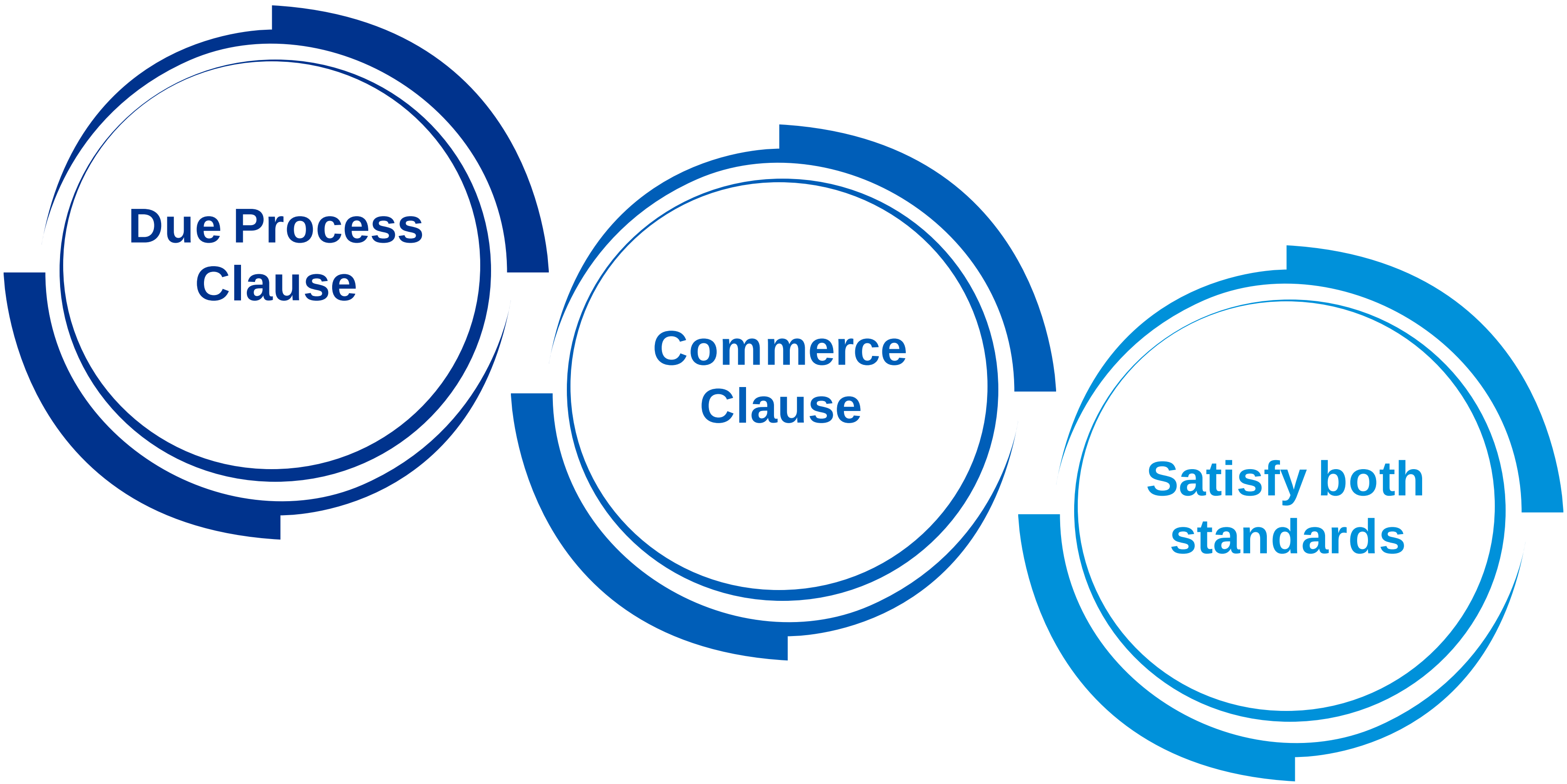
Nexus considerations

Passthrough entity's nexus with a particular jurisdiction in which it is doing business

Passthrough entity owner's nexus with a particular jurisdiction in which the passthrough entity is doing business

Passthrough entity nexus

Passthrough entity nexus and passthrough owner nexus is determined under general nexus principles



Post-*Wayfair* Income Tax Rules

Bright-line economic activity nexus rule

— Hawaii

— Massachusetts

— Oregon Commercial Activity Tax

— Pennsylvania

— Philadelphia

— San Francisco Proposition D (Nov. 2018)

— Texas

— Washington

Additional jurisdictions are expected to adopt new rules or informally adjust nexus standards

PTE owner nexus developments

Swart Enterprises, Inc. v. FTB, 7 Cal.App.5th 497 (2017)

- LLC member who owned 0.2% interest in manager-managed LLC was not doing business in California, not subject to $800 minimum tax
  - No authority to participate in the management and control of the LLC
  - Not liable for the debts and obligations of the LLC
  - Did not own an interest in specific property of the LLC
  - Could not act on behalf of the LLC
- Decision references *In Appeal of Amman & Schmid Finanz AG et al.*, 96-SBE-008 (CA BOE 1996), which held that an out-of-state corporation only connected to California by owning a limited partner interest in a limited partnership was not “doing business” in California
- See FTB Notice 2017-01, CA Legal Rulings 2011-01, 2014-01, and 2018-01
- See also *Appeal of Jali, LLC*, 2019-OTA-204P (7/8/19)

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Withholding requirements on nonresident owners and measures to enforce nonresident filing and payment of taxes

Nonresident Withholding

31 states require withholding on certain nonresident partners

Applicability & rates depend on type of owner

How do states define "nonresident" for individual persons and business entities?

Basis of Tax:

- Distributive share of apportioned/allocated state income
- Actual distributions

Owner files state return to claim payments against tax/obtain refunds

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Withholding Exemptions/Opt-Out

- Rules may vary between partnerships and S-corporations

- Possible exemptions:
  - *De minimis* threshold
  - Exemption Forms or Affidavits: owner consents to state taxation
  - Participation in Composite/Group tax return
  - Exempt entities, investment/publicly traded partnerships, insurance company, etc.

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Common Withholding Problems

- Withholding may not be reflective of ultimate tax liability
  - Issues with multi-tiered entities
  - Net Operating Losses

- Owner may have to make separate estimated tax payments if withheld amount is insufficient to cover liability

- As partnership enters new states, distribution/guaranteed payment agreements with owners may need to be modified

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Composite returns: mechanics of electing and filing

Composite Returns

- Single group return filing on behalf of nonresident owners
- Eliminates need for owner to file separate state return
- Administrative convenience vs. lower tax liability

- Calculation of tax:
  - Typically computed by multiplying owner's share of income apportioned/allocated to state by the highest marginal tax rate
  - Some states provide alternative calculation options

- Which entities can file?
  - State approval may be required
  - Minimum number of participants may be required

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Composite Returns

- Which owners can participate? Typical requirements may include:
  - Nonresident for entire tax year
  - Does not maintain permanent place of abode in state
  - The owner’s only source of state income comes from this pass-through entity (or other PTEs where composite returns are filed)
  - Same tax year as PTE or other owners

- What about disregarded entities?

Challenges for Pass-through Entities

- Recordkeeping
  - Owners' elections
  - Calculating estimates and preparing returns
- Estimated payments
  - May need separate payments if withholding for some partners and filing composite for others
- Coordinating scheduled distributions with state estimate/return payment requirements
- Mitigating risk

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Mechanics - Required Information from Owners

- Entity type – how is the owner taxed?
- Is the owner a resident/nonresident of each state?
- Does the owner have a withholding exemption?
- Is the owner eligible to participate in the composite return?
- If eligible, does the owner choose to participate in the composite return?
- Has partnership/S-Corporation collected the appropriate forms/affidavits?
- Annual election memo to owners strongly recommended

Example – Owner Memo

Georgia requires partnerships to withhold state income taxes on its nonresident members' distributable shares of income unless the member participates in the composite tax return or files a withholding exemption affidavit (see attached Form NRW-Exemption). Members who do not participate in the composite return may be required to file a separate Georgia tax return.

1. Are you a resident of Georgia during 2019?

   Yes _____ No _____

2a. If you are a nonresident, are you eligible to participate in the composite tax return filing?

   Yes _____ No _____

2b. If eligible, will you participate in the composite tax return filing?

   Yes _____ No _____

2c. If participating in the Georgia composite return, do you have any other sources of taxable GA income?

   Yes _____ No _____

2d. If participating in the Georgia composite return, please indicate your federal tax filing status and number of dependents:

   _____ Single _____ Married filing jointly _____ Married filing separately _____ Number of dependents

3. If you are a nonresident who is not electing to participate in the composite return, have you requested a withholding exemption by completing Form NRW-Exemption?

   Yes _____ No _____

Mechanics - Withholding

- Election Timing
  - When should elections be collected from owners?
  - Duration of elections: annual, biannual, or perpetual
  - CA waiver request requires state approval

- Estimated Payments
- Information Reporting to State
- Inclusion of elections with partnership/S-Corporation tax return

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Individual Tax Return Example

1710601912

2012 and Forward Form G2-A WITHHOLDING ON NONRESIDENT MEMBERS SHARE OF TAXABLE INCOME SOURCED TO GEORGIA

YEAR	1. PAYER'S NONRESIDENT(NR) WH#	2. PAYER'S FEDERAL ID NUMBER
3. PAYER'S NAME AND ADDRESS BIG BIRD LLC 123 SESAME STREET ANYWHERE, NY 10101		4. RECIPIENT'S FEIN/ID NUMBER 5. RECIPIENT'S NAME AND ADDRESS OSCAR GROUCH HOLLYWOOD, CA 90048
6. AMOUNT OF NONRESIDENT MEMBER'S SHARE OF TAXABLE INCOME SOURCED TO GEORGIA 50,000		7. GEORGIA TAX WITHHELD 2000

GEORGIA DEPARTMENT OF REVENUE
PROCESSING CENTER
PO BOX 105685
ATLANTA GA 30348-5685

COPY 1- STATE COPY

INSTRUCTIONS FOR COMPLETING FORM G2-A

This form shall be used for taxable years beginning on or after January 1, 2012. Should be completed by and filed by the entity who submitted the withholding payment directly to the Department of Revenue.

Enter Year in which the tax year of the distributing entity ends.

Box 1. Enter Georgia Payer's Nonresident Withholding Number.

Box 2. Enter Federal Identification Number.

Box 3. Enter name and address of payer.

Box 4. Enter social security number if recipient is an individual or federal identification number if recipient is a business.

Box 5. Enter name and address of member/shareholder.

Box 6. Enter the amount of nonresident member's share of taxable income sourced to Georgia.

Box 7. Enter amount of Georgia income tax withheld.

On or before the earlier of the date the return is filed or the due date for filing the income tax return of the flow through entity (without extension), all G2-As issued for the year should be mailed along with Form G-1003 to:

GEORGIA DEPARTMENT OF REVENUE
PROCESSING CENTER
PO BOX 105685
ATLANTA GA 30348-5685

Mail your payment with the GA-V Payment Voucher to:

Georgia Department of Revenue
Processing Center
PO Box 740387
Atlanta, GA 30374-0387

(Rev. 05/27/16)

1. WITHHOLDING TYPE: ☐ W-2 ☒ G2-A ☐ G2-LP ☐ 1099 ☐ G2-FL ☐ G2-RP	1. WITHHOLDING TYPE: ☐ W-2 ☐ G2-A ☐ G2-LP ☐ 1099 ☐ G2-FL ☐ G2-RP	1. WITHHOLDING TYPE: ☐ W-2 ☐ G2-A ☐ G2-LP ☐ 1099 ☐ G2-FL ☐ G2-RP
2. EMPLOYER/PAYER FEDERAL ID NUMBER (FEIN) ☒ SSN ☐	2. EMPLOYER/PAYER FEDERAL ID NUMBER (FEIN) ☐ SSN ☐	2. EMPLOYER/PAYER FEDERAL ID NUMBER (FEIN) ☐ SSN ☐
99-9999999		
3. EMPLOYER/PAYER STATE WITHHOLDING ID	3. EMPLOYER/PAYER STATE WITHHOLDING ID	3. EMPLOYER/PAYER STATE WITHHOLDING ID
4. GA WAGES / INCOME	4. GA WAGES / INCOME	4. GA WAGES / INCOME
5. GA TAX WITHHELD	5. GA TAX WITHHELD	5. GA TAX WITHHELD
2000		

23. **Georgia Income Tax Withheld on Wages and 1099s** .... 23.
(Enter Tax Withheld Only and include W-2s and/or 1099s)

24. **Other Georgia Income Tax Withheld** 24. 2000
(Must include G2-A, G2-FL, G2-LP and/or G2-RP)

TAXABLE YEAR **2019** **Other State Tax Credit** CALIFORNIA SCHEDULE **S**

Attach to Form 540, Form 540NR, or Form 541.

Name(s) as shown on your California tax return: OSCAR GROUCH | SSN, ITIN, or FEIN

Part I Double-Taxed Income (Read specific line instructions for Part I before completing.)

(a) Income item(s) description	(b) Double-taxed income taxable by California	(c) Double-taxed income taxable by other state
BIG BIRD LLC	50,000	50,000
1 Total double-taxed income	50,000	50,000

Part II Figure Your Other State Tax Credit (Read specific line instructions for Part II before completing.)

2 California tax liability. See instructions	2	100,000 00
3 Double-taxed income taxable by California. Enter the amount from Part I, line 1, column (b)	3	50,000 00
4 California adjusted gross income. See instructions	4	1,000,000 00
5 Divide line 3 by line 4. Do not enter more than 1.0000	5	0.0500
6 Multiply line 2 by line 5	6	5,000 00
7 Income tax liability paid to other state (use state's abbreviation) GA See instructions	7	2,000 00
8 Double-taxed income taxable by other state. Enter the amount from Part I, line 1, column (c)	8	50,000 00
9 Adjusted gross income taxable by other state. See instructions	9	50,000 00
10 Divide line 8 by line 9. Do not enter more than 1.0000	10	1.0000
11 Multiply line 7 by line 10	11	2,000 00
12 Other state tax credit. Enter the smaller of line 6 or line 11. Use Credit Code 187. See instructions	12	2,000 00

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Mechanics - Composite Filing

- Entity election - may need approval prior to filing

- Partner elections – generally binding for the tax year
  - When can owners still file separate state returns?

- Some states require elections or consent forms from owners, tax power of attorney

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Elections and strategies

Election/Planning Strategies

- Owners must evaluate their own tax situation
  - Composite tax at highest marginal rates vs. graduated rates
  - Forego standard deductions, personal exemptions

- Re-evaluate due to tax reform changes
  - States offering pass-through entity level tax option

- States that do not follow pass-through treatment
  - Owners may still benefit from tax paid by entity in certain states
  - Planning in states that require separate S-elections and Q-Sub elections
  - FTB Legal Ruling No. 2017-01
  - *H. Alan Rosenberg v. Commissioner*, GA Tax Tribunal No. 1414626

Election/Planning Strategies

- Loss years
  - States may not allow carryforwards on composite returns, no carryback option

- Statute of Limitations risks for owners
  - Nexus/sourcing issues on other sources of income
  - Residency/domicile issues

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Disposition of interest by nonresident owner

Recent Sales Factor Changes

- **2018 single-sales factor**
  - Kentucky
  - Maryland (phase in from 2018-2022)
- **2020 single-sales factor**
  - Missouri (mandatory)
- **2018 market sourcing**
  - Kentucky
  - Montana
  - Oregon
- **2019 market sourcing**
  - Colorado
  - Indiana
- **2020 market sourcing**
  - Hawaii (still 3-factor formula)
  - Missouri
  - Vermont

Allied-Signal (1992)

Operational vs. investment function

- U.S. Supreme Court clarified the notion it advanced in ASARCO and Woolworth (1982), explicitly recognizing “that the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases”
- “What is required [for apportionment] is that the capital transaction serve an operational rather than an investment function”

Is income from an “investment asset” apportionable?

- Consider the “objective characteristics of the asset’s use and its relation to the taxpayer’s activities within the taxing state”
- Use of funds not dispositive – whether investment acquired with funds from Allied-Signal’s disposition of ASARCO stock would have been operated as part of unitary business “reveals little about whether ASARCO was run as part of … unitary business”
- Did not make a bright-line distinction between short-term and long-term investment, though short-term investment of working capital was provided as an example of apportionable income

Sales factor inclusion/exclusion

UDITPA

- UDITPA refers to "total sales" but defines "sales" as "all gross receipts of the taxpayer not allocated"

MTC Model Regulations

- The MTC regulations previously used the term "sales" which included gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business
- The MTC regulations now use the term "receipts" which "means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded."
- States may have state-specific exclusions:
  - Receipts from sales of certain assets
  - Receipts from income not included in the tax base

Sale of Passthrough Entity Interest

Taxpayer type

— Corporation or Partnership?

— Individual or Business?

Enterprise and Asset Unity

— Seller engaging in a trade or business?

— Management decisions and capital flow

— Investment versus Business

  — Was the partnership/LLC interest the only asset held by the taxpayer?

State-specific rules

— Look-through down to the sold entity's activities

— Did the taxpayer allocate or apportion the partnership activity?

Does the seller have direct activity in this state?

Tax base (gain/loss in net income) versus apportionment (sales factor) rules

Conduit vs. entity treatment approach

Other considerations

— Installment sales, Real estate transfer taxes, Nonresident seller gain withholding

CA Sourcing – FTB Regulations

California Franchise Tax Board held another Interested Parties Meeting (IPM) in July of 2019 to discuss the further proposed revisions to 18 CCR 25136-2

— California adopted mandatory market-based sourcing effective 1/1/2013

— Receipts from services are sourced to California to the extent "the purchaser receives the benefit of the service" in California

— Sourcing of gain on certain sales of stock or partnership interests

  — Look at the assets (or receipts) of the entity sold in order to attribute a portion of the gain to California if the entity sold had property (or activities) in California

— Consider the California investment partnership rules if interest sold was held by a partnership

Recent amendments to CA's partnership/partner apportionment rules

— Changes made to 18 CCR 17951-4 (personal income tax; Income from a Business, Trade or Profession) and 18 CCR 25137-1 (corporate income tax; Apportionment and Allocation of Partnership Income)

— Business / nonbusiness income determination made at the (nonunitary) partnership level (and not at the partner level)

— In reporting to nonresident partner, a partnership sources income from a business using the corporate rules for determining California source income

— Unitary partner uses "profit" percentage to pick up factors, not "capital" percentage

Texas Sourcing

Sale of Single Member LLC interest

— Tax Policy Memo 201810001L: Comptroller concluded that the sale of a membership interest in an SMLLC was the sale of an intangible asset even if the entity had disregarded entity treatment for federal income tax purposes.

Location of Payor

— Texas sourcing rule for receipts from the sale of certain intangibles that includes the sale of ownership interests in other entities.

— Under the location of payor rule, these receipts are sourced based on the legal domicile of the payor (i.e., the purchaser of the entity interest).

  — The legal domicile of a corporation or LLC is defined to be its state of formation, while a partnership's legal domicile is defined to be the partnership's "principal place of business" (which can be the location of its day-to-day operations or its commercial domicile).

Sale of securities

— Based on the location of the payor, but if sold through an exchange and the payor can't be identified, then 7.9% of the revenue is deemed as Texas receipts.

Economic Nexus

— Consider December 2019 regulation change (bright-line economic nexus).

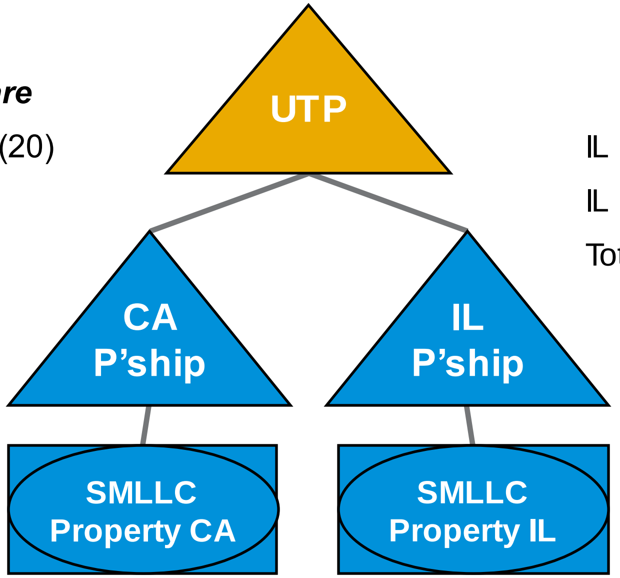
Example: Apportionment v. Allocation

UTP's Distributive Share

CA P'ship Income/(Loss): (20)

CA Sales: 200

Total Sales: 200



UTP's Distributive Share

IL P'ship Income/(Loss): 10

IL Sales: 100

Total Sales: 100

Apportionment method*

UTP federal income: (20) + 10 = (10)

CA Sales: 200; IL Sales: 100

Total Sales: 300

CA income: 200/300 * (10) = (6.6)

IL income: 100/300 * (10) = (3.3)

Apportionment results in CA/IL loss

Allocation method*

UTP federal income: (20) + 10 = (10)

CA income = 200/200 * (20) = (20)

IL income = 100/100 * 10 = 10

Allocation results in CA loss

Allocation results in IL income

**simplified example using only sales factor, assuming no conformity modifications, etc.*

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Tax reporting and planning issues – S corporations

State S Corporation Considerations

State conformity to federal treatment

— States that don't follow federal treatment

— Separate state elections

— Entity-level state and local taxes

— S Corporation built-in gains tax

Transactions - potential issues and opportunities

— IRC 338(h)(10) treatment

— Installment sale treatment

— Seller residency, sourcing gain, and credit for taxes paid

— Transaction taxes and successor liability

CA FTB Technical Advice Memorandum 2020-01

— Calculation of Shareholder Basis in an S corporation When Some Years are Closed by the Statute of Limitations

Credit for Taxes Paid - Updates

Massachusetts DOR Directive 19-1

— Massachusetts resident individuals get the state's credit for taxes paid (CFTP) to another state (i.e., section 6(a) credit) for individual's share of Connecticut passthrough entity tax

— Massachusetts will add back the individual's federal deduction for the Connecticut passthrough entity tax

Smith v. Robinson, Supreme Court of Louisiana (2/27/19)

— Affirmed lower court decisions that Louisiana resident could take CFTP for Texas Franchise Tax

— In invalidating a section of the Louisiana statutes, the court found impermissible double taxation that discriminated against interstate commerce in violation of the dormant Commerce Clause

Taxpayer v. Utah State Tax Commission (7/12/19)

— Utah part-year resident individual paid tax on municipal bond income to another state where he was a part-year resident

— Another state's tax can only be claimed in Utah CFTP if: 1) derived from sources within that other state, and 2) if that income is also subject to Utah taxation

— Taxpayer did not show this income was derived from sources within the other state and the part-year resident would need to show that income was taxed in both Utah and the other state

Illinois Credit for Taxes Paid Change

S.B. 1515 (8/26/19) - Replaces the prior "base of operations" rule

— Applicable for tax years ending on or after December 31, 2020

— Instead the new law provides that certain Illinois nonresidents spending more than 30 working days in Illinois during the year are deemed to earn compensation in Illinois

— Compensation paid in Illinois if:

  — The individual's service is performed entirely within the state (localized to IL);

  — The individual's service is performed both in and outside of Illinois, but the service performed outside Illinois is incidental to the individual's service is performed within Illinois (localized to IL), or

  — New section:

    - Some of the service is performed in the state (not localized to any state),
    - The service performed in Illinois is nonincedental to services performed outside state, and
    - Services performed in Illinois are for more that 30 working days during the tax year.

Credit for taxes paid limitation computation does not use the 30-day threshold:

$$\textit{IL CFTP limit} = \text{IL income tax} \times \frac{\text{IL inc sourced to other states using IL rules}}{\text{Federal AGI +/- IL modifications (IL inc)}}$$

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States pass-through entity taxation

Other SALT pass-through entity taxes

Examples of net income / gross receipts taxes on partnerships

— District of Columbia UBT

— Gross receipts taxes: Nevada, Ohio, Oregon (new), Texas, Washington

— Illinois Replacement Tax

— Kentucky LLET

— New Hampshire BPT and BET

— New York City UBT

— Other City taxes: California various cities (Los Angeles, San Francisco, etc.), Kentucky various cities (Occupational Tax), Michigan various cities, Missouri (Kansas City and St. Louis), Ohio various cities, Philadelphia, Portland / Multnomah County Tax, Virginia various cities (BPOL), West Virginia various cities (B&O), Tennessee Excise

Oregon Corporate Activity Tax

Oregon CAT applies to all types of business entities

— Effective for tax years beginning on or after Jan. 1, 2020 at rate of .57%

— No tax is due if taxable commercial activity does not exceed $1 million

Tax base and sourcing

— Total amount realized from business transactions and activity less 35% of greater of 1) cost of goods sold or 2) labor costs, not to exceed 95% of receipts

— 43 types of receipts excluded from “commercial activity” including:

- Proceeds from sale of IRC 1221, 1231 assets
- Dividends received
- Interest income for some taxpayers (but lenders may need to include)
- Distributive income from PTE
- Receipts from transactions among members of unitary group

— Management Fees (professional services)

- Section (4)(d)(C)(i)(II): “For purposes of assigning the receipts from a sale of a professional service, a taxpayer’s customer is the person that contracts for the service, irrespective of whether another person pays for or also benefits from the taxpayer’s services.” See Example 31 (no lookthrough up to a fund’s partners)

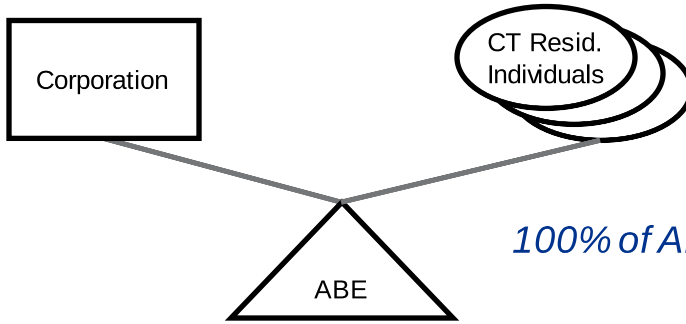
10k deduction limit – state reactions

Pass-through entity taxes post-TCJA

- Connecticut (mandatory) – starting TY18 for pass-through entities
  - TY19 changes: CT DRS SN 2019(6)
- Wisconsin (elective) – starting TY18 for S corporations and TY19 for partnerships
- Oklahoma (elective) – starting TY19 for pass-through entities
- Louisiana (elective) – starting TY19 for S corporations and other flow-through entities
- Rhode Island (elective) – starting TY19 for pass-through entities
- New Jersey (elective) – starting TY20 for pass-through entities
- Other proposals: Arkansas, Michigan, Minnesota, and New York State
- 2019-2020 Treasury and IRS Priority Guidance Plan (Mar. 2020 update)
  - PART 1 (TCJA): 13. Guidance on applying the state and local deduction cap under §164

CT Affected Bus. Entity (ABE) Example

50%/50% split ownership



100% of ABE income sourced to CT

ABE CT Tax	Corporation	CT Resid. Indiv.	Total
ABE CT-modified FTI (per K-1)	1,000,000	1,000,000	2,000,000
ABE Tax Rate			6.99%
ABE Tax			139,800
Partner share of ABE Tax	69,900	69,900	
Partner credit for ABE Tax - 87.5%	61,163	61,163	

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