A Primer on Income Tax Compliance for Multistate[1] Pass-Through Entities and Their Owners

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Abstract

Over the past 40 years, changes in the federal tax law and the development of new types of state authorized business entities have resulted in a massive shift in the federal tax reporting of business entities. Forty years ago, most businesses filed federal tax returns as C corporations. Now, business federal tax returns are predominantly filed as pass-through entities (*i.e.*, S corporations or partnerships). This shift has necessitated a greater focus by tax advisors and tax preparers on state tax compliance of multistate businesses operated as pass-through entities and on state tax compliance of the owners of the pass-through entities. The multitude of issues presented for state income tax compliance for multistate pass-through entities and their owners and the practical problems created for these businesses and their owners are examined in this Article.

I. Introduction

In the 1970s, corporate tax rates were lower than individual tax rates,[2] which thereby enabled businesses to grow more efficiently in a C corporation structure since more after-tax income could be reinvested for business growth in a C corporation structure than in other forms of business ownership. To the

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[1]While numerous municipalities throughout the United States impose income taxes, the focus of this Article will be on the income taxes of the states and the District of Columbia.

[2]*U.S. Federal Individual Income Tax Rates History, 1862–2013*, Tax Found., Oct. 16, 2013, http://taxfoundation.org/sites/taxfoundation.org/files/docs/fed_individual_rate_history_nominal.pdf; *Federal Corporate Income Tax Rates, Income Years 1909–2012*, Tax Found., July 6, 2012, http://taxfoundation.org/article/federal-corporate-income-tax-rates-income-years-1909-2012. In 1974, the maximum marginal federal corporate tax rate was 48% while the maximum marginal federal individual tax rate was 70% (maxed out at 50% with respect to earned income). *U.S. Federal Individual Income Tax Rates History, 1862–2013*, *supra*; *Federal Corporate Income Tax Rates, Income Years 1909–2012*, *supra*.

extent that the owner could justify salary payments as reasonable compensation, the owner could also avoid the principal disadvantage of C corporation status—double taxation on corporate earnings. The C corporation advantage of lower tax rates was further bolstered by the *General Utilities* doctrine,[3] which enabled owners to sell the business without imposition of taxes at the corporate level on the appreciation of the business assets. The combination of these factors enabled a business owner to avoid double taxation of corporate earnings and appreciation, operate as a C corporation to minimize current business income taxes on operations, and accumulate substantial equity in the business that was taxed only once to the shareholder at preferred capital gain rates upon the sale of the business.

II. C Corporation and Pass-Through Tax Filings

In 1980, roughly 53% of all businesses organized as entities filed tax returns as C corporations.[4] These entities reported over 92% of all business receipts of all businesses organized as entities.[5] While S corporations had been around for more than 20 years,[6] only 13% of entity business returns were S corporation returns,[7] and these returns reported only about 3.5% of all business receipts of businesses organized as entities.[8] Partnership tax filings represented

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[3]This doctrine arose out of the case Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). In *General Utilities*, the taxpayer distributed shares of Island Edison Company common stock to its shareholders as a dividend and the shareholders subsequently sold the distributed stock to Southern Cities Utilities Company. *Id.* at 202-03. The court ruled that the distribution of the appreciated stock to the taxpayer's shareholders did not trigger the recognition of gain on those shares by the distributing corporation. *Id.* at 206. While the case only involved the distribution of appreciated corporate stock, the doctrine was more broadly applied to negate any gain recognition on distribution of appreciated property to shareholders. *See, e.g.*, Commissioner v. Godley's Estate, 213 F.2d 529, 531 (3d Cir. 1954) ("There is no doubt, however, that [*General Utilities*] has received judicial and administrative acceptance as standing for the proposition that a corporation does not realize income from the distribution of property which has appreciated in value over its cost.").

[4]*SOI Tax Stats – Integrated Business Data*, Internal Revenue Serv., Table 1, Selected Financial Data on Businesses 1980–2008, Dec. 18, 2013, http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data. In 1980 there were 2,163,458 C corporation returns filed out of a total of 4,088,501 returns filed by C corporations, S corporations, and partnerships. *Id.* Regulated investment companies, which file on Form 1120-RIC, and real estate investment trusts, which file on Form 1120-REIT, are not included in the S corporation figures in this Article. While these entities are taxed in a similar manner to S corporations, there are relatively few tax returns filed by these entities and the total gross receipts of these entities are insubstantial when compared to those of the other types of business entities. *See id.*

[5]*Id.* In 1980, business receipts reported by C corporations on tax returns totaled $5,526,725,253,000 while total reported business receipts of C corporations, S corporations, and partnerships totaled $6,002,721,453,000. *Id.*

[6]S corporations were first authorized in 1958. Technical Amendments Act of 1958, Pub. L. 85-866, § 64(a), 72 Stat. 1606, 1650 (1958).

[7]*See supra* note 4. In 1980, there were 545,389 S corporation returns filed. *Id.*

[8]*Id.* Total business receipts reported by S corporations were $204,887,368,000. *Id.*

about a third of all business entity tax returns[9] but only about 4.5% of total business receipts of businesses organized as entities.[10] While there were far more businesses filing returns as sole proprietorships than as corporations or partnerships, the total business receipts reported by sole proprietorships was less than the total combined business receipts reported by S corporations and partnerships[11] and only a small fraction of the business receipts reported by C corporations.[12] Without doubt, C corporation structure was the preferred income tax structure for businesses.

By 2008, the total number of C corporation returns filed had actually declined significantly,[13] and C corporations had come to represent less than 20% of all business entity returns,[14] while S corporations had risen to over 45% of all business entity returns,[15] and partnership tax filings had risen to 35% of all business entity returns.[16] While C corporation business receipts on these returns remained substantially greater than those on returns of S corporations and partnerships,[17] the sheer volume of tax return filings by S corporations and partnerships revealed the tectonic shift in business tax return compliance that had occurred during this period.

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[9] *Id.* In 1980 there were 1,379,654 partnership returns filed. *Id.*

[10] *Id.* Total business receipts reported by partnerships were $271,108,832,000. *Id.*

[11] *Id.* In 1980, 8,931,712 individual returns reported business income out of a total of 13,021,904 total returns reporting business income. *Id.* However, the $411,205,713,000 of business income reported on individual returns comprised only about 6.5% of the $6,413,930,882,000 of business receipts reported on all returns. *Id.*

[12] *Id.*

[13] *Id.* The number of returns filed declined from 2,163,458 in 1980 to 1,782,478 in 2008. *Id.*

[14] *Id.* Total corporate and partnership returns reporting business income in 2008 was 8,993,227. *Id.*

[15] *Id.* In 2008 there were 4,049,944 S corporation returns filed. *Id.*

[16] *Id.* In 2008 there were 3,146,006 partnership returns filed. *Id.*

[17] *See id.* C corporations reported business receipts of $18,704,829,413,000 in 2008, while S corporations and partnerships reported $6,013,292,245,000 and $4,343,871,123,000, respectively. *Id.*

Figure 1. Entity Tax Return Filings, 1980–2008

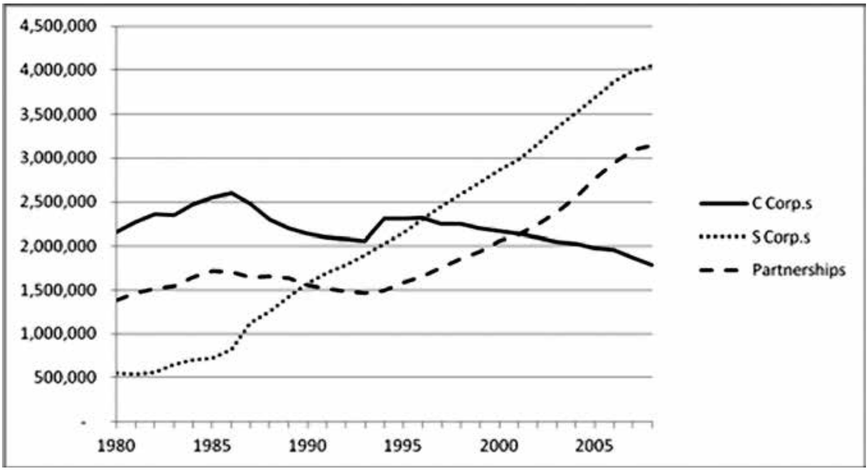
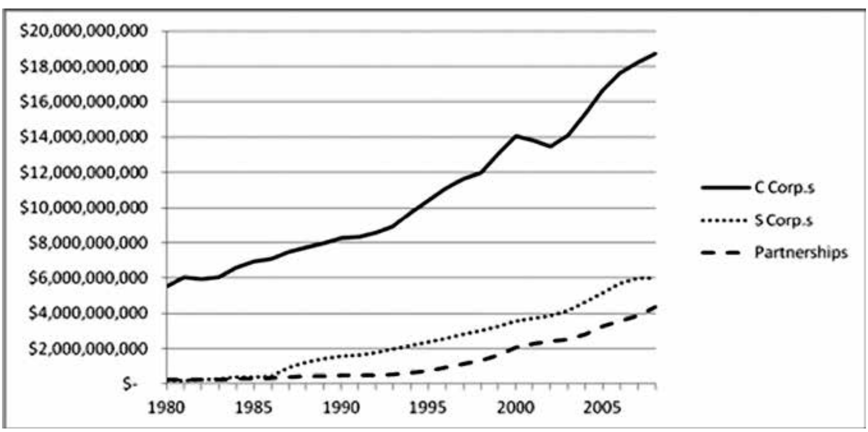


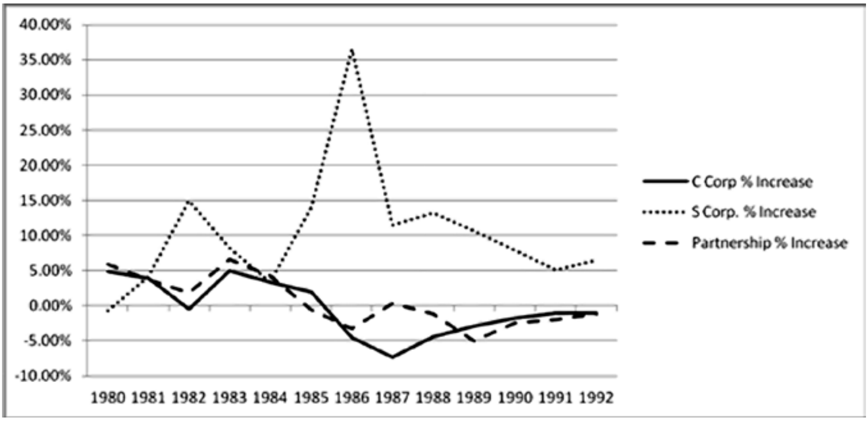
Figure 2. Entity Business Tax Receipts (in Thousands of Dollars), 1980–2008



Until the early 1990s, percentage increases in business tax filings of S corporations from year to year were consistently larger than for both C corporations and partnerships, with the percentage increase in S corporation filings being less than or equal to the percentage increase in C corporation or partnership filings only for a couple of years preceding the Tax Reform Act of 1986.[18] As might be expected, the most significant increase in these filings occurred in the years immediately following the enactment of the Tax Reform Act of 1986.[19]

[18] *See id.*; *infra* Figure 3.
[19] *See id.*; *infra* Figure 3.

Figure 3. Percentage Increase in Entity Tax Filings During Year, 1980–1992



III. Federal Tax Law Changes Influencing Choice of Entity

While the shift in business tax return filings occurred gradually over this period, several tax law changes were principally responsible for this shift. The most significant tax law change that contributed to these changes occurred in the Tax Reform Act of 1986,[20] which made two significant changes to the business tax environment affecting how businesses chose to be organized for tax purposes. The first was the inversion of tax rates in the 1986 Act pursuant to which, for the first time since the enactment of the federal income tax, top marginal corporate income tax rates were higher than the top individual income tax rates.[21] This change made it possible to reinvest more after-tax earnings for growth in an S corporation or partnership tax structure and to return more after-tax funds to the business owners than if the business was structured as a C corporation. The second was the repeal of the *General Utilities* doctrine in the Act,[22] resulting in C corporations no longer being able to avoid a corporate level tax on asset appreciation upon a distribution of appreciated assets, whether upon liquidation in connection with a sale of the business or otherwise.[23] In contrast, no entity level gain is recognized for partnerships[24] or for S corporations that have never been C corporations,

[20] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat 2085 (1986).

[21] *See supra* note 2. Following full implementation of the changes in the Act, the maximum marginal individual income tax rate by 1988 was 28% while the maximum marginal corporate tax rate was 34% (although the rate was actually 39% for income between $100,000 and $335,000 to eliminate the benefit of lower tax rates for higher income corporations). *Id.*

[22] Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(c), 100 Stat 2085, (1986) (codified in I.R.C. § 311(b)(1)).

[23] *See* I.R.C. § 311(b)(1).

[24] I.R.C. § 741.

and entity level gain of an S corporation that was previously a C corporation could be avoided if the corporation remained an S corporation for the requisite built-in-gains period before the sale or distribution of the appreciated asset.[25] The changes in the 1986 Act resulted in massive conversions of C corporations to S corporations by small businesses that could qualify for S corporation treatment. In the ten years from 1985 to 1995, the number of S corporation filings nearly tripled,[26] while the number of C corporation filings decreased by nearly ten percent.[27] Partnership tax filings also declined during this period by about eight percent,[28] due both to the crackdown on tax shelters resulting from the changes in the 1986 Act[29] and the adoption of the publicly traded partnership rules in 1987, which limited the availability of partnership tax filing status for partnerships with broad public ownership.[30] By the end of this period, there were nearly as many S corporation tax filings as there were C corporation filings, while ten years previously C corporation filings were more than triple those of S corporations.[31]

[25] I.R.C. § 1374(a). While S corporations that previously were C corporations are subject to a "built-in-gains" tax which operates in a similar fashion to the imposition of corporate-level taxes, this tax disappears if the sale occurs after the expiration of the built-in-gains tax period. § 1374(a), (c)(1). Under the law prior to 1986, this period was three years, but was extended to ten years in the 1986 Act. *Compare* I.R.C. § 1374(c)(1) (1982), *with* I.R.C. § 632(a) (1986). Since then the built-in-gains tax period has been reduced, although the reduction in term is scheduled to be phased out if not otherwise extended by future legislation. *See* I.R.C. § 1374(d)(7)(B)-(C). The Tax Reform Act of 1986 also significantly broadened the tax base by eliminating many deductions and also increased the application of the alternative minimum tax for both corporations and individuals. *See*, *e.g.*, Pub. L. No. 99-514, § 131, 100 Stat. 2085 (1986) (repealing deduction for two-earner married couples); Pub. L. No. 99-514, § 701, 100 Stat. 2085 (1986) (amending the alternative minimum tax).

[26] *See supra* note 4. S corporation filings increased from 724,749 in 1985 to 2,153,119 in 1995. *Id.*

[27] *Id.* C corporation filings dropped from 2,549,091 in 1985 to 2,312,382 in 1995. *Id.*

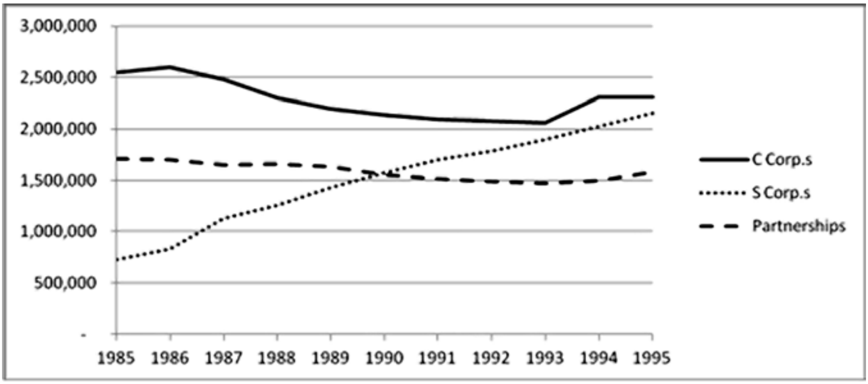
[28] *Id.* Partnerships filed 1,713,603 returns in 1985 and 1,580,900 returns in 1995. The decrease in partnership tax filings in the 1980s and early 1990s began to turn around in the early mid-1990s as LLCs began to gain in popularity. *See id.*

[29] The most significant change affecting tax shelters in the Tax Reform Act of 1986 was the enactment of the passive loss rule in section 469, which had the effect of disallowing current loss deductions on many partnership tax shelter investments.

[30] Added in Pub. L. No. 100-203, § 10211(a), 101 Stat. 1330 (1987). While the law provided a ten-year grandfathering period for existing partnerships, new partnerships which were publicly traded would be classified as corporations for tax purposes. I.R.C. § 7704(a), (g)(1). While there are exceptions to these rules for partnerships with at least 90% of their income consisting of passive income from certain natural resources industries, these rules nevertheless reduced the formation of new entities taxed as partnerships. *See* § 7704(c)(1)-(2), (d).

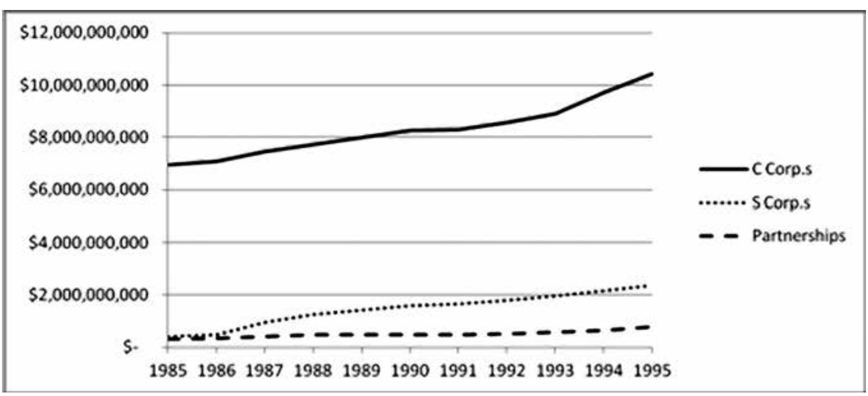
[31] *See supra* note 4.

Figure 4. Entity Tax Return Filings, 1985–1995



While C corporation business receipts remained much larger than business receipts of S corporations and partnerships, and while the business receipts reported by C corporations continued to increase during this period,[32] the rate of increase approximated the overall rate of inflation during that period.[33] In contrast, business receipts reported by S corporations increased by a factor of nearly six during the same time frame.[34]

Figure 5. Entity Business Tax Receipts (in Thousands of Dollars), 1985–1995



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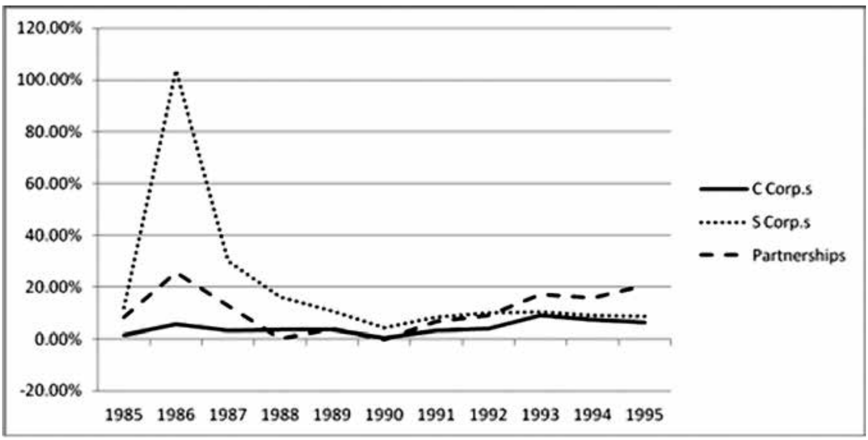
[32] *Id.* Business receipts reported on C corporations increased from $6,953,447,173,000 in 1985 to $10,419,343,855,000, an increase of nearly 50%. *Id.*; *see infra* Figure 5.

[33] During the same period, the CPI-U increased from 107.6 at the end of 1985 to 152.4 at the end of 1995, an increase of about 42%. Bureau Of Labor Statistics, Dep't Of Labor, CPI Detailed Report Feb. 2014, at 91 tbl.24 (2014), *available at* http://www.bls.gov/cpi/cpid1402.pdf.

[34] *See supra* note 4. S corporations reported business receipts of $416,041,188,000 in 1985 and $2,366,453,853,000 in 1995. *Id.*

The most dramatic increase in reported business receipts of S corporations occurred in the few years following the enactment of the Tax Reform Act of 1986 when numerous conversions from C corporations to S corporations occurred.[35] While partnership business receipts also showed a significant increase during this period, that increase was dwarfed by the increase in S corporation business receipts.[36] It was not until the mid-1990s that increases in business receipts from year to year for partnerships outpaced the increase for S corporations.[37]

Figure 6. Percentage Increase in Business Tax Receipts from Prior Year, 1985–1995



While C corporations could relatively easily convert to S corporation status without significant adverse tax effects,[38] a conversion of a C corporation to partnership tax status would in many cases involve the imposition of a significant tax bill since the conversion would be treated as a taxable liquidation of the C corporation.[39] This made the conversion from a C corporation to an S corporation a viable option, while the conversion of a C corporation to a partnership tax structure was generally not feasible.

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[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] The most significant detriment of a conversion from a C corporation to an S corporation occurred if the corporation accounted for its inventory for tax purposes on LIFO rather than FIFO. In that case, the corporation was required to recognize the difference between the LIFO and FIFO values of the inventory as income under section 1363(d) in the final C corporation year of the corporation. This cost, however, was attenuated somewhat by provisions which permitted the tax with respect to this income recognition to be paid over four years. I.R.C. § 1363(d)(2).

[39] *See* Reg. § 301.7701-3(g)(1)(ii), -3(g)(1)(iii); Rev. Rul. 63-107, 1963-1 C.B. 71.

IV. New Forms of Business Entities and Improved Tax Classification Clarity

The emergence of LLCs in the 1990s caused further changes in the business tax filing landscape. Wyoming adopted the first LLC act in 1977.[40] Because of the entity classification principles in force at the time,[41] there was initial uncertainty as to whether this new type of business entity would be taxed as a corporation or a partnership, and no other states adopted LLC implementing legislation until 1982.[42] A 1988 Service revenue ruling, however, confirmed that a Wyoming LLC would be taxed as a partnership,[43] which gave other states the impetus to adopt LLC legislation modeled on the Wyoming

[40] Wyoming Limited Liability Company Act, Wyo. Stat. Ann. § 17-15-103 (1977) (repealed 2010). Wyoming recently replaced its LLC Act with an updated version in 2010. *See* 2010 Wyoming Limited Liability Act, 2010 Wyo. Sess. Laws, ch. 94, § 1; Wyo. Stat. Ann. §§ 17-29-101 to -111.

[41] The criteria for business entity classification prior to 1997 were contained in Regulation section 301.7701-2(a)(1)(1996) and based the entity classification on a facts-and-circumstances analysis of six different corporate characteristics. If an entity were determined to have a preponderance of corporate characteristics it would be characterized as a corporation for tax purposes. *See* Reg. § 301.7701-2(a)(1)(1996). Since two of the characteristics at issue were common both to corporations and to partnerships and trusts, only four of the characteristics were usually at issue. *See id.*

[42] 1982 Fla. Laws ch. 82-177, §2 (codified as amended at Fla. Stat. § 608.401-.514).

[43] Rev. Rul. 88-76, 1988-2 C.B. 360.

law. As a result, 36 states had adopted LLC Acts by 1993.[44] In 1995, the Commissioners on Uniform Laws approved the Uniform Limited Liability Company Act,[45] and by 1997, all 50 states and the District of Columbia had

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[44] *See* Alabama Limited Liability Company Act, Act No. 93-724, 1993 Ala. Acts 1425 (enacted May 20, 1993) (codified at Ala. Code §§ 10-12-1 to -61 (1995)); Small Business Entity Tax Pass Through Act, Act 1003, 1993 Ark. Acts 2928 (enacted Apr. 12, 1992) (codified at Ark. Code Ann. §§ 4-3-101 to -32-1401 (Michie Supp. 1997)); Connecticut Limited Liability Company Act, Pub. Act No. 93-267, 1993 Conn. Acts 884 (enacted June 23, 1993) (codified at Conn. Gen. Stat. §§ 34-100 to -242 (West 1997)); Act of Apr. 5, 1993, No. 174, 1993 Ga. Laws 123 (enacted Apr. 5, 1993) (codified at Ga. Code Ann. §§ 14-11-100 to -1109 (1994 & Supp. 1998)); Act of Mar. 26, 1993, ch. 224, 1993 Idaho Sess. Laws 760 (enacted Mar. 26, 1993) (codified at Idaho Code Ann. §§ 53-601 to -672 (West 1994 & Supp. 1998)); Act of May 13, 1993, Pub. L. No. 8-1993, § 301, 1993 Ind. Acts 1694, 1970 (enacted May 13, 1993) (codified at Ind. Code Ann. §§ 23-18-1-1 to -13-1 (West 1994 & Supp. 1998)); Michigan Limited Liability Company Act, No. 23, 1993 Mich. Pub. Acts 138 (enacted Apr. 14, 1993) (codified at Mich. Comp. Laws Ann. §§ 450.4101 to -5200 (West Supp. 1998)); Act of July 2, 1993 §§ 359.700-359.832, 1993 Mo. Laws 965, 975-1003 (enacted July 2, 1993) (codified at Mo. Ann. Stat. §§ 347.010 to .187 (West Supp. 1999)); Montana Limited Liability Company Act, ch. 120, 1993 Mont. Laws 269 (enacted Mar. 18, 1993) (codified at Mont. Code Ann. §§ 35-8-101 to -1307 (1997)); Act of June 2, 1993, LB 121, §§ 1 to 45, 1993 Neb. Laws 333, 335-50 (enacted June 2, 1993) (codified at Neb. Rev. Stat. §§ 21-2601 to -2653 (1997)); Act of June 23, 1993, ch. 313, 1993 N.H. Laws 323 (enacted June 23, 1993) (codified at N.H. Rev. Stat. Ann. §§ 304-C:1 to -C:85 (1995 & Supp. 1998)); New Jersey Limited Liability Company Act, ch. 210, 1993 N.J. Laws 1215 (enacted July 30, 1993) (codified at N.J. Stat. Ann. §§ 42:2B-1 to -70 (West Supp. 1998)); Act of Apr. 7, 1993, ch. 280, §§ 1 to 74, 1993 N.M. Laws 2752, 2753-828 (enacted Apr. 7, 1993) (codified at N.M. Stat. Ann. §§ 53-19-1 to -74 (Michie Supp. 1998)); Act of July 15, 1993, ch. 354, § 1, 1993 N.C. Sess. Laws 1080, 1080-135 (enacted July 15, 1993) (codified at N.C. Gen. Stat. §§ 57C-1-01 to -10-07 (1997)); Limited Liability Companies, ch. 92, 1993 N.D. Laws 390 (enacted Apr. 12, 1993) (codified at N.D. Cent. Code §§ 10-32-01 to -156 (1995 & Supp. 1997)); Oregon Limited Liability Company Act, ch. 173, 1993 Or. Laws 435 (enacted June 24, 1993) (codified at Or. Rev. Stat. Ann. §§ 63.001-.990 (Supp. 1998)); An Act to Provide for Limited Liability Companies, ch. 344, 1993 S.D. Laws (enacted Mar. 13, 1993) (codified at S.D. Codified Laws §§ 47-34A-101 to -1207 (Michie Supp. 1998)); Act of Dec. 13, 1993, No. 112, 1993 Wis. Laws 708 (enacted Dec. 13, 1993) (codified at Wis. Stat. Ann. §§ 183.0102-.1305 (West Supp. 1998)).

[45] Uniform Limited Liability Company Act, 6B U.L.A. 545 (2008 & Supp. 2013).

enacted LLC implementing statutes.[46] By 2005, the number of LLC returns filed as partnerships had risen to a level above the combined number of general and limited partnership returns filed during that year. LLC returns filed as partnerships comprised 53% of all partnership returns and nearly half of the business receipts shown on partnership tax returns.[47] After 2005, the proportion of partnership returns filed by LLCs continued to grow.[48]

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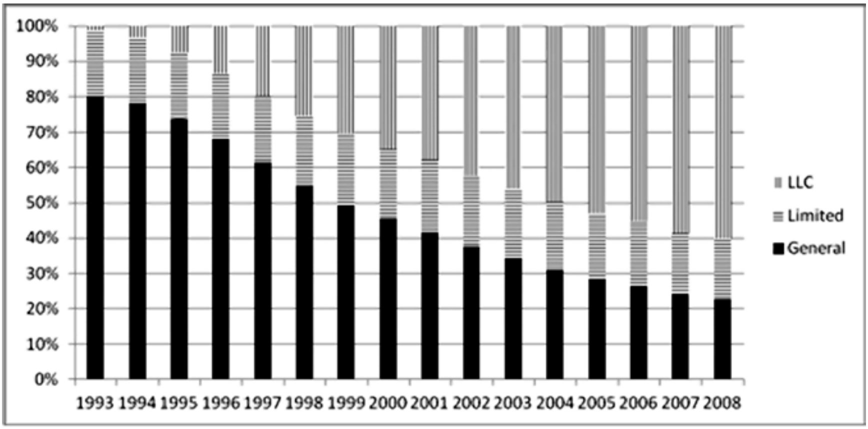
[46] *See* Limited Liability Company Act, 1994 Alaska Sess. Laws 1 (enacted June 8, 1994) (codified at Alaska Stat. §§ 10.50.010-.995 (1998)); California Limited Liability Company Act, 1994 Cal. Legis. Serv. 6009, 6025, ch. 1200, § 27 (West) (enacted Sept. 30, 1994) (codified at Cal. Corp. Code §§ 17000-17705 (West 1999)); D.C. Code § 29-101.01 (enacted 2010); 1996 Haw. Sess. Laws 92 (enacted June 7, 1996) (codified at Haw. Rev. Stat. §§ 428-101 to -1302 (West 1997)); 1994 Ky. Acts 389 (enacted Apr. 11, 1994) (codified at Ky. Rev. Stat. Ann. §§ 275.001-455 (West 1996)); Maine Limited Liability Company Act, 1994 Me. Legis. Serv. ch. 718 (West) (enacted Apr. 20, 1994) (codified at Me. Rev. Stat. Ann. tit. 31, §§ 601-762 (1996 & Supp. 1998)); An Act Relative to Business Organizations in the Commonwealth, 1995 Mass. Legis. Serv. ch. 281 (enacted Nov. 28, 1995) (codified at Mass. Gen. Laws Ann. ch. 156C, §§ 1-68 (West 1998)); Mississippi Limited Liability Company Act 1994, 2010 Miss. Laws ch. 532 (enacted 2010) (codified at Miss. Code Ann. §§ 79-29-101 to -1204 (West 1996 & Supp. 1998)); New York Limited Liability Company Law, 1994 N.Y. Laws 3240 (enacted July 26, 1994) (codified at N.Y. Ltd. Liab. Co. Law §§ 101-1403 (McKinney Supp. 1999)); 1994 Ohio Laws File 103 (enacted Apr. 15, 1994) (codified at Ohio Rev. Code Ann. §§ 1705.01-1705.58 (West 1994)); Limited Liability Act, 1994 Pa. Laws 703 (enacted Dec. 7, 1994) (codified at 15 Pa. Cons. Stat. Ann. §§ 8901-8998 (West 1995 & Supp. 1998)); South Carolina Limited Liability Company Act, 1994 S.C. Acts 343 (enacted June 16, 1994) (codified at S.C. Code Ann. §§ 33-44-101 to -1409 (Law Co-op. Supp. 1998)); Tennessee Limited Liability Act, 1994 Tenn. Pub. Acts 654 (enacted Apr. 22, 1994) (codified at Tenn. Code Ann. §§ 48-201-101 to -248-606 (West 1995 & Supp. 1998)); An Act Relating to Nonprofit Corporations: Limited Liability Companies: and Fraudulent Transfers, 1996 Vt. Acts & Resolves 567 (enacted May 22, 1996) (codified at Vt. Stat. Ann. tit. 11, §§ 3001-3162 (West 1997 & Supp. 1998)); 1994 Wash. Sess. Laws 1018 (enacted Apr. 1, 1994) (codified at Wash. Rev. Code Ann. §§ 25.15.005-.902 (West Supp. 1999)). For a thorough discussion on the birth and growth of LLC legislation, see generally Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 Ohio St. L.J. 1459, 1463-78 (1998).

[47] *SOI Tax Stats – Integrated Business Data*, *supra* note 4. In 2005, there were 1,465,223 partnership returns filed by LLCs out of a total of 2,763,625 total partnership returns filed. The LLCs reported business receipts of $1,602,977,271,000 while a total of $3,280,057,196,000 of business receipts were reported on all partnership returns. *Id.*

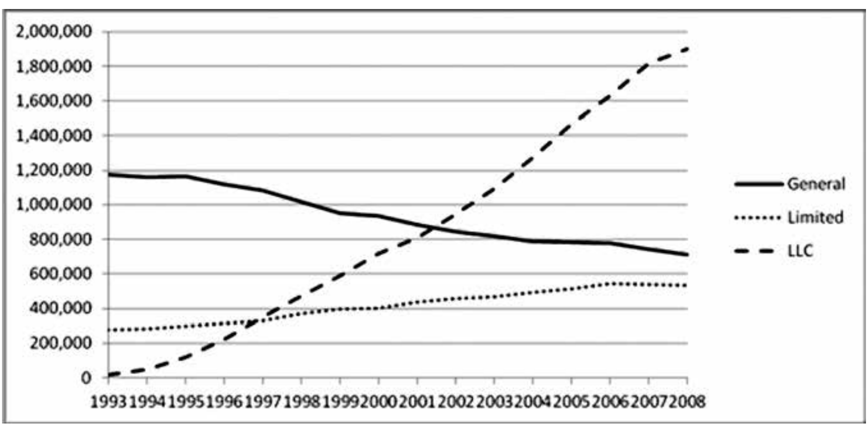
[48] *See id.*

Figure 7. Composition of Partnership Tax Filings, 1993–2008



During the period from 1993 through 2008, the number of general partnership filings declined significantly, the number of limited partnership filings increased at a steady rate, and the number of LLC filings exploded.[49]

Figure 8. Number of Partnership Tax Filings, 1993–2008



Interestingly, S corporation filings and total partnership tax filings grew at comparable rates during this period, with each rising by over 70% from 1995

[49] *See id.*; *infra* Figure 8.

to 2005.[50] Thus, despite the emergence of LLCs[51] and the greater flexibility offered by LLCs both with respect to ownership and capital structures as compared to S corporations, S corporations continued to grow in popularity during this period.

The adoption of the "check-the-box" regulations[52] in 1997 further contributed to the rise of partnership tax filings since they provided greater certainty for businesses regarding the method of federal income taxation than had previously been available. This certainty has resulted in partnership tax filings now growing at a slightly higher rate than S corporation tax filings.[53] From 1997 through 2008, partnership tax filings increased by 79%,[54] while S corporation tax filings increased by 65%.[55] These tax filing statistics, however, undoubtedly substantially understate the increase in LLC formation since they fail to account for single member LLCs, which are generally treated as disregarded entities under the "check-the-box" regulations and hence do not generate partnership tax returns.[56]

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[50] *Id.* There were 2,153,119 S corporation returns filed in 1995 and 3,684,086 filed in 2005, an increase of about 71%. *Id.* During the same period, total partnership tax filings increased from 1,580,900 in 1995 to 2,763,625 in 2005, an increase of almost 75%. *Id.*

[51] It is important to note that single member LLCs are generally treated as disregarded entities and hence do not file partnership tax returns. Reg. § 301.7701-3(a). As a result, these single member LLCs are not included in these statistics on partnership tax filings, at least after enactment of the "check-the-box" regulations.

[52] T.D. 8697, 61 Fed. Reg. 66584-01 (Dec. 18, 1996) (adopting Reg. § 301.7702-1 to -3).

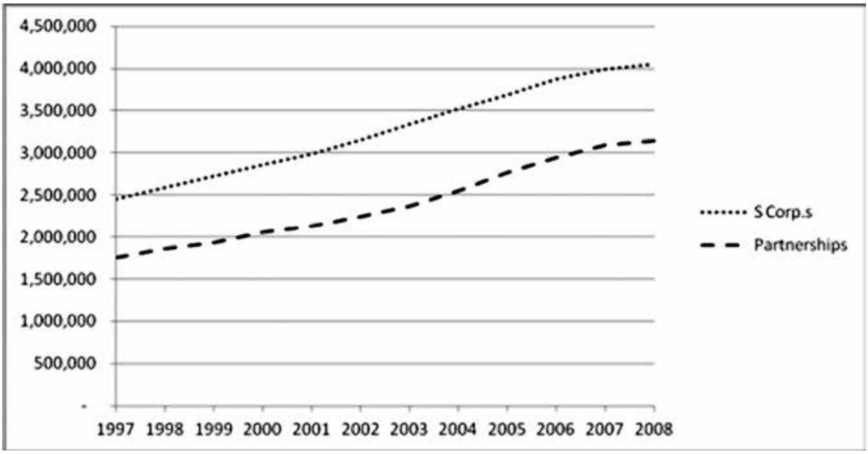
[53] *See infra* Figure 9.

[54] *SOI Tax Stats – Integrated Business Data, supra* note 4. Partnership filings increased from 1,758,627 in 1997 to 3,146,006 in 2008. This increase was attributable to an increase in LLC partnership tax filings, which rose from 349,054 to 1,898,178 during the same period. *Id.* During this time frame partnership tax filings by entities other than limited liability companies declined by about 11% from 1,409,573 to 1,247,828. *Id.*

[55] *Id.* S corporation filings increased from 2,452,254 in 1997 to 4,049,944 in 2008. *Id.*

[56] *See* Reg. § 301.7701-3(a).

Figure 9. Partnership and S Corporation Tax Filings, 1997–2008



The continued popularity of S corporations as a form of business organization has also been sustained by liberalization of the S corporation rules. The Subchapter S Revision Act of 1982[57] increased the number of permissible shareholders of S corporations from 15 to 35, thereby making S corporation status more broadly available to small businesses.[58] The Small Business Job Protection Act of 1996 increased the permissible number of shareholders again from 35 to 75 and additionally permitted new types of trusts to be shareholders of S corporations.[59] Perhaps most significantly, the 1996 Act for the first time permitted S corporations to have tax-exempt entities as shareholders.[60] This change enabled Employee Stock Ownership Plans (ESOPs) to be shareholders of S corporations, thereby enabling taxation of a significant amount of the income generated by the corporation to be deferred until the distribution of funds to "ESOP" participants upon retirement.[61] The American Jobs Creation Act of 2004[62] further liberalized the availability of S corporation status by increasing the number of permitted shareholders from 75 to 100 and by providing that members of the same family could be counted as one shareholder for purposes of the shareholder limit.[63]

The continuing growth in S corporation filings in the last 20 years is surprising to many professionals who see an LLC form of organization as preferable to an S corporation because of the absence of ownership and capital

[57] Pub. L. 97-354, §2, 96 Stat. 1669 (1982).

[58] *See, e.g.*, Jerald August, *Benefits and Burdens of Subchapter S in a Check-the-Box World*, 4 Fla. Tax Rev. 287 (1999).

[59] Pub. L. 104-188, §1301, 110 Stat. 1755 (1996).

[60] *Id.* § 1316.

[61] *See* I.R.C. § 1361(c)(6).

[62] Pub. L. 108-357, § 232, 118 Stat. 1418 (2004).

[63] *Id.* § 231.

structure restrictions with an LLC that exist with S corporations.[64] Moreover, the ease and general lack of adverse tax consequences of converting an LLC taxed as a partnership to a corporation taxed as a C corporation are not present in converting a corporation to partnership tax status.[65] Notwithstanding these advantages of an LLC taxed as a partnership over an S corporation, there are several reasons for the continuing popularity of S corporations. First, the liberalization of the S corporation rules identified above make the relative disadvantages of S corporation status less severe as compared to LLCs.[66] Second, S corporations present some opportunities to minimize employment taxes for owners that are not present in entities taxed as partnerships.[67] Third, the extraordinary benefits of ESOP ownership are only available to corporations, and hence, they can be utilized with an S corporation but not with an LLC or a partnership.[68] Finally, a C corporation can convert to an S corporation

[64] S corporations can only have certain types of entities as owners—principally certain trusts, estates, and tax exempt entities, see section 1361(c)—while LLCs are not limited as to their permissible owners. Moreover, S corporations can have only one class of stock (except for classes with different voting rights), see section 1361(b)(1)(D), (c)(4), while LLCs have the broad latitude on ownership interests which partnerships can have.

[65] An entity taxed as a partnership can generally convert to a corporation and have nonrecognition of gain on the transfer of the partnership assets to the corporation under section 351. In contrast, if an S corporation converts to a partnership, a deemed liquidation of the corporation occurs which triggers gain on the distribution of appreciated assets in the liquidation.

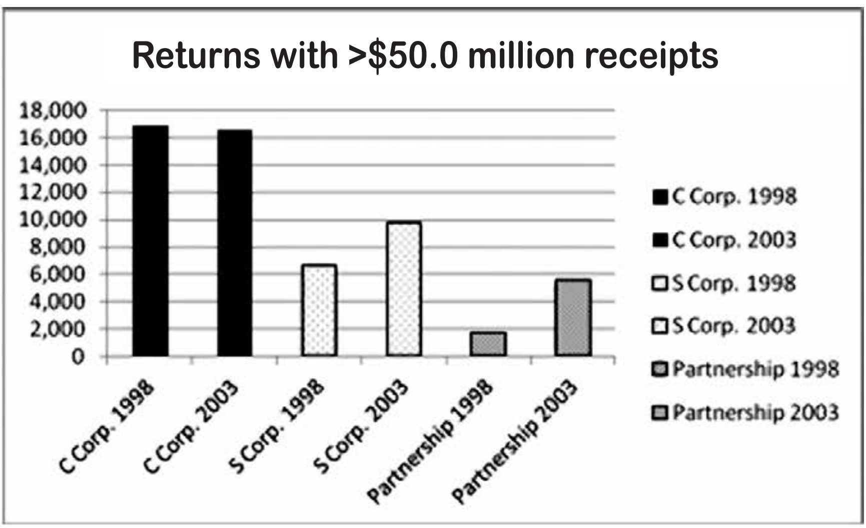
[66] *See, e.g.*, August, *supra* note 58.

[67] Taxpayers have attempted to exploit the differences between the Federal Insurance Contributions Act (F.I.C.A.) and the self-employment tax to reduce their employment tax liabilities. The self-employment tax consists of “net earnings from self employment” which generally covers any earnings from a trade or business carried on by such individual, I.R.C. § 1402(a), but excluding the distributive share of any item of income or loss of a limited partner (other than guaranteed payments as remuneration for services rendered). I.R.C § 1402(a)(13). This definition means that a partner’s distributive share of business income in an entity taxed as a partnership is generally regarded as self-employment income subject to the self-employment tax if the taxpayer materially participates in the business. In contrast, F.I.C.A. is imposed only on “wages” as defined in section 3121(a). Many taxpayers have attempted to avoid employment taxes by forming an S corporation in which to conduct business and then paying only a nominal salary for their services rendered, paying out most of the earnings as dividends, and claiming that F.I.C.A. is imposed only on the salary portion of their earnings from the business. These positions have met with limited success and the Service has in many cases been successful in recharacterizing all or part of the dividend payments as wages in professional services S corporations. *See* Watson v. United States, 668 F.3d 1008, 1018 (8th Cir. 2012); Spicer Accounting, Inc. v. United States, 918 F.2d 90, 93 (9th Cir. 1990); Joseph Radtke, S.C. v. United States, 712 F. Supp. 143, 145-46 (E.D. Wisc. 1989). *See also* Rev. Rul. 73-361, 1973-2 C.B. 331 (1973). Nevertheless, an S corporation can still minimize employment taxes to the extent the wages paid can be justified as reasonable compensation. Rev. Rul. 74-44, 1974-1 C.B. 287 (1974).

[68] Section 409 sets forth the requirements for ESOPs. An ESOP is a defined contribution plan formed to invest primarily in employer securities. § 409(a)(2). Section 409(*l*) defines employer securities in terms of common stock, which necessarily limits its application to equity interests in corporations. Thus, a plan of an entity taxed as an S corporation will qualify while a plan of an entity taxed as a partnership will not.

with less adverse tax consequences than converting to a partnership,[69] thereby maintaining the viability of S corporations to C corporations desiring to gain the tax benefits of pass-through tax treatment.

As the number of pass-through tax filings has increased, the relative size of pass-through entities has also increased. While C corporations as a group continue to dominate the ranks of larger business entities, in recent years pass-through entities have begun to catch up. In 1998, two-thirds of entity filings of entities with more than $50.0 million of annual receipts were C corporations, while about a quarter of those entities were S corporations and a very small portion were partnerships.[70] Five years later slightly over 50% of such entity filings were C corporation filings, with S corporation filings growing to over 30% of all such filings and partnerships growing to about 18% of such filings.[71] During this time frame the actual number of C corporations filing returns showing greater than $50.0 million of business receipts actually declined, while the number of S corporations showing greater than $50.0 million of business receipts increased by 46% and the number of partnerships showing greater than $50.0 million of business receipts increased a whopping 232%.[72]



[69] A C corporation which maintains inventory on a LIFO basis must, however, recognize as income the difference between the LIFO and FIFO value of the inventory on a conversion to S corporation status. *See supra* note 38.

[70] *SOI Tax Stats – Integrated Business Data*, *supra* note 4, at tbl.2, Number of Businesses, Business Receipts, Net Income, Deficit and Other Selected Items, by Form of Business, Industry and Business Receipt Size, Tax Year 1998. In 1998, there were 25,227 total business entities filing returns and showing $50.0 million or more of business receipts. *Id.* Of these, 16,878 were C corporations, 6,664 were S corporations, and only 1,685 were partnerships. *Id.*

[71] *Id.* Of these, 16,516 were C corporations, 9,757 were S corporations, and 5,603 were partnerships. *Id.*

[72] *See supra* notes 70-71.

Federal tax law changes since the 1986 Act have diminished the relative tax benefits of pass-through tax status as compared to C corporation status.[73] Proposed corporate tax reform may further diminish those relative benefits.[74] However, notwithstanding those changes, pass-through tax status remains beneficial to many small businesses because of the avoidance of double taxation on corporate earnings and asset appreciation and because of the increased tax basis owners acquire with respect to retained business earnings, which decreases taxable gain upon sale of the interest.[75] Barring major future tax law changes, pass-through tax treatment will likely remain the tax treatment of choice for small businesses for the foreseeable future.

V. Pass-Through Entity Tax Compliance

In many respects the tax compliance issues for a pass-through entity are similar to those presented to C corporations. There are, however, some issues pass-through entities must deal with that are not confronted by C corporations. In addition, unlike C corporations, pass-through entities need to be concerned about how their tax compliance decisions affect their owners' tax

[73] Individual income tax rate changes since 1993 have eliminated the rate inversion enacted in the Reagan years and returned to the traditional approach in which top marginal individual rates exceed the top marginal corporate rate. From 1993 through 2000, the top marginal individual rate was 39.6% while the top marginal corporate rate was 35% beginning in 1994 (34% in 1993). While the top marginal individual and corporate rates were the same (35%) from 2003 through 2012, in 2013 the top marginal individual rate was returned to its level of 20 years earlier (39.6%) while the corporate rate remained at 35%. *See* Federal Individual Income Tax Rates History, *supra* note 2; Federal Corporate Income Tax Rates, *supra* note 2. The enactment of the net investment income tax further decreased the relative benefits of pass-through entities since the tax is effectively a rate increase for high-income owners of pass-through entities who are not active in the day-to-day operations of the business. All of these changes eliminated the rate inversion benefit of pass-through tax status, although the elimination of double taxation of corporate earnings and appreciation remain a benefit of pass-through tax status.

[74] On July 30, 2013, in a speech in Tennessee, President Obama outlined a tax reform proposal designed to reduce the top corporate tax rate to no higher than 28%. *Fact Sheet: A Better Bargain for the Middle Class: Jobs*, White House, July 30, 2013, http://www.whitehouse.gov/the-press-office/2013/07/30/fact-sheet-better-bargain-middle-class-jobs. The proposal, called the "Pro-Growth Tax Reform and Jobs Package" received vociferous opposition from congressional Republicans on the basis that, despite the significant rate decrease for C corporations, the proposal purported to increase net government revenues through the elimination of various deductions and credits and to use those increased revenues to increase federal spending. The proposal also has received vocal criticism from pass-through entity trade groups for providing only corporate rate reductions without any corresponding individual tax rate changes.

[75] Pass-through entities not only generally avoid double taxation on distributed business earnings, but retained earnings of the business also increase the taxpayer's income tax basis in his or her equity interest, thereby reducing the taxable gain upon the sale or exchange of such interest. I.R.C. §§ 705, 1367. In addition, asset appreciation within partnerships does not sustain an entity level of taxation on sale and such appreciation within S corporations does not result in an entity level of taxation on sale except in limited circumstances. *See supra* notes 24-25 and accompanying text.

compliance. With a C corporation, if an item is adjusted upon audit, the effect is internal to the corporate taxpayer and does not directly affect its shareholders' tax filings. In contrast, with pass-through entities, adjustments to the pass-through entity tax return inevitably affect the tax returns of all of its owners as well. Therefore, the tax compliance consequences of taking an erroneous position on a tax issue for a pass-through entity are far more severe than for C corporations, since an audit adjustment will not only affect the entity return but all owners of the entity as well. With pass-through entities that have numerous owners, this concern is a significant consideration to be taken into account by tax preparers. It also undoubtedly has an impact on the willingness of pass-through entities to take aggressive tax reporting positions as compared to their C corporation brethren.

VI. Determination of State Tax Filing Requirement

The threshold state tax issue for pass-through entities is fundamentally the same as for C corporations: Is the entity required to file a state income tax return? This determination is a function of analyzing whether the pass-through entity has "minimum contacts" in the state sufficient to subject the entity and its owners[76] to the taxing jurisdiction of the state and whether the pass-through entity can utilize the protection from state income taxation offered by Public Law 86-272.[77]

The Due Process Clause and the Commerce Clause of the U.S. Constitution prohibit a state from taxing a nonresident entity or individual unless the contacts of such entity or individual are sufficient to create "nexus."[78] The seminal U.S. Supreme Court cases on nexus specifically deal with sales and use tax.[79] These cases specifically require a physical presence in the taxing state in order for a state to have a sufficient nexus to require the collection of sales and use tax.[80] Such physical presence historically has been established by the presence of property within the state or the existence of a business office within the state.[81] In some cases, the regular and systematic presence of out-of-state property or employees within the state has also been regarded as sufficient to establish physical presence in the state, such as, for example, when the

[76] See *infra* note 222 for a discussion of the jurisdiction of states to tax passive investors in pass-through entities whose only contact with the state is the ownership of the interest in the pass-through entity.

[77] 15 U.S.C. § 381 (2012).

[78] Quill Corp. v. North Dakota, 504 U.S. 298, 313 (1992).

[79] Nat'l Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753 (1967); *Quill Corp.,* 504 U.S. at 298. It is noteworthy that the United States Supreme Court has consistently refused to grant certiorari in the cases involving "economic nexus" for income tax purposes discussed below.

[80] *Quill Corp.*, 504 U.S. at 312.

[81] *Bellas Hess*, 386 U.S. at 754.

taxpayer regularly delivers its products to customers within the state through the use of its own delivery vehicles rather than by common carrier.[82]

States have also asserted nexus for imposition of state income taxes when the taxpayer undertakes activities within the state through the use of independent contractors rather than with employees. As long as the activities of the independent contractor would subject the taxpayer to tax in the state were they conducted by employees, nexus will exist.[83] In *Scripto, Inc. v. Carson*, the Supreme Court held that marketing activities of independent contractors in Florida created nexus for collection of Florida sales tax.[84] The holding in *Scripto* was reaffirmed 25 years later in *Tyler Pipe Industries v. Department of Revenue*[85] in which the court held that nexus for imposition of Washington's business and occupation tax existed by virtue of in-state activities of independent contractors engaged by the taxpayer.[86]

As a result of these cases, the Multistate Tax Commission has taken the position that mail-order sellers who provide warranty services to customers through third-party service providers create a constitutional nexus for sales and use tax purposes.[87] This approach has been sustained in court decisions in several states.[88]

A number of states have also taken the position that common ownership of a mail-order entity without physical presence in the state and an affiliate

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[82] Several states have held that a regular and systematic presence of company-owned trucks making delivery within the state subjects the company to state income tax liability. Brown's Furniture, Inc. v. Wagner, 665 N.E.2d 795, 803 (Ill. 1996); Town Crier v. Dep't of Revenue, 733 N.E.2d 780, 786 (Ill. App. Ct. 2000); John Swenson Granite Co. v. State Tax Assessor, 685 A.2d 425, 429 (Me. 1996). In addition, until 2001 the Multistate Tax Commission took the position that shipping or delivering goods by means of a company's vehicles was an unprotected activity under Public Law 86-272. The Commission has since amended its guideline and now does not list this as either an unprotected or a protected activity. Multistate Tax Commission, Statement of Information Concerning Practices of Multistate Commission And Signatory States Under Public Law 86-272 (2001). However, some state courts have held that such activity is protected under Public Law 86-272. Nat'l Private Truck Council v. Va. Dep't of Taxation, 480 S.E.2d 500, 501-02 (S.C. 1997); Nat'l Private Truck Council v. Commissioner, 688 N.E.2d 936, 939-40 (Mass. 1997). In addition, several other states' revenue departments have taken the position that delivery in company-owned vehicles may be protected under Public Law 86-272. Rev. Rul. 24-01-01, Neb. Dep't of Revenue (Feb. 22, 2001); Decision No. 2005-05-10-22, Okla. Tax Comm. (May 10, 2005); Ala. Admin. Code r. 810-27-1-4-.19.

[83] Scripto, Inc. v. Carson, 362 U.S. 207, 211 (1960).

[84] *Id.*

[85] 483 U.S. 232, 250 (1987).

[86] It is noteworthy that while some independent contractors will be sheltered from creating tax liability for the entity in the state by virtue of Pub. L. No. 86-272, that was not the case in *Tyler Pipe* since the Washington tax at issue was a gross receipts tax and not a tax on net income to which Pub. L. No. 86-272 applies. *Id.* at 248.

[87] Multistate Tax Commission, Nexus Bulletin 95-1 (1995, rev. 1996).

[88] Dell Catalog Sales L.P. v. N.M. Taxation and Revenue Dep't, 199 P.3d 863, 872-73 (N.M. Ct. App. 2008), *cert. denied*, 556 U.S. 1148 (2009); State v. Dell Int'l, Inc., 922 So. 2d 1257, 1264, 1266 (La. Ct. App. 2006).

that has physical presence in the state is sufficient to create nexus for the mail-order company if the in-state affiliate makes substantial sales in the state.[89] While some state courts have held that common ownership by itself does not create nexus for the out-of-state entity,[90] other courts have held that nexus exists when the actions of the affiliate directly benefit the business of the out-of-state entity so as to make the in-state affiliate effectively an agent of the out-of-state entity.[91]

In recent years, a number of states have also enacted "click through" nexus provisions for sales and use tax purposes pursuant to which an internet seller is regarded as subject to state taxing jurisdiction when the internet seller refers customers to an in-state business for a commission if the referred sales within the state and total sales within the state are in excess of specified annual dollar figures.[92]

Since the U.S. Supreme Court cases addressing the nexus requirement specifically involved only the constitutional requirements for imposition of sales taxes,[93] states have continued to aggressively assert that nexus can be established for state income tax purposes through an economic presence in the state even though the entity may not have physical presence in the state through the presence of property or employees within the state.[94] The source of the states' positions can be found in language in *Tyler Pipe* approving of the Washington Supreme Court's determination that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."[95] The states' claims to

[89] SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (1995).

[90] Current, Inc. v. State Bd. of Equalization, 29 Cal. Rptr. 2d 407, 412 (Cal. Ct. App. 1994); SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666, 673 (Conn. 1991); Bloomingdale's By Mail, Ltd. v. Pennsylvania, 567 A.2d 773, 777-78 (Pa. Commw. Ct. 1989).

[91] Borders Online, Inc. v. State Bd. Of Equalization, 29 Cal. Rptr. 3d 176, 182 (Cal. Ct. App. 2005).

[92] 2011 Cal. Stat. ch. 7, AB 28; 2008 Idaho Sess. Laws ch. 49.

[93] As noted below, the United States Supreme Court has consistently denied certiorari in economic nexus cases decided by state courts related to income tax nexus.

[94] Imposing a higher standard on nexus for sales and use taxes than for income taxes makes sense for a number of reasons. First, because of the proliferation of local sales taxes and a relatively smaller increase in the number of jurisdictions imposing local income taxes, the compliance burden for sales taxes is potentially much greater for sales taxes than income taxes. Secondly, the sales tax and the income tax measure different types of economic activity. A sales tax is imposed only on a sale, which logically requires a very specific *situs* to determine the taxing jurisdiction, and physical presence more clearly delineates that *situs*. An income tax, however, measures general economic activity within a jurisdiction, which may not require physical presence for the business to gain benefits from such activity. Third, since a sales tax is actually imposed on the purchaser with the seller acting as collection agent for the tax, it simply seems less fair to impose tax liability on the seller than with income taxes.

[95] Tyler Pipe Indus. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987) (quoting Tyler Pipe Indus. v. State Dep't of Revenue, 715 P.2d 123, 126 (Wash. 1986)).

jurisdiction to impose income tax based on an economic nexus have found a favorable reception in the state courts.

Many states have been successful in asserting that the licensing of intangibles to other entities located within the state for the production of income is sufficient to create the economic presence by the out-of-state entity necessary to establish nexus. For instance, in *Geoffrey, Inc. v. South Carolina Tax Commissioner*,[96] the South Carolina Supreme Court held that a trademark holding company with no physical presence in the state was subject to the taxing jurisdiction of the state when it licensed its trademarks and trade names to affiliates within the state in exchange for a percentage of net sales. Cases in most other states have reached similar conclusions.[97] Since the royalties and franchise fees paid by the in-state entities to the out-of-state entities reduce the income of the affiliated in-state entity subject to state income tax, these cases served to prevent companies from reducing their income subject to state income tax simply through the use of affiliated trademark licensing companies. These cases thus served to prevent tax avoidance through the use of affiliated entities.

A broader application of the principle that licensing of intangibles creates nexus was found in *KFC Corp. v. Iowa Department of Revenue*,[98] in which an out-of-state corporation was found subject to Iowa income tax because of its receipt of franchise fees paid by independent Iowa franchisees. In that case the Iowa Supreme Court found that KFC had nexus for income taxation in Iowa, concluding that the licensing by KFC of its trademarks and other intangibles for use in Iowa was the functional equivalent of physical presence under *Quill*.[99] The *KFC* case constituted a major extension of the principles asserted in the *Geoffrey* case since the revenue from intangibles was generated from payments by independent parties rather than by affiliates.[100] Thus, unlike the trademark holding company cases, the *KFC* case did not represent a state tax dodge by members of an affiliated group. Instead it represented application of a broader economic nexus principle that any licensing of intangibles for profit may subject an out-of-state entity to state taxing jurisdiction.

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[96] 437 S.E.2d 13, 19 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

[97] *See* Dep't of Revenue v. Gap (Apparel) Inc., 886 So. 2d 459, 462 (La. Ct. App. 2004); SYL, Inc. v. Comptroller, 825 A.2d 399 (Md. 2003); Geoffrey, Inc. v. Commissioner, 899 N.E.2d 87, 92-93 (Mass. 2009), *cert. denied*, 557 U.S. 920 (2009); Lanco, Inc. v. Div. of Taxation, 908 A.2d 176, 176-77 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); Kmart Properties, Inc. v. Taxation and Revenue Dep't, 131 P.3d 27, 38 (N.M. Ct. App. 2001), *rev'd*, 131 P.3d 22 (N.M. 2005); A & F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004), *appeal dismissed*, 611 S.E.2d 168 (N.C. 2005); Geoffrey, Inc. v. Tax Commissioner, 132 P.3d 632, 638-39 (Okla. Civ. App. 2005). However, at least one court has held that a trademark holding company did not have nexus by virtue of licensing trademarks to entities within the state because of the lack of physical presence in the state. *See* ACME Royalty Co. v. Brick Inv. Co., 96 S.W.3d 72, 75 (Mo. 2002).

[98] 792 N.W.2d 308, 323-24 (Iowa 2010).

[99] *Id.*

[100] *See id.* at 309.

In recent years, a number of states have also found nexus to exist for state income tax purposes when a taxpayer without physical presence in the state has substantial economic presence in the state as evidenced by certain types of efforts to seek business from residents of the state.[101] For instance, in *Tax Commissioner v. MBNA America Bank, N.A.*[102] the West Virginia Supreme Court held that a bank's economic presence in the state was sufficient to find nexus for state income tax purposes when it issued and serviced credit cards for customers in the state notwithstanding the bank's lack of physical presence in the state. A similar result was reached in *Capital One Bank and Capital One F.S.B. v. Commissioner of Revenue*.[103] Notwithstanding the foregoing, a few states have followed the lead of the Multistate Tax Commission's model statute for application of the physical presence requirement for taxing jurisdiction[104] to provide by statute or regulation that there is no economic nexus as long as certain of the applicable apportionment factors in the state are less than a threshold amount.[105]

Under the auspices of federal power to regulate interstate commerce, in 1959 Congress provided for a safe harbor limited exemption from state income taxation under certain circumstances in Public Law 86-272.[106] This law prohibits a state from imposing a net income tax if the taxpayer's only in-state business activity consists of solicitation of orders by representatives for sales of tangible personal property and if the orders are approved or rejected outside of the state and filled by shipment or delivery from a point outside the state.[107]

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[101] See, for example, Or. Admin. R. 150-317.010 (2014), which presents this position by regulation.

[102] 640 S.E.2d 226, 235-36 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

[103] 899 N.E.2d 76 (Mass. 2009), *cert. denied*, 557 U.S. 919 (2009). *See also* MBNA America Bank v. Ind. Dep't of Revenue, 895 N.E.2d 140 (Ind. T.C. 2008).

[104] Multistate Tax Commission, Factor Presence Nexus Standard for Business Activity Taxes (2002). This model statute provides that substantial nexus for imposition of state business activity taxes (including taxes based on net income) only exists for an out-of-state entity if the entity's property, payroll, or sales in the state exceeds either $50,000 of property, $50,000 of payroll, or $500,000 of sales. *Id.* Since few states have adopted the model legislation, even an insubstantial amount of property, payroll, or sales within a state may be sufficient to create nexus under the views of most state taxing departments.

[105] See, for example, Cal. Rev. & Tax Code § 23101(b) (West 2014), which provides that nexus for an out of state entity exists if sales in the state exceed the lesser of $500,000 or 25% of the taxpayer's total sales, or if property within the state exceeds the lesser of $50,000 or 25% of total property, or if payroll exceeds the lesser of $50,000 or 25% of total payroll. *Id.* Colorado by regulation imposes a similar standard for the imposition of state income tax on out-of-state entities. Colo. Code Regs. § 39-22-301.1(2)(b) (2014).

[106] Pub. L. No. 86-272, § 101, 73 Stat. 555 (1959) (codified as 15 U.S.C. § 381). This law was a reaction to the United States Supreme Court's decision in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 452-54 (1959) in which the court held that a small sales force and office within a state was sufficient to establish nexus for state income tax purposes. *Id.*

[107] 15 U.S.C. § 381(a) (2012).

While at first blush Public Law 86-272 would appear to provide a broad exemption from state taxation, it is actually quite limited since: (1) it only applies to state taxes on net income and not state taxes on gross receipts, franchise taxes, or other similar fees imposed on entities, (2) it protects only sales of tangible personal property and not leasing of tangible personal property or the licensing of intangibles or sales of services,[108] and (3) it does not insulate the entity from taxation if the actions of the representative in the state exceed the mere solicitation of orders that are accepted outside the state by shipments originating outside the state.[109] The very limited application of this statute was highlighted in *Wisconsin Department of Revenue v. Wrigley* in which the United States Supreme Court held that activities in the state which were more than *de minimus* in nature and which are not ancillary to the solicitation of orders prevented the protection of Public Law 86-272 from applying to the taxpayer.[110]

The Multistate Tax Commission attempts to limit the application of Public Law 86-272 to the maximum extent possible by indicating that it is the intent of the state signatories to impose their net income tax to the fullest extent constitutionally permissible subject to state and federal legislative limitations, and that only activities that fall within the clear and manifest purpose of Congress will result in taxpayer exemption from imposition of state income tax under Public Law 86-272.[111] The Multistate Tax Commission's guidelines provide that ancillary activities are only those activities that serve no independent business function apart from their connection to the solicitation of orders and *de minimus* activities are only those activities that taken together establish only a trivial connection with the state.[112] The Multistate Tax Commission provides an extensive listing of in-state activities that are not considered solicitation of orders or ancillary thereto (and therefore not protected activities if performed at more than a *de minimus* level), including activities such as making repairs to property, collecting delinquent accounts, investigating customer credit worthiness, installation, conducting training, resolving customer complaints, and numerous other activities.[113] While the Multistate Tax Commission also lists several activities that will be deemed protected, it is nevertheless quite easy for a business's in-state activities to extend

108 This limitation on the scope of Public Law 86-272 is particularly significant today, as our economy has transformed from one principally dependent upon the sale of products which constitute tangible personal property to one tied more significantly to the sale of services and the licensing of intangible property.

109 15 U.S.C. § 381.

110 505 U.S. 214, 228-32 (1992). In *Wrigley*, the court held that the actions of the taxpayer's representative in the state in replacing stale gum, supplying gum for displays, and storing gum were not ancillary to solicitation of orders and, since conducted on more than a *de minimus* basis, were activities beyond the protection of Pub. L. No. 86-272. *Id.* at 235.

111 Multistate Tax Commission, Statement of Information Concerning Practices of Multistate Commission and Signatory States Under Public Law 86-272 (2001).

112 *Id.*

113 *Id.*

beyond the protected activities.[114] Moreover, the Multistate Tax Commission makes little effort to define what activities establish only a "trivial connection" with the state so as to avoid the taxing jurisdiction of a state. While the position statement of the Multistate Tax Commission is not law, it pretty clearly expresses the intentions of the member states regarding enforcement and is looked to by nonmember states for the same purpose.

A number of states impose taxes and fees that are not taxes on net income and therefore not protected by Public Law 86-272. These taxes are generally of two types: (1) taxes on gross receipts in lieu of an entity tax on net income,[115] and (2) franchise, privilege taxes, or fees imposed for the privilege of doing business within the state that are not measured by entity net income.[116] These taxes are generally not prohibited by Public Law 86-272 since they are not taxes measured by net income.[117] In addition, a majority of states with income taxes impose state income taxes on S corporations with

[114]It is telling that the Multistate Tax Commission guidance with respect to Public Law 86-272 lists 21 activities that are not protected but only 13 activities that are protected. *Id.*

[115]Three states without a corporate income tax impose gross receipts taxes—Ohio, Texas, and Washington. Ohio Rev. Code Ann. § 5751.02 (West 2014); Tex. Tax Code Ann. §§ 182.021-182.121 (West 2014); Wash. Rev. Code Ann. § 82.04.220 (West 2014). However, these taxes apply not only to C corporations but also to S corporations, LLCs, partnerships, and, in the case of Washington, sole proprietorships. Ohio imposes a commercial activity tax based upon gross receipts if the business receipts, property, or payroll within the state exceed the standards for nexus provided by the Multistate Tax Commission. Ohio Rev. Code Ann. § 5751.01(E)(1) (West 2014). Texas imposes a business margins tax based upon the lower of gross revenue less cost of goods sold, gross revenue less compensation, or 70% of gross revenue. Tex. Tax Code Ann. § 171.101 (West 2014). Washington also imposes a business and occupation tax based on gross receipts in the state based upon modified standards for nexus. Wash. Rev. Code Ann. § 82.04.066 (West 2014). Michigan had previously provided a Single Business Tax imposed on gross receipts within the state in addition to its corporate income tax, but it was repealed effective for tax years ending after 2008. Mich. Comp. Laws Ann. § 208 (West 2014).

[116]Nearly all states impose franchise taxes or filing fees on business entities as a condition to doing business in the state which are not measured by the entity's net income. *See, e.g.*, Mich. Comp. Laws Ann. § 208.1263 (West 2014). Registration of the entity in the state and payment of applicable franchise taxes or filing fees are typically required as a condition to doing business within the state and for access to the state courts. Some of these taxes are imposed on particular types of entities and not on other types of entities. Some are taxes on business net worth and others are direct entity fees. These taxes and fees vary widely amongst the states.

[117]*See* Pub. L. No. 86-272, § 101, 73 Stat. 555 (1959) (codified as 15 U.S.C. § 381).

respect to their share of the two different types of federal taxes imposed on S corporations that previously were C corporations.[118]

VII. Application of Apportionment and Allocation to Entity Income

Under the Due Process Clause and the Commerce Clause of the U.S. Constitution, a state may impose its income tax only on income fairly apportioned to the state.[119] The determination of compliance with this requirement is made by the application of income allocation and apportionment principles.[120] Because the states have significant latitude in the determination of the proper apportionment factors[121] and because of state variations in the manner of applying these factors, more than or less than 100% of all business income may be subject to state income taxation.[122]

The initial determination of income taxed in a state is a function of first identifying what income is allocable to a particular state and what income is subject to apportionment amongst the states in which the entity does business. The Uniform Division of Income for Tax Purposes Act (UDITPA) provides that business income is subject to apportionment while income other than business income is subject to allocation.[123] Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[124]

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[118] Alabama, Alaska, Arizona, Arkansas, California, Florida, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New Mexico, Oregon, Pennsylvania, Rhode Island, South Carolina, Utah, and Vermont impose such taxes on S corporations. In most cases these state taxes are imposed on the built-in gains of the corporation and on the passive investment income of the corporation in excess of the federal specified limits under the same circumstances as such taxes are imposed on S corporations at the federal level. Some states also impose a state level tax on the difference between LIFO and FIFO inventory of a C corporation which accounts for inventory on a LIFO basis when it converts to an S corporation.

[119] Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 164 (1983).

[120] *Id.*

[121] See Moorman Manufacturing v. Bair, 437 U.S. 267, 273-75 (1978), in which the United States Supreme Court sustained Iowa's use of a single sales factor apportionment formula in determining the income of a corporation subject to Iowa corporate income tax. At the time of this decision, most states used a three-factor formula in which sales, property, and payroll were equally weighted. *Id.* at 283, n.1 (Powell, J., dissenting). The court rejected the taxpayer's claim that Iowa's apportionment method violated the Due Process Clause and Commerce Clause notwithstanding the court's acknowledgment that the state's apportionment formula may result in more than 100% of the corporation's income being subject to state income taxes because of the application of the three-factor formula in the taxpayer's domiciliary state. *Id.* at 276-77 (majority).

[122] *See id.*

[123] Nat'l Conference of Comm'rs on Uniform State Laws, *Uniform Division of Income for Tax Purposes Act* § 1(a) (1957) (approved by the American Bar Association at its meeting at New York, New York, July 16, 1957, Comments Amended 1966).

[124] *Id.* § 1(a).

Income other than business income is treated as nonbusiness income which is subject to allocation rather than apportionment.[125]

The definition of business income encompasses two different tests—a transactional test and a functional test.[126] The transactional test is based on the first portion of the business income definition and focuses on income derived from transactions arising in the ordinary course of business of the taxpayer.[127] In contrast, the functional test is based on the second portion of the business income definition and, according to the comments of the Multistate Tax Commission, includes income from the disposition of property used in a trade or business.[128] Amendments to UDITPA currently under consideration would clearly establish the existence of two separate types of income and would further clarify the intent of the member states that income generated upon the liquidation of a business would be apportionable.[129]

One question that arises in determining what income is business income is whether the determination is to be made at the entity level or at the owner level. States generally make the determination at the entity level because of practical considerations[130] based upon the theory that a pass-through entity is acting as an agent for the pass-through entity owners and any business activity of the entity is therefore attributed to its owners. This approach will result in pass-through entity income becoming business income subject to apportionment as long as the activity of the pass-through entity is a trade or business. However, in certain cases this approach could result in the income not being regarded as business income even though it would be so regarded if the determination were instead made at the owner level. For instance, if a real-estate development company were to make an investment in a pass-through entity that simply invests in real estate in another state, a determination of the character of the income at the owner level rather than the entity level

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[125] *Id.* §§ 1(e), 9.

[126] *Id.* § 1(a). The states regard the definition as encompassing two distinct types of income. However, a few state courts have held that, because of the "and includes" language in the middle of the definition, it encompasses only a transactional test and that the second clause relating to the functional test qualifies the first clause relating to the transactional test. *See, e.g.*, Uniroyal Tire Co. v. State Dep't of Fin., 779 So. 2d. 227 (Ala. 2000); *In re* Appeal of Chief Indus., Inc., 875 P.2d 278, 288 (Kan. 1994); Phillips Petroleum Co. v. Iowa Dep't of Revenue and Fin., 511 N.W.2d 608, 610 (Iowa 1993); Associated P'ship I, Inc. v. Huddleston, 889 S.W.2d 190, 195-96 (Tenn. 1994). Following these cases, the states involved amended their statutes to clarify that the definition included two separate and distinct types of income and that the second clause of the definition did not modify or limit the first clause.

[127] Nat'l Conference of Comm'rs on Uniform State Laws, *supra* note 123.

[128] *Id.*

[129] Multistate Tax Commission, Multistate Tax Compact Article IV Recommended Amendments (2012). Taxpayers have argued that since upon liquidation of an entity there is no remaining business, the gain on the liquidation can therefore not be business income.

[130] It is difficult for a state to determine whether an entity owner is in a trade or business conducted while it is easier to make the determination at the entity level. For example, California determines whether income is business income at the entity level. Cal. Code Regs. tit. 18, § 25137-1 (2012).

would convert what otherwise might be nonbusiness income into business income for the particular owner. Of course, it is likely that in any particular case a state will take the position that maximizes its state tax collections unless an applicable statutory provision or rule precludes taking an either-or approach.[131]

Income such as interest, dividends, rents, royalties, and gain from the sale of assets may be either business income or nonbusiness income depending upon the circumstances. For instance, rental of excess real estate owned by a business will typically be regarded as nonbusiness income if the entity is not in the trade or business of leasing real estate, while real estate rental income would be regarded as business income if the entity were in the trade or business of renting real estate. Similarly, while interest and dividends would not generally seem to fit the definition of business income, many states regard such income as business income to the extent that it is earned in connection with a unitary business doing business in the state.[132] The critical issue is whether the income is generated as an integral part of the entity's trade or business.[133] In *Mobil Oil Corp. v. Commissioner of Taxes*, the United States Supreme Court held that a state could tax an apportioned percentage of the dividends a corporation received from foreign subsidiaries because those subsidiaries were part of the same integrated business enterprise as its business activities in the state.[134] However, a dozen years later, in *Allied Signal, Inc. v. Director, Division of Revenue*, the United States Supreme Court held that a state could not tax an out-of-state corporation on its gain on the sale of its interest in another corporation since the ownership of the other corporation was not regarded as an integral part of the trade or business of the taxpayer.[135]

The functional test presents numerous areas of uncertainty. Most states will assert that income generated on the regular sale of equipment used in the production of tangible personal property sold by the taxpayer will be business income subject to apportionment under the business income definition.[136] While the Multistate Tax Commission's Regulations provide an exclusion for incidental or occasional sales of a fixed asset used in the regular course of the taxpayer's trade or business,[137] most states also include receipts for incidental or occasional sales in the sales factor if the amount of such receipts is deemed

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[131] *See, e.g.*, 61 PA. CODE § 153.29(c)(2)(2008). Pennsylvania takes the position that income is business income if it would be considered as such either at the partnership or partner level. *Id.*

[132] *See, e.g.*, IOWA ADMIN. CODE r. 701-54.2(1) (2007).

[133] *See infra* notes 134-135.

[134] Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 440-42 (1980).

[135] Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 788-90 (1992).

[136] JOHN C. HEALY & MICHAEL S. SCHADEWALD, 2012 MULTISTATE CORPORATE TAX GUIDE vol. 1 5165-71 (2011).

[137] MULTISTATE TAX COMM'N ALLOCATION AND APPORTIONMENT REGULATION § IV.18(c)(1) (1973).

substantial.[138] However, it is often unclear when an isolated sale of such an item is deemed substantial so as to be included in the sales factor. Problems are also created with respect to gains on the sale of depreciable property, at least with respect to depreciation recapture income, since the depreciation deductions will have reduced income in prior years in which the apportionment ratios in the state were different than in the year of sale or because the business was not subject to the taxing jurisdiction of the state in the year a depreciation deduction was taken, but the business is subject to the taxing jurisdiction of the state in the year of sale.

Until the United States Supreme Court definitively determined that states would have significant latitude in the method of apportionment they employed,[139] nearly all of the states used a three-factor formula in determining the apportionment of income of a nonresident entity to a state.[140] Under the traditional three-factor formula, the taxpayer determines the ratio of the sales within the state to worldwide sales, the ratio of property within the state to worldwide property, and the ratio of payroll within the state to total worldwide payroll.[141] Then, the three ratios are averaged and the taxpayer's business income is multiplied by this average ratio to determine the apportioned income subject to tax in the state.[142]

According more weight to the sales factor, however, tends to increase the percentage of an out-of-state, multistate entity's apportionment to the state and its resulting state tax liability since such entities typically will have most of their property and payroll located outside of the state. At the same time, heavier weighting of the sales factor tends to decrease the percentage of an in-state-domiciled, multistate entity's apportionment to the state since it deemphasizes the property and payroll of the entity that is likely to be concentrated in the state. In the absence of a provision taxing all of the income of an in-state entity or throwback or throwout[143] provisions, the heavier weighting of sales will dramatically decrease the state income tax liability of an in-state-domiciled entity and increase the state income tax liability of out-of-state companies. This advantage given to businesses with substantial property and

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[138] Healy & Schadewald, *supra* note 136, at 5172-75. This treatment is in accordance with Multistate Tax Comm'n Allocation and Apportionment Regulation § IV.18(c)(2) (1973).

[139] *See* Moorman Mfg. v. Bair, 437 U.S. 267, 273-75 (1978).

[140] *Id.* at 283 n.1 (Powell, J., dissenting).

[141] *Id.* at 270 n.3 (majority opinion).

[142] *Id.*

[143] A throwback provision will allocate the apportionment factors allocable to another state which does not have jurisdiction to tax (such as, for example, because of the application of Public Law 86-272) back to the domiciliary state while a throwout provision eliminates the apportionment factors allocable to another state which does not have jurisdiction to tax (such as, for example, because of the application of Public Law 86-272). Several states have such provisions although many states do not. One of the problems for taxpayers is the maintenance of appropriate records to identify the state of shipment to which a sale may be thrown back, since generally taxpayers maintain good records on place of destination but do not always cross reference those records to the place of shipment.

payroll in the state can be even more significant if the business is insulated from taxation in other states because of Public Law 86-272, in which case some businesses may incur little or no state income tax liability to nondomiciliary states.[144] Political pressures to use the state's apportionment method as an economic development tool has resulted in significant changes in states' apportionment methods in favor of heavier weighting of sales in many states over the past 40 years.

While the majority of the states still employ some version of the three-factor formula, only about a dozen states continue to weigh the three factors equally.[145] More states double weight sales,[146] and a few states weight sales as an even higher proportion of the apportionment calculation.[147] In addition, about a dozen states use a single-factor-sales formula which takes no consideration of the property or payroll factors.[148] A few states also permit the taxpayer to choose amongst two or more apportionment formulas.[149] The Multistate Tax Commission's commentary to the proposed amendments to UDITPA, while recognizing state sovereignty to determine its own apportionment methodology, would recommend state use of a three-factor approach with double weighting of the sales factor.[150]

A state's membership in the Multistate Tax Commission has proven problematic for a few states with default apportionment methods that differ from the current Multistate Tax Commission's specified apportionment method (three-factor apportionment with equal weighting). Courts in some states have held that a taxpayer can elect either to use the state's default apportionment methodology or the apportionment method specified by the Multistate Tax Commission if the state is a member of the Multistate Tax Commission.[151] These cases have led to states permitting the election of one of two or more apportionment methods in certain cases.[152]

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[144] If, however, the state has a throwback provision, these benefits may not be gained by the in-state entity.

[145] Alabama, Alaska, Connecticut, Delaware, Hawaii, Kansas, Louisiana, Mississippi, Missouri, Montana, New Mexico, North Dakota, Oklahoma, and Utah. In addition the District of Columbia uses an equally-weighted three-factor formula. Some of these states, however, permit alternative methods with respect to certain categories of taxpayers, such as a single-factor sales or a two-factor sales and property approach.

[146] Arizona, Arkansas, California, Florida, Idaho, Kentucky, Maryland, Massachusetts, New Hampshire, New Jersey, North Carolina, Tennessee, Vermont, Virginia, and West Virginia.

[147] Arizona weights the sales factor 80% if elected, Minnesota weights the sales factor 93%, and Ohio weights the sales factor 60%.

[148] Colorado, Georgia, Illinois, Indiana, Iowa, Maine, Michigan, Nebraska, New York, Oregon, Pennsylvania, South Carolina, Texas, and Wisconsin.

[149] Arizona, California, Kansas, Rhode Island, and Utah.

[150] Multistate Tax Commission, Multistate Tax Compact Article IV Recommended Amendments, Art. IV. 18(b)(1) (2012).

[151] *See, e.g.*, Gillette Co. v. Franchise Tax Bd., 147 Cal. Rptr. 3d 603, 606-07 (Ct. App. 2012), *cert. granted*, 291 P.3d 327 (Cal. 2013).

[152] California and Utah offer optional methods as a result of such litigation.

The states also have alternative apportionment methods available in specialized industries where it is difficult to source the three-factor apportionment factors to a particular state such as those in transportation industries such as trucking companies, airlines, and railroads; and media companies such as television and radio broadcasters, publishers, and telecommunications providers.[153] The application of the general sourcing rules are also difficult to apply with respect to certain service entities, such as financial institutions and other specialized businesses, such as public utilities. Thus, alternative apportionment methods are often available to these types of businesses.[154] These alternative apportionment methods either modify or exclude the traditional apportionment factors or provide for certain industry specific factors.[155]

Finally, most states permit a taxpayer to petition the state for the exclusion of one or more of the traditional factors or inclusion of additional factors based on the taxpayer claim that the state's methodology does not fairly represent the taxpayer's business activity in the state in their particular circumstance.[156] Of course, no state is incentivized to give a taxpayer relief since invariably such relief would reduce the income tax collections the state would otherwise receive from the petitioning entity.[157]

Application of the apportionment rules is further complicated with respect to tiered entities. If the owner of a pass-through entity is another entity, does the lower-tier owner include its proportionate share of the apportionment factors of the pass-through entity it owns in the calculation of its apportionment ratio? Most states that include an owner's share of income or loss from a pass-through entity in that entity's apportionable income will permit such

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[153] *E.g.*, Conn. Agencies Regs. § 12-221a-1 (2014).

[154] *E.g.*, Or. Admin. R. 150-314.280-(A), (N) (2014).

[155] *Id.*

[156] A business entity may want to petition the state when its overall business activities generally provide positive net income but the business sustains losses in the state. The incentives for the state, however, disfavor providing alternative apportionment methods for businesses since such methods will invariably reduce revenue, and as a result these petitions are rarely approved. See, for example, Virginia Public Document (P.D.) Rul. No. 13-86 (Va. Dep't of Taxation, June 6, 2013), in which Virginia denied a taxpayer's application to use separate accounting in lieu of apportionment to allocate an extraordinary gain from the sale of real estate located in another state.

[157] The proposed amendments to UDITPA would give the taxpayer the opportunity to petition for use of an alternative method in certain circumstances but would also give the state the opportunity to impose a different apportionment method if the state believed that the method used by the taxpayer did not fairly represent the extent of business activity in the state. Multistate Tax Commission, *supra* note 150.

inclusion, at least if the two entities are part of the same unitary business.[158] The inclusion of the lower-tier entity's share of the upper-tier entity's apportionment factors can have a material impact on the apportionment ratio of the lower-tier entity. For instance, if the upper-tier entity has a 25% apportionment ratio for the state and the lower-tier entity's independent activities in the state generated a 50% apportionment ratio, the inclusion of the upper-tier entity's apportionment factors in the determination of the lower-tier entity's apportionment ratio could significantly reduce the apportionment ratio of the lower-tier entity if the lower-tier entity's ownership of the upper-tier entity was significant and the upper-tier entity had significant business activities.[159] One of the problems for the lower-tier entity, however, is that often the lower-tier entity does not have the information on the upper-tier entity's apportionment factors from which to derive the lower-tier entity's share of such factors.[160] If, however, the lower-tier entity can get a copy of the state tax return of the upper-tier entity, this information can be gleaned from that tax return. Another problem exists in more complicated pass-through entity ownership arrangements where it is difficult to properly ascertain the lower-tier entity's share of the upper-tier entity's apportionment factors, such

158 See N.Y. Comp. Codes R. & Regs. tit. 20, § 9-65 (2014); Ga. Comp. R. & Regs. 560-7-7.03 (2014). One state has taken the position that partnership income, but not the partnership's apportionment factors, are taken into account by the lower-tier entity. Ky. Rev. Pol. 41 P 200, 1 Ky. Tax Rptr. (CCH) ¶ 16-029 (June 1, 1983). A few states have expressly provided that the lower-tier entity's share of the upper-tier entity's apportionment factors can be utilized only if the business of the upper-tier entity and the lower-tier entity are regarded as a unitary business. (Georgia, Illinois, New Hampshire and South Carolina).

159 Consider, for example, this hypothetical example in a single sales factor state. The upper-tier entity has $1,000,000 of total sales, $250,000 of which are within the state and the lower-tier entity owns 50% of the upper-tier entity. The lower-tier entity has $500,000 of total sales, $250,000 of which are within the state. The lower-tier entity's apportionment ratio, determined without regard to the upper-tier entity factors, would be 50%, which would be applied both to the lower-tier entity's independent business income as well as its share of the upper-tier entity's income. If, however, the lower-tier entity can include its share of the upper-tier entity's apportionment factors, its apportionment ratio decreases to 37.5%, determined as follows: numerator equals $375,000 = $250,000 of lower-tier entity in-state sales plus $125,000 of the lower-tier entity's share of the upper-tier entity's in-state sales ($250,000 x 50% ownership interest); denominator equals $1,000,000 = $500,000 of lower-tier entity's total sales plus $500,000 of the lower-tier entity's share of the upper-tier entity's total sales ($1,000,000 x 50% ownership interest).

160 The Illinois Department of Revenue rejected a Texas limited partner's request to use an alternative apportionment method where the limited partner indicated that it was unable to obtain apportionment information from its partnership investments and hence was unable to calculate an Illinois sales-factor ratio. The Department noted an Illinois statutory provision (35 Ill. Comp. Stat. 5/305 (2014)) which requires a partner to allocate its share of Illinois source income based on the apportionment calculation of the partnership. General Information Letter No. IT 13-0001-GIL (Ill. Dep't of Revenue, Mar. 21, 2013). Often pass-through entities fail to provide state Schedule K-1s or other state apportionment information to their owners, making determination of the owner's apportionment ratio for the state very difficult.

as is the case with a partnership agreement with special allocation provisions or complicated waterfall income allocation provisions.

While these apportionment methods are of critical importance to C corporations, they are of relatively less importance to pass-through entities with owners residing in states with an income tax. This is because states generally tax their residents on all of the residents' income regardless of where that income was earned.[161] While a resident will in most cases receive an out-of-state tax credit for taxes paid in other states to diminish the tax paid to the resident state, an individual residing in a state with an individual income tax will nearly always pay state income tax on 100% of his or her income.[162] In contrast, a C corporation pays tax on its income multiplied by the sum of all the apportionment ratios of states that have jurisdiction to tax the corporation. In some cases, this will result in more than 100% of the corporation's total income being subject to state income tax. In other cases, such as when the corporation does business in states without corporate income taxes or when the corporation gains the protection of Public Law 86-272 so as to prevent the imposition of state income taxes by one or more states, the corporation may pay state income tax on substantially less than all of its income. Notwithstanding the lesser importance of the state apportionment systems to pass-through entities, they remain important in states in which the pass-through entity is obligated to file returns and for nonresident owners in those states.

Once the apportionment method of a state is determined, the taxpayer then must source sales, property, and payroll amongst the various states in

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[161] Ariz. Admin. Code § R15-2G-101 (2014); Cal. Rev. & Tax. Code § 17041 (West 2014); 35 Ill. Comp. Stat. 5/301(a) (2014); Mass. Gen. Laws ch. 62, § 17(a) (2014); N.J. Admin. Code § 18:35-1.3(b)(2) (2014); N.D. Cent. Code § 57-38-08.1 (2014). Occasionally, a state permits residents to apportion business income from a pass-through entity in the owner's resident state. *See, e.g.*, Friedell v. Commissioner, 270 N.W.2d 763, 766 (Minn. 1978); Ellis v. S.C. Tax Commissioner, 309 S.E.2d 761 (S.C. 1983); Sweitzer v. Wis. Dep't of Revenue, 222 N.W.2d 662, 665-66 (Wis. 1974). In each of these cases, the court permitted a resident owner of a pass-through entity interest to apportion the entity's business income attributable to the resident's state. In response to these cases, however, the applicable state legislatures revised their statutes to disallow apportionment by resident owners of multistate entities.

[162] A few states permit resident owners of multistate pass-through entities to pay resident state tax only on the apportioned income allocable to the state. *See* Neb. Rev. Stat. § 77-2734.01 (2014); N.M. Stat. Ann. § 7-2-11(A) (2014); Okla. Stat. tit. 68, § 2358 (2014). One state provides a unique mechanism for giving resident owners of S corporations a portion of the benefit of apportionment in lieu of utilization of the credit for taxes paid to other states. Iowa Code § 422.8(2)(b) (2014) provides an election to take an S corporation apportionment credit against a resident's Iowa income tax liability with respect to an S corporation which does business in multiple states. This credit is constructed to give the resident a partial benefit related to the state's single-factor apportionment method (with no throwback rule). For S corporations that are protected from taxation in many states because of Public Law 86-272, these mechanisms which permit residents to pay resident state income tax only on income apportioned to the state of residency will in most cases reduce the shareholder's state income tax liability much more than the credit for taxes paid to other states.

which the taxpayer does business. UDITPA provides fairly definitive rules for sourcing each of the factors which have generally been accepted by the states.[163] These rules provide that sales, property, or payroll associated with nonbusiness income are not considered either in the numerator or denominator of the apportionment ratio determination.[164]

Sales of tangible personal property are generally sourced to the state in which delivery occurs, regardless of the freight-on-board terms applicable to the sale.[165] This principle is designed to assign the sale to the jurisdiction in which the customer is located or in which the property is used.[166] Sales to the federal government, however, are not sourced to any jurisdiction and such sales are included neither in the numerator nor the denominator of the sales fraction.[167] In addition, some states utilize the "throwback" rule, pursuant to which sales that are not sourced to another state because the destination state either has no income tax or cannot tax the entity because of the absence of nexus or the protection of Public Law 86-272 are instead sourced to the state from which shipment occurred.[168] Sales other than sales of tangible personal property are sourced to the state in which the income-producing activity generating the sale is performed.[169] If the income-producing activity is performed in more than one state, the sale is sourced to the state in which the majority of the income-producing activity is performed based on the state in which the majority of the direct cost of performance is incurred.[170]

The proposed amendments to UDITPA would significantly change the determination of how sales are sourced among the states by determining the sourcing of the sales based on what the Multistate Tax Commission calls a "market based" approach.[171] Because of the trend of the states over time to give heavier weighting to the sales factor in the apportionment calculation, the determination of how sales are sourced has heightened importance. These

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[163] Nat'l Conference of Comm'rs of Unif. State Laws, Uniform Division of Income for Tax Purposes Act (1957) (amended 1966).

[164] *Id.* § 16.

[165] Notwithstanding this general rule, many states take the position that occasional sales of a large piece of equipment will not be included in the sales factor.

[166] Nat'l Conference of Comm'rs of Unif. State Laws, *supra* note 163, §§ 16-17.

[167] *Id.* § 16.

[168] States without a throwback rule will treat such sales as part of the denominator of the sales fraction but not part of the state's numerator of the fraction, thereby reducing the amount of income that would otherwise be subject to tax in that state were the throwback rule in effect. West Virginia employs the "throwout" rule, in which such sales are included neither in the numerator or the denominator of the sales fraction and which therefore impose state income tax on a larger portion of the entity's income than if there is no throwback rule but a smaller portion than if the state utilizes the throwback rule. W. Va. Code R. § 110-24-7 (2010).

[169] Nat'l Conference of Comm'rs of Unif. State Laws, *supra* note 163, § 17.

[170] California and several other states adopted changes to their sales sourcing rules before the amendments to UDITPA discussed below had been proposed which would abandon the cost-of-performance test with respect to services and use the test of where the benefit of the service is received. *See, e.g.*, Cal. Rev. & Tax. Code § 25136 (West 2014).

[171] Multistate Tax Commission, *supra* note 129, art. IV, § 17(a).

proposed amendments have been developed because of the change in the U.S. economy from the time of the original adoption of UDITPA from a manufacturing and mercantile based economy to an economy more oriented towards the sale of services and the licensing of intangibles.[172] Technological innovations wrought by the omnipresent computer in the way products are delivered and the character of the products and services delivered also required a rethinking of the sourcing rules for sales.[173] Under the proposed amendments to UDITPA, a taxpayer's market for sales and the resulting sourcing of a sale with respect to sales or rental of real property or tangible personal property would be based on the location of the property and the taxpayer's market for the sale of a service would be based on the location where the service is delivered.[174] Intangible property that is licensed would be sourced to where the intangible is used if utilized in connection with marketing a good or service to a consumer or if receipts are contingent on the productivity, use or disposition of the intangible.[175] If intangibles could not be sourced to a particular state, a throwout rule with respect to such sales would be utilized.[176] The proposed amendments would also apply a general throwout rule if the taxpayer was not taxable in a state to which the sale is sourced.[177]

Under UDITPA, the property factor is determined based upon the average value of tangible property within the state and everywhere used during the tax period in the regular course of the taxpayer's trade or business.[178] Intangible property and property that produces only nonbusiness income is not considered in the calculation of the ratio.[179] In order to assure certainty with respect to the calculation of the ratio, in most states the value of property is determined by original cost, including additions and improvements, but without regard to depreciation.[180] In most cases, average value is determined by averaging the beginning of year value with the end of year value, but some states permit or require the determination by monthly averaging of values.[181]

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[172] *Id.* at 19.

[173] Consider, for example, cloud computing; the use of computer databases like Lexis and Westlaw; applications downloaded for use on a cell phone; services provided by a call center; the remote repair of a computer; web design performed in one state for a web site stored on a server located in another state, which is accessed by persons around the world; advertising provided by Google; and the installation of Microsoft software on laptops and PCs. Even under the proposed amendments, however, it is difficult to properly source these sales in many cases.

[174] Multistate Tax Commission, *supra* note 129, § 17(a)(1)-(3).

[175] *Id.* § 17(a)(4)(i), (ii)(B).

[176] *Id.* § 17(a)(4)(ii)(C).

[177] *Id.* § 17(c).

[178] Nat'l Conference of Comm'rs of Unif. State Laws, *supra* note 163, § 12; *see* Multistate Tax Comm'n Allocation and Apportionment Regulation § IV.10.(a) (1973).

[179] Multistate Tax Commission, *supra* note 129, at 12 n.41.

[180] A few states require property to be valued at fair market value rather than cost, and a few states also consider net book value rather than cost in valuing property in its property factor.

[181] Healy & Schadewald, *supra* note 136, at 5083-89.

The payroll factor is calculated by comparing the aggregate amount of compensation paid to employees in the state to the total compensation paid to all employees everywhere.[182] Compensation paid to independent contractors or related to the production of nonbusiness income is not considered.[183] Compensation included in the apportionment factor calculation is generally that income which is taxable to the employee.[184] Under the Multistate Tax Commission principles, compensation of an employee who performs services in multiple states will not be split amongst the states but instead will be allocated to one state based upon a facts-and-circumstances determination tied to the employee's state of residence, base of operations, and state of supervision of activities.[185]

The final issue is to source nonbusiness income. Under UDITPA criteria, nonbusiness income from real or personal property is sourced to the state in which the property is physically located[186] and nonbusiness royalties from intangible assets are allocated to the state in which the assets are used,[187] while other nonbusiness income is allocated to the state of commercial domicile of the entity.[188]

VIII. Application of State Modifications to Federal Income

Each state independently determines its income tax base, what income is taxable, and what income is exempt from tax. Generally, states determine their tax base by reference to federally determined income (typically adjusted gross income or taxable income).[189] Income allocation and apportionment is then applied to the taxpayer's income tax base as determined under state law.[190]

Some of the adjustments to federal income are mandated by constitutional considerations, such as the exclusion of U.S. interest from the state tax base.[191] Other adjustments, however, are a function of state specific policy considerations. The most frequent state adjustments based on policy considerations arise because of state budgetary concerns. This results in the state deciding not to couple with federal tax changes that would temporarily decrease state

[182] Nat'l Conference of Comm'rs of Unif. State Laws, *supra* note 163, § 13.

[183] Multistate Tax Commission, *supra* note 129, at 12 n.41.

[184] It is unclear how partnership guaranteed payments for services rendered are to be treated under state payroll ratio calculations. Since most states do not specially allocate guaranteed payments but instead treat it as apportionable income, it would seem more appropriate to not include guaranteed payments for services rendered by partners as payroll in the determination of the payroll ratio.

[185] Multistate Tax Commission, *supra* note 129, § 14.

[186] *Id.* §§ 5-6.

[187] *Id.* § 8.

[188] *Id.* § 7.

[189] Walter Hellerstein, State Taxation, ¶ 8.01 Introduction (3d ed. 1999).

[190] *Id.*

[191] *Id.* ¶ 7.06 Income from Federal and State Obligations (2014).

tax collections.[192] This has occurred frequently in recent years, particularly with respect to section 179 expensing and bonus depreciation.[193]

The universal adjustments to federal income relate to income that is either exempt from federal tax or exempt from state tax because of intergovernmental comity concerns and constitutional concerns. States also adjust from federal income for state taxes deducted to arrive at federal taxable income which are nondeductible against the income subject to state tax. Income exempt from federal income tax (*i.e.*, state and local interest) is added back to determine state taxable income. Income exempt from state tax (*i.e.*, U.S. interest) is subtracted to determine state taxable income. In a similar vein, expenses of earning federal tax exempt income, which are nondeductible for federal tax purposes, may be deductible for state income tax purposes since the related income is also subject to state taxation. Expenses of earning state tax exempt income become nondeductible for state income tax purposes since such income is also exempt from state income tax.

State income taxes, which are deductible for federal income tax purposes, are also usually removed from the state income tax base by an addition to federal income for state income tax purposes. In the event that federal income taxes are deductible for state income tax purposes,[194] those amounts are subtracted to determine income subject to the state income tax as part of the intergovernmental tax adjustment process. Refunds are treated in a similar manner, that is, state refunds taxable for federal tax purposes may be nontaxable for state tax purposes, and federal refunds will be taxable for state tax purposes if the related federal income taxes were deducted for state income tax purposes.

Amounts are also adjusted for state income tax purposes when the state tax policy varies from the federal tax policy on such items. This arises in situations in which the state does not couple with federal tax provisions in applying its state income tax provisions. The most common conflict between federal and state tax policy in recent years has come with respect to the federal tax incentives for cost recovery designed to spur business investment—in particular, the provisions related to section 179 expensing[195] and bonus depreciation.[196] As Congress has adjusted the cost recovery rules to stimulate

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[192] *Id.* ¶ 7.02 Conformity to Federal Income Tax Base: Overview (2014).

[193] *See supra* notes 195-196 and accompanying text.

[194] Most states do not permit deduction of federal taxes on state income tax returns because changes in federal taxes necessarily thereby affect state tax collections with federal deductibility. However, six states do. Three states (Alabama, Iowa, and Louisiana) have unlimited deductibility of federal taxes, and three states (Missouri, Montana, and Oregon) have dollar limits on deductibility of federal taxes.

[195] *See* I.R.C. § 179. Many jurisdictions do not couple on section 179 expensing, including Arkansas, Arizona, California, the District of Columbia, Georgia, Indiana, Kentucky, Maryland, Minnesota, New Jersey, North Carolina, New Hampshire, Ohio, Pennsylvania, Rhode Island and Wisconsin. In addition, Alabama and Oregon did not couple with some of the section 179 expensing changes.

[196] *See* I.R.C. § 168(k).

economic growth through increased business capital investment from time to time, many states have not coupled with the federal law because of state budgetary concerns one or more times, resulting in the necessity for maintaining separate depreciation schedules for federal tax purposes and for various state tax purposes.[197]

An example of the complexity caused by state failure to couple with federal tax cost recovery provisions illustrates the problem. In year one, federal law provides for section 179 expensing up to $500,000 and 100% bonus depreciation. State A couples on the section 179 expensing provisions but not on the bonus depreciation provisions. State B couples on the bonus depreciation provisions but not on the section 179 expensing provisions. The result is that the entity must maintain a variety of depreciation schedules—not just for the current year but until all depreciable assets acquired in the current year have been fully depreciated. The entity must maintain a regular federal depreciation schedule as well as an alternative-minimum-tax depreciation schedule in addition to any different depreciation schedule required under its financial statement accounting requirements. The entity must also maintain a separate State A depreciation schedule and a separate State B depreciation schedule as well. So this particular entity doing business in only two states must maintain a minimum of five different depreciation schedules—one for financial statement accounting, two for federal tax purposes, one for State A and one for State B. This problem may be compounded by the fact that a state might couple with respect to one of the many changes in federal depreciation rules or section 179 expensing over the years but not with respect to others.[198] Thus, for example, State C may have coupled with respect to the 2002 and 2003 provisions for bonus depreciation[199] but not for the 2010 Act provisions

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[197] *Many States Expected to Decouple from Recently Enacted Federal Bonus Depreciation and Expensing Provisions*, Grant Thornton LLP, Jan. 31, 2011, http://www.grantthornton.com/staticfiles/GTCom/Tax/SALT%20Alert%20files/GrantThornton_SALTAlert_01-31-11_Inc.pdf; Jamey G. Rappis, *Tax Aspects of the American Recovery and Reinvestment Act of 2009: On the Road to Recovery?*, 82 Wis. Lawyer 10, 52 (Apr. 2009). States generally have additions and subtractions from federal taxable income or federal adjusted gross income and the depreciation adjustment is usually one of the largest adjustments to the state income tax base. Some states even have separate state depreciation schedules. *See infra* note 203 and accompanying text.

[198] *See* I.R.C. § 179.

[199] Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 101, 116 Stat. 21 (constituting the first federal provision to provide for first year bonus depreciation, providing for a first year additional depreciation deduction of 30% of the adjusted basis of qualifying property); Jobs and Growth Tax Reconciliation Act of 2003, Pub. L. No. 108-27, § 201, 117 Stat. 752 (increased the bonus depreciation percentage from 30% to 50%, but these bonus depreciation provisions expired); Economic Stimulus Act of 2008, Pub. L. No. 110-185, § 103, 122 Stat. 613 (50% bonus depreciation reinstituted); American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1201, 123 Stat. 115 (extended bonus depreciation); Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2022, 124 Stat. 2504 (extended bonus depreciation again).

for bonus depreciation.[200] This would require another separate depreciation schedule for State C that differs both from the federal depreciation schedule and the depreciation schedules for State A, which never coupled on bonus depreciation, and State B, which coupled on both bonus depreciation changes. Similar variations in state depreciation schedules would result from a state's refusal to couple to the various changes in the section 179 expensing under federal law.[201] Because of state budgetary pressures, most states have on one or more occasions refused to couple with either the increased section 179 expensing or the bonus depreciation provisions enacted by Congress over the past decade.[202]

If the entity is required to file taxes in many states, the number of separate state tax depreciation schedules may increase further.[203] As noted above, all of these separate depreciation schedules must be maintained until all of the capital items subject to the different depreciation and section 179 expensing rules have been fully depreciated under the least advantageous cost recovery provisions of the various jurisdictions. In early years, states that do not couple with the liberalized federal rules are likely to have net additions to state income before apportionment. However, since these cost recovery variations are merely timing matters, these same states will have net subtractions in later years as the state depreciation catches up with the federal cost recovery.

Since the cost recovery differences discussed above are attributable to taxpayer elections, an entity may be able to minimize or eliminate these differences through coordinating state and federal tax elections with respect to cost recovery. For instance, if state limits on section 179 expensing are more limited than federal limits, an entity could avoid the multiple depreciation schedules by expensing for federal tax purposes the same amount and same items as can be expensed for state tax purposes. A similar approach could be taken with respect to bonus depreciation and other federally permitted current expensing of capital expenditures, such as research and development or organizational expenses, if differences exist from the federal and state rules. Of course, the current federal tax cost of such an approach may be more than the entity is willing to bear and the entity may prefer multiple depreciation schedules to reduced deductions.

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[200] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 401, 124 Stat. 3296 (boosted the bonus depreciation percentage from 50% to 100%).

[201] The changes in section 179 expensing created two areas of potential variances between federal and state law—the changes in the maximum amount eligible for section 179 expensing and the maximum investment limitation. Exceeding either the state limit on the amount eligible for section 179 expensing or the state maximum investment limitation will result in a state modification to entity income.

[202] Healy & Schadewald*, supra* note 136, at 3103-16, 3119-28.

[203] Arizona, Arkansas, Iowa, Kentucky, Maryland, Minnesota, North Carolina, Ohio, and Wisconsin also require the attachment of a state Form 4562 to the state return.

Faced with these complications and the likelihood of a proliferation of depreciation schedules, some entities may choose to ignore state variations in depreciation methodology and use only a couple of depreciation schedules, particularly if the depreciation deduction differences after the application of state apportionment percentages are not significant. Of course, such an entity risks a state tax adjustment that necessitates amendments to multiple state income tax returns of multiple nonresident shareholders for multiple tax years.

These cost recovery variations may result in added complexity when depreciable assets are sold if the state determines its adjusted basis for an asset based on state pass-through income rather than using the federal adjusted basis for the asset. With pass-through entities, this difference also may result in different gain or loss on the sale or exchange of the ownership interest in the entity itself, since the basis of the interest may be differentially adjusted for the cost recovery deductions for federal tax purposes and for state tax purposes.[204] Again, for practical reasons many pass-through entity owners will end up ignoring these state variations as they calculate gain or loss on the sale or exchange of their pass-through entity interests.

There are also other areas where the difference between federal tax treatment of income or expenses differs from state tax treatment of such items and creates a similar dilemma. For instance, most states do not couple with federal tax law with respect to the domestic activities deduction of section 199.[205] States are also not consistent in how they handle an adjustment for state taxes deducted on the federal return.[206] In addition, many states disallow

[204] The Model S Corporation Income Tax Act provides that basis in S corporation stock for state tax purposes is adjusted based on the state additions or subtractions from federal Schedule K-1 amounts. Model S Corporation Income Tax Act (1991). The Model Act also addresses the beginning state tax basis of a nonresident for state tax purposes and sets that beginning basis at zero when a nonresident shareholder first becomes subject to the taxing jurisdiction of a state. *Id.* The effect of such a provision is to limit deduction for losses in that state to previously reported income apportioned or allocated to that state. A few states have adopted this position.

[205] Alabama, Georgia, Hawaii and Indiana have chosen not to couple with section 199, while Colorado has chosen to couple with section 199. Those states which couple based upon the provisions of the Code as in effect as of a certain date may have effectively coupled with section 199 without fully understanding that they have done so.

[206] Some states adjust for all state income taxes, some for only income taxes of other states, and some disallow state franchise taxes as a deduction. These varying state adjustments result in numerous different state income tax bases.

a net operating loss carryforward.[207] Similarly, not all states permit the current deduction of various other miscellaneous items in the same manner as federal law. Finally, owners of pass-through entities may discover that as a result of all of these federal and state tax differences net operating losses differ for federal and state tax purposes even if the business operates only in one state.

IX. State Specific Elections

The most important area relating to different federal and state tax elections relates to entity characterization for tax purposes. While most states follow the "check-the-box" entity classification rules set forth in Treasury Regulation section 1.7704, several states require a separate state Subchapter S election to obtain comparable pass-through entity tax treatment for the corporation and its shareholders.[208] In the event such a corporation makes the federal election but neglects to make the state election, the corporation may be subject to state income taxes as an entity even though it has no liability for federal income taxes. Moreover, since an effective S election will result in adjustments to the shareholder's basis in his or her stock because of pass-through of income and deductions and the effect of distributions on shareholder basis, such adjustments may not be made for state income tax purposes in a state in which the S election was not effective.

[207] Net operating losses present a unique problem for states with a multistate taxpayer. Should the federal net operating loss be apportioned and allocated in a manner similar to operating income? What if the loss arose in a year in which the entity did not do business in the state or in a year in which the apportionment ratio for the taxpayer was different than in the year in which the loss would be utilized? Because of such problems, many states simply choose to not permit net operating loss carryovers. Similarly, passive activity loss carryovers may not be deductible for investors in pass-through entities. In *Billion v. Commissioner of Revenue,* 827 N.W. 2d 773 (Minn. 2013), the Minnesota Supreme Court disallowed passive loss deductions by passive investors in a Minnesota S corporation, reasoning that Minnesota law does not recognize a separate passive activity loss deduction and therefore does not allow a deduction for a carryover of net passive activity losses incurred by the entity. Taxpayers can also be whipsawed when gains are recognized by the entity but the taxpayer has a loss on the disposition of the interest in the entity. In *In re Petition of Craig A. Olsheim,* 2013 WL 2156376 (N.Y. Tax. App. Trib. 2013), an administrative law judge disallowed a loss deduction on disposition of a partnership interest claimed to be New York sourced even though gain from the sale of New York real estate by the partnership was included as New York source income.

[208] Arkansas, Mississippi, New Jersey, and New York require a separate state S corporation election. If the state election is not filed in these states, the corporation will be taxed as an S corporation for federal purposes but as a C corporation for state purposes. In addition, a few states make ongoing compliance with state S corporation status very difficult to maintain. For instance, Georgia requires filing of consents by all new S corporation shareholders to an S corporation state filing, whereas other states require periodic renewals of consents or periodic grants of powers of attorneys by the entity owners.

There are also four jurisdictions[209] that do not permit flow-through tax treatment for state income tax purposes and two states that permit an S corporation to elect to be taxed as a C corporation for state income tax purposes.[210] A variance between federal pass-through entity treatment and state C corporation treatment may result in basis adjustments to S corporation stock for federal purposes that are not applicable for state purposes. Fortunately, most of these concerns are not present with partnerships since most states recognize federal tax entity classification rules for these entities.[211]

X. Determination of Residency of Owners

The residence of shareholders is not an issue for C corporations since generally states do not require withholding on dividends paid to state residents or on dividends paid by state domiciled corporations to nonresidents of the corporation's domiciliary state. However, for pass-through entities, the residency of the owners is important since it determines the tax filing requirements of the owners and the state tax filing requirements of the pass-through entity should the pass-through entity file composite returns on behalf of its nonresident owners. Moreover, the entity may be subject to a withholding requirement with respect to income allocable to nonresidents. Residency is also important with respect to owners of pass-through entities since most states with income taxes tax residents on all of their worldwide income subject only to credits for taxes paid to other jurisdictions.[212]

The various states' determination of residency varies. Some states determine residency based on domicile, which generally is one's permanent place of residence.[213] In other cases, states will determine residency based upon the taxpayer's current place of residence.[214] If different states' residency determinations differ, the determinations can result in a taxpayer being deemed to be

[209] Louisiana, New Hampshire, Tennessee, and the District of Columbia. New York City presents additional problems for S corporations and their shareholders, as it does not recognize the S election and taxes the entity on its income. The city also taxes the owners on their proportionate share of the corporate income, thereby resulting in double taxation of the entity's income even if the income is not distributed to shareholders.

[210] These states are Pennsylvania and Wisconsin. As a result of the states requiring a separate state S election, the states which do not recognize the federal S election and the states for which a taxpayer may elect C corporation status despite a federal S election, an S corporation taxpayer may be taxed as a C corporation in as many as ten different jurisdictions.

[211] Robert W. Jamison, William N. Kulsrud, Teresa Stephenson & Linda Ethridge Curry, 2010 Multistate Tax Guide to Pass-Through Entities 2-12 (2009).

[212] One state, however, has a unique method of giving a resident shareholder of a multistate S corporation some of the benefit of the state's single factor apportionment formula (without a throwback provision). Iowa Code § 422.8(2)(b) (2013) provides for a reduction in the portion of a multistate S corporation's income which is subject to Iowa income tax tied to the entity's Iowa apportionment calculation through the means of a credit against the resident's Iowa tax liability.

[213] *See generally* John H. Gadon, Debra S. Herman & Felicia S. Hoeniger, *Personal Income Tax Issues Related to Residency and Domicile*, 26 Prac. Tax law. 9 (2012).

[214] *See generally id.*

a resident of multiple states in the same tax year. Moreover, an individual may be a part-year resident of a state and a nonresident for the balance of the tax year. These issues frequently arise with respect to short-term job placements, college attendance, and military service.

Fortunately, in most cases the determination of the residency of an owner is not in question. Moreover, rarely do states question residency of owners of pass-through entities nor do the states have the resources to determine the residency of pass-through entity owners and instead choose to rely on the reporting of such residency by the pass-through entities.

XI. Owner Tax Compliance

The states consistently take the position that business income generated by a pass-through entity in the state subjects the nonresident owners of the pass-through entity to state income taxation[215] as long as the pass-through entity has nexus with the state and the activities of the pass-through entity are not protected by Public Law 86-272.[216] This position is grounded in the theory that pass-through entities are aggregations of their member owners rather than entities separate and distinct from the owners.[217] States have also relied on the theory that the entities conducting the business activities in the state are acting as agents for the nonresident owners who thereby become subject to the jurisdiction of the taxing state through principles of agency.[218] While numerous pass-through owners have challenged this position over the years, their efforts have often been rejected where litigated,[219] and the United States Supreme Court has held that a state is not constitutionally precluded from taxing a nonresident on income derived from a business entity operating within the state.[220] Based on the United States Supreme Court's decision, the states appear to uniformly take the position that nonresident owners cannot escape state taxation of pass-through entity business income by virtue of the owners lacking any physical presence in the state and that such nonresident owners are therefore subject to state income tax on business income from

[215] *See, e.g.*, General Information Letter No. IT 12-0028-GIL (Ill. Dep't of Revenue, Sept. 27, 2012), in which the Illinois Department of Revenue ruled that a nonresident individual partner receiving guaranteed payments from a partnership doing business in Illinois was subject to Illinois income tax on Illinois source business income.

[216] Interstate Income Act of 1959, Pub. L. No. 86-272, §§ 101-104, 15 U.S.C. §§ 381-384 (2012).

[217] This theory, while consistent with the logic and policy of Subchapter K, has less appeal when considered under Subchapter S where a corporation is the actual business entity and there is pass-through tax treatment only by virtue of explicit statutory provisions.

[218] People *ex rel.* Badische Anilin & Soda Fabrik v. Roberts, 42 N.Y.S. 502, 505 (App. Div. 1896), *aff'd*, 46 N.E. 161 (N.Y. 1897); Chapman v. Browne, 48 N.Y.S.2d 598, 599 (App. Div. 1944), *appeal denied*, 50 N.Y.S.2d 461 (1944); Asworth Corp. v. Revenue Cabinet, No. 06-CI-00288, 2007 WL 7302945 (Ky. Cir. Ct. 2007), *amended by* 2007 WL 7302946 (Ky. Cir. Ct. 2007), *cert. denied*, 131 S. Ct. 1046 (2011).

[219] *See supra* note 218.

[220] Int'l Harvester Co. v. Wis. Dep't of Revenue, 322 U.S. 435 (1944).

the pass-through entity.[221] However, pass-through entity owners continue to assert that states lack the authority to impose state income taxes on business income attributed to such owners who are passive and who do not exert control over the activities of the pass-through entity.[222]

This principle asserted by the states generally thereby requires all nonresident owners of a pass-through entity conducting business within a state to file state income tax returns in that state as nonresidents. While their in-state income will be subject to apportionment to comply with constitutional strictures, the requirement of each owner filing a return in each state in which the pass-through entity conducts business can nevertheless be quite burdensome to the owners.

Because multiple state taxation of owners of pass-through entities creates a significant administrative burden for such owners and because states have great difficulty enforcing state tax filing compliance by pass-through entity owners who have no physical presence in the state, many states have adopted measures both to ease the administrative burden for the owners as well as to improve state tax collections from the nonresident owners of pass-through entities.

Since states have difficulty collecting taxes from nonresidents and since there can be a question concerning the jurisdiction to tax a nonresident

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[221] *See* Jamison, Kulsrud, Stephenson & Curry, *supra* note 211, at 2-12 to 2-13.

[222] Historically states have not imposed tax on nonresident owners of investment pass-through entities generating passive sources of income. *See, e.g.*, Lanzi v. Ala. Dep't of Revenue, 968 So. 2d 18 (Ala. Civ. App. 2006); Borden Chems. & Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. App. Ct. 2000); Bridges v. Autozone Props., Inc., 900 So. 2d 784, (La. 2005). This approach has been justified since the income generated is not business income but instead is nonbusiness income typically allocable to the owner's state of residency. However, some courts have also permitted nonresident limited partners of entities generating business income to avoid state income tax on the basis that the limited partner has no authority or control over the business activities of the entity and the state statute did not provide for taxation of such limited partners. In those cases, however, states have often revised their statutes or regulations to clarify the intent of the state to tax the business income attributable to such partners. A few recent cases, however, have renewed this controversy by holding that corporate limited partners are not subject to imposition of a state's income tax by virtue of their ownership of limited partnership interests in a limited partnership doing business in the state. *See, e.g.*, UTELCOM, Inc. v. Bridges, 77 So. 3d 39 (La. Ct. App. 2011); BIS LP, Inc. v. Dir., Div. of Taxation, 2011 WL 3667622 (N.J. Super. Ct. App. Div. 2011). The court in *UTELCOM* based its decision on the language of the state statute and concluded that when acting as a limited partner the taxpayer was not conducting business in the state in its corporate capacity as required by the statute. In contrast the court in *BIS LP* based its decision on a determination that the business of the pass-through entity and the business of the corporate owner were not unitary so as to attribute nexus in the state to the corporate owner. Recently, in *Marshall, Jr. v. Pennsylvania*, 41 A.3d 67 (Pa. Commw. Ct. 2012), a Pennsylvania intermediate appellate court ruled that a nonresident individual who was a passive investor owning a limited partnership interest in an entity which owned commercial real estate in Pittsburgh was subject to Pennsylvania income tax since the partnership's business activities were specifically directed to activities within the state.

pass-through entity owner who has no physical presence in the state,[223] many states require pass-through owners to sign agreements stating that they will file state nonresident returns and consenting to the jurisdiction of the state to impose income taxes on their pass-through income.[224] If such agreements are not obtained, in most cases the pass-through entity will be required to withhold or pay state income tax with respect to nonresident income.

Absent actual nonresident filing or obtaining agreements by nonresidents to file returns, the entity will usually either be subject to withholding or will be required to file a composite state return on behalf of nonresident owners.[225]

XII. Composite State Income Tax Returns

A composite state tax return is a state income tax return filed by a pass-through entity on behalf of its owners who are not residents of the state.[226] In some cases composite state tax returns are provided for by state statute,[227] in others by state revenue department regulation,[228] and in others only by

[223] This problem is particularly acute with S corporations because of authority to the effect that a state does not have jurisdiction to tax a nonresident shareholder of a corporation if the shareholder's only connection with the state is ownership of stock of the corporation which does business within the state. *See* Miller v. McColgan, 110 P.2d 419 (Cal. 1941); People v. Am. Bell Tel. Co., 22 N.E. 1057 (N.Y. 1889). Note that these cases predate the creation of S corporations in 1958. As a result, states attempt to extend the authority for taxation of nonresident partners to S corporations as their corporate equivalent. See Isaacson v. Iowa State Tax Commissioner, 183 N.W.2d 693 (Iowa 1971); Meyer v. Charnes, 705 P.2d 979 (Colo. App. 1985); Kulick v. Dep't of Revenue, 624 P.2d 93 (Or. 1981), *appeal dismissed*, 454 U.S. 803 (1981).

[224] Alabama, Arkansas, Colorado, Georgia, Hawaii, Kansas, Louisiana, Maine, Massachusetts, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, North Carolina, Oklahoma, Oregon, Rhode Island, and West Virginia all have forms of agreements for nonresidents to sign agreeing to file a nonresident return. In most cases, failure to file agreements for all shareholders results in imposition of a withholding obligation on the pass-through entity. In some cases, however, filing of a composite return discharges the entity's duties to withhold.

[225] In *Tsitalia LLC v. Alabama Department of Revenue*, an administrative law judge ruled that Alabama had jurisdiction to impose composite income taxes regardless of whether the state had jurisdiction to tax nonresident owners of the entity since the entity had sufficient nexus with Alabama to support imposition of the Alabama composite taxes which were imposed on the entity rather than the nonresident individual. Tsitalia LLC v. Ala. Dep't of Revenue, Ala. Dep't of Revenue, Admin. Law Div., Dkt. No. BIT 12-492, Feb. 1, 2013, *available at* http://revenue.alabama.gov/aljrules/12-492.pdf. In *Vogt v. Department of Revenue*, however, an administrative law judge ruled that Alabama's jurisdiction to collect income tax from an Alabama sited entity did not extend authority to impose income tax on the nonresident owners. Vogt v. Dep't of Revenue, Ala. Dep't of Revenue, Admin. Law Div., Dkt. No. INC 11-660, Jan. 3, 2013, *available at* http://revenue.alabama.gov/aljrules/11-660-2.pdf

[226] Walter Hellerstein, State Taxation, ¶ 20.08[2][a][iv] (3d ed. 1999).

[227] *See*, *e.g.*, Ala. Code § 40-18-24.2 (2011); La. Rev. Stat. Ann. § 47:201.1 (2001).

[228] *See, e.g.*, Iowa Admin. Code r. 701-48.1(422) (2008).

administrative practice of the state revenue agency.[229] In most states, the filing of a composite state income tax return is optional for the entity and its owners, but in a few states a composite state income tax return is required.[230] In a few states, the entity must obtain approval from the state revenue agency in order to file a composite return.[231]

The requirements that states impose with respect to composite filing vary widely amongst the states. Several states permit a composite return filing only if a specified minimum number of owners join in the composite return.[232] A few require all nonresident owners who have not filed separate returns as nonresidents to be included in the composite return.[233] Several states provide for owner inclusion in the composite return only if such owner's income sourced to the state is in excess of a specified dollar amount.[234] Several states also do not permit inclusion of certain types of nonresident entity owners on the composite return, such as trusts, estates, or corporations.[235]

In many states, composite state returns will tax the income allocable or apportionable to the state attributable to the nonresidents' ownership in the entity at the highest marginal state income tax rate applicable to the nonresident owner, usually without accounting for any deductions or exemptions that would be available to an owner if that owner were to file a separate nonresident state return.[236] However, several states permit the use of the graduated rate structures on composite state returns rather than imposing the composite tax at the highest marginal tax rate, and some states permit limited deductions and exemptions.[237] Several states disallow a section 179 deduction on a composite return based on the position that the state is unable to determine

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[229] *See, e.g.*, Ky. Revenue Cabinet, Kentucky Tax Alert July 1991; Maryland Income Tax Division, Administrative Release No. 6 Taxation of Pass-through Entities Having Nonresident Members (Sept. 2012), *available at* http://taxes.marylandtaxes.com/Resource_Library/Tax_Publications/Administrative_Releases/Income_and_Estate_Tax_Releases/ar_it6.pdf.

[230] Alabama requires the filing of a composite return if the applicable nonresident pass-through agreements are not obtained from every shareholder; California requires the entity to allow nonresident owners the option to be included in a composite return. Indiana requires composite returns.

[231] New Mexico requires prior approval for filing a composite return.

[232] Massachusetts, Michigan, North Dakota, Oregon and Wisconsin permit a composite return only on behalf of more than one entity owner. Arizona and New Mexico permit a composite return only if more than ten entity owners are included in the return.

[233] *See* Jamison, Kulsrud, Stephenson & Curry, *supra* note 211.

[234] *Id.*

[235] California, Maryland, New Jersey, Pennsylvania and Wisconsin do not permit certain trusts to be included on a composite return. Most states, however, will permit grantor trusts to be included on the return by virtue of state recognition of federal grantor trust provisions.

[236] *See generally* Jamie S. Fenwick et al., State Taxation of Pass-Through Entities and Their Owners, at Chapter 6 S Corporations (2013).

[237] For instance, Hawaii, Iowa, Mississippi and Wisconsin specifically provide for utilization of the state's graduated income tax rate structure on a composite return. Maryland and Michigan allow prorated personal exemptions based upon the proportion of the entity's income taxed by the state.

whether the nonresident owner would be subject to a limit on the allowance of such deduction.[238] In some cases in which the section 179 deduction is disallowed on the composite return, the state will, however, permit utilization of such deduction as depreciation over several years instead.[239] Some states do not require imposition of tax on a nonresident in the composite return filing if such nonresident's share of the entity's state-sourced income is not in excess of a threshold amount referenced to the state minimum filing requirements.[240]

Most states do not permit an owner's inclusion in an entity's composite return filing if the owner has income from other sources subject to tax by the state,[241] but several states do.[242] The limits on inclusion of particular nonresidents on the composite return create dilemmas for the tax preparer in certain situations. For instance, if an owner is an owner of multiple pass-through entities doing business in the state, a limitation on inclusion in the composite return may prevent the owner from being included in either pass-through entity's composite state income tax return.[243] Directors' fees or other compensation paid to nonresident owners may preclude the recipient owners from being included in the composite state return for the domiciliary state of the pass-through entity.[244] The tax preparer is also presented with the paradox of how to determine whether a particular owner has income from other sources taxable in any particular state if the tax preparer does not also prepare the owner's individual tax returns.

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[238] California, Nebraska, North Carolina, and Virginia specifically take this position. The states' positions on utilizing a section 179 deduction on a composite return are separate and distinct from the question of whether the state couples with the federal treatment of section 179 expenses. Rather, the position is based on the inability of the state to ascertain whether a nonresident included in a composite return has section 179 expenses from other sources that would make the nonresident's share of the pass-through entity section 179 expenses nondeductible by virtue of the total section 179 expenses exceeding the applicable limit.

[239] Most states taking this position allow deduction of the disallowed section 179 amounts over five years.

[240] This is generally the case if the state income allocable to the nonresident is not in excess of the level at which state income tax return filing would be required.

[241] If a state has a progressive income tax rate structure and the composite tax is not imposed at the highest marginal income tax rate on all of the apportioned pass-through income allocable to the owner, permitting the owner to be included on the composite return if the owner has other income sourced to the state may result in the owner being taxed at lower effective rates than if the owner were to file a nonresident return. However, if the state has a flat tax rate and does not allow exemptions or deductions on a composite return, there is no reason to limit inclusion on a composite return to those with no other income sourced to the state.

[242] Alabama, Indiana, Massachusetts, and South Carolina permit inclusion of a nonresident who has other sources of income taxable in the state. However, such an individual is still required to file a state return to report such individual's other income taxable in the state.

[243] A few states have recognized this dilemma and have provided that such a taxpayer can be included in composite returns filed by each pass-through entity.

[244] *See generally* Fenwick et al., *supra* note 236.

State requirements with respect to owner consent to the state composite tax filing also vary from state to state. Several states require the nonresident owners to consent annually to their inclusion in the composite income tax return filing.[245] Several states require pass-through entity owners to grant a power of attorney to the entity to handle their state income tax reporting obligations on their behalf.[246]

For fiscal year entities, the tax preparer must also determine whether the composite return is to be filed on a fiscal year basis tied to the fiscal year of the entity or on a calendar year basis tied to the tax years of the owners. Most states are silent as to this issue and the tax preparer is left to decide.[247] A fiscal year entity must also decide whether to file the composite return on the state's tax forms for the year in which its fiscal year begins or the forms for the year in which the fiscal year ends. Several states specifically require filing on the forms for the year in which the fiscal year of the entity ends since that is also the year for which calendar year owners will be filing returns to report their share of the entity income.[248]

While computerized tax preparation programs have made the process of tax preparation of multistate pass-through entities feasible, these programs often do not do a good job with proper preparation of composite state returns. A tax preparer should carefully review any computer generated composite state return to make sure that it has been prepared in accordance with the requirements of the applicable state. It is also advisable to contact the specific state revenue department for instructions on composite return filing to minimize any follow up issues arising after the filing of the composite return.

XIII. Withholding on Distributions to Nonresidents

A further mechanism that states use to facilitate income tax collection of nonresident tax liabilities is the imposition of withholding tax responsibility

245 Arizona, California, Georgia, Oklahoma, Pennsylvania, and South Carolina require annual election forms to be signed by nonresidents to be included in a composite return, although only Georgia, Oklahoma, and South Carolina require filing of such consents with the composite return (Georgia requires the filing only with respect to new owners).

246 Hawaii, Michigan, and Vermont all specifically require entity owners included on a composite return to grant a power of attorney to the entity to include such owners on a composite state income tax return filing.

247 Since the composite return is filed by the entity, arguably it should be filed on a fiscal year basis. However, the stronger argument is for filing on a calendar year basis as long as a majority of the owners report on a calendar year basis since it is the income of these nonresidents that is being reported, and the entity is only an accommodation party filing the return on behalf of such nonresidents.

248 California, Maine, Massachusetts, Michigan, Ohio, Oregon, Pennsylvania, Texas, and Wisconsin. This can present problems for computerized tax preparation services since they must await the issuance of new forms by the state and then must incorporate the form into the tax software and get it approved by the state before it can be utilized by the tax preparer. In some cases the forms are not available by the time the composite return is due.

on pass-through entities with nonresident owners.[249] States imposing such withholding obligations typically require the pass-through entity to withhold state income taxes with respect to nonresidents of the state based upon applying the state's highest marginal state income tax rate to the nonresidents' share of the income of the entity allocable or apportionable to the state.[250] In some states, withholding is not required of corporate owners of pass-through entities although the corporate owner remains obligated to file a nonresident return.[251] Most of these withholding taxes are collected quarterly[252] in a manner similar to estimated tax payments, although some are payable only annually.[253] Such withholding taxes may then be credited against the state income tax liability of any nonresident for which such withholding is made if the nonresident files a nonresident state return in that state and against the composite tax liability on a state composite tax return.[254] In most cases, the state makes no further attempts to collect taxes from nonresidents in the event the entity pays the withholding tax with respect to its nonresident owners.

Some states require withholding only from nonresidents who are not included in a composite return filing by the pass-through entity.[255] Other states do not so condition the withholding obligation.[256] Withholding requirements of certain states require the filing of both quarterly as well as annual withholding tax returns.[257]

The withholding requirements for pass-through entities in the various states are often murky. Withholding generally applies to distributions payable to the owners, but the states are often not clear whether the withholding tax rate applies to the gross amount of the distribution, the portion of the distribution representing a distribution of apportioned state income, or simply the aggregate income allocable or apportionable to the owner from whom the withholding is made. Based on the fact that the withholding is intended as a substitute for tax filing and payment by the nonresident, the withholding

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[249] *See generally* Fenwick et al., *supra* note 236, at Chapter 5 State Withholding Requirements for S Corporations.

[250] *See id.*

[251] *See id.*

[252] *See, e.g.*, Or. Admin. R. 150-314.781 (2012) (requiring quarterly remittance of nonresident withholdings as quarterly estimated tax payments on behalf of the nonresident owners); *see also* Wis. Dep't of Revenue, *Limited Liability Companies (LLCs),* Tax Pub. No. 119 (2014), *available at* www.revenue.wi.gov/pubs/pb119.pdf.

[253] Georgia has recently shifted from monthly withholding on distributions to nonresidents and annual withholding on distributive shares of nonresidents to annual withholding on all taxable income sourced to Georgia, whether or not distributed. 2012 Ga. Laws Act 687 (H.B. 965), amending Ga. Code Ann. § 48-7-129.

[254] *See generally* Fenwick et al., *supra* note 236, at Chapter 5 State Withholding Requirements for S Corporations.

[255] *See id.*

[256] *See id.*

[257] Indiana, Kentucky, Michigan and Wisconsin. In some cases these withholding returns can be filed in conjunction with entity returns or composite returns, and in some cases they must be filed through the state's website.

rate should logically be applied against the state income allocable or apportionable by the state to the owner from whom withholding is being made. However, often the allocable or apportionable income allocable to the owner is not known at the time the distribution is made, particularly if the withholding is payable quarterly rather than annually. In addition, it is possible that the amount required to be withheld may exceed the total distributions to the owner.[258] In this case, does the entity owe the difference or is its liability for withholding limited to the amount distributed? Many states appear to generally take the position that pass-through entities are required to remit the withholding tax based on each nonresident owner's income apportionable or allocable to the state regardless of whether or not there are sufficient distributions to such owners from which to make the withholding.[259] Such a position essentially results not in a withholding tax but in the entity becoming secondarily liable for the state taxes owed by the nonresident owner.

Some business entities have challenged the authority of a state to require withholding by the entity from nonresidents since the withholding obligation essentially serves as a guarantee of the owner's state tax payment obligation by the pass-through entity.[260] However, the constitutionality of the imposition of such withholding taxes is no longer in question after the United States Supreme Court's decision in *International Harvester*.[261]

XIV. Owner Credits for Taxes Paid to Other States

An owner of a pass-through entity interest who files a nonresident return in another state and pays income taxes attributable to the income taxed by such state is usually allowed a credit against such owner's resident state income taxes.[262] Typically the credit is allowed in an amount no greater than the amount of tax that is imposed by the owner's resident state on the income taxed by the other state.[263] This credit mechanism has the effect of eliminating double taxation on the income taxed by both the nonresident state and the resident state. However, the effect of the mechanism is also to tax the

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[258] Because of the imposition of income taxes on the pass-through entity owners, in most cases substantial distributions will be made to enable the owners to discharge their federal and state income tax obligations which will be well in excess of the state withholding obligation. These state withholding obligations should, however, be taken into account when determining the magnitude of tax distributions to owners. If the distributions are not large enough, an owner may not have sufficient amounts of tax distributions after withholding to discharge their federal and home state tax obligations.

[259] *See* Jamison, Kulsrud, Stephenson & Curry, *supra* note 211.

[260] See *supra* note 222 for a discussion of cases involving the authority of a state to impose taxes generally on the pass-through income attributed to a nonresident owner.

[261] Int'l Harvester Co. v. Wis. Dep't of Revenue, 322 U.S. 435 (1944).

[262] *See generally* Fenwick et al., *supra* note 236, at Chapter 16 Credit for Taxes Paid by S Corporations in Other Jurisdictions; James A. Amdur, Annotation, *State Income Tax Treatment of S Corporations and Their Shareholders*, 118 A.L.R. 597 (2004).

[263] *See* Jamison, Kulsrud, Stephenson & Curry, *supra* note 211, at 2-15.

pass-through entity owner at the higher of the tax rate of the other state or the tax rate of the home state.

While there is no constitutional requirement that a state offer a credit to its residents for taxes paid to another state, most states offer such a credit since they want to avoid the ire of their residents with respect to double taxation of their out-of-state income. However, in some cases a credit is allowed to a resident of the state only if the state determines that the income was properly taxable by the other state under the taxation principles of the resident state.[264]

There are several issues presented to owners of pass-through entities with respect to utilization of their home state's out-of-state tax credit. The principal issue is what state taxes paid to other states are creditable against the owner's home state income taxes. For instance, is the owner's pro rata share of another state's share of taxes paid by an S corporation on built-in gains or passive investment income creditable against the owner's home state income taxes? And what about state income taxes paid by a corporation in a state that does not recognize the corporation's federal S election, either because it generally does not recognize the federal election, the corporation elected for state tax purposes to be taxed as a C corporation, or because the corporation failed to file a required separate state S election? Since these taxes are imposed on the entity rather than the owner, it would seem that a state's assertion that such taxes should not be allowed as a credit against the owner's home state taxes may be sustained.

Should composite state income taxes paid by the entity to another state be creditable against home state taxes? While composite taxes are paid in lieu of taxes on the owner's share of the entity income, they are not taxes paid by the owner and hence may not be regarded as creditable against the owner's home state taxes if the state permits credit only for taxes paid by the taxpayer. Fortunately for these owners, it appears that most states will allow the composite income taxes paid by the entity and any withholding taxes paid by the entity as credits against the owner's home state income taxes, at least as long as the owner indirectly is deemed to pay these taxes by a reduction in distributions from the entity, which the owner would otherwise be entitled to receive.[265] However, several jurisdictions specifically disallow a credit for the owner's share of any entity level taxes such as built-in gains taxes or corporate taxes paid by virtue of treatment of the entity as a corporation for purposes of the application of the state's income taxes.[266]

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[264] *See, e.g.*, Christman v. Franchise Tax Bd., 134 Cal. Rptr. 725, 732 (Cal. Ct. App. 1976).

[265] However, in *Vine v. Arizona Department of Revenue*, the board of tax appeals found that the Arizona Department of Revenue acted properly by denying credit for taxes paid to Indiana and Virginia because those states do not allow composite filers to take the credit for taxes paid. Vine v. Ariz. Dep't of Revenue, No. 1416-95-I (Ariz. Bd. of Tax Appeals Dec. 19, 1996).

[266] D.C. Code Ann. § 47-1806.04 (2008); Va. Code Ann. § 58.1-332 (2013).

XV. Increased Complexity in Entity Tax Compliance

As noted previously, the changes in the tax laws and the new forms of business entities emerging in the 1990s have resulted in a large increase in the number of pass-through entity tax returns. This has dramatically changed the landscape for business tax preparers. Since a C corporation pays all of the taxes on its business income directly, no reporting of corporate income to shareholders is required by the tax code.[267] In contrast, pass-through entities are required to issue Schedule K-1s to each and every owner on an annual basis regardless of whether any distributions are made to the owners.[268] Moreover, because the nature of the income, deductions, and credits attributed to the owner from the pass-through entity can have a differential income-tax effect amongst different owners,[269] the Schedule K-1s must detail many different specific items of income, deduction, or credit to each owner.[270] The multiple K-1s that must be attached to federal returns of pass-through entities will often make a pass-through entity's federal return consist of many more pages than for a similarly situated C corporation. Fortunately, the growth of computerized tax preparation has facilitated this reporting for pass-through entities. In addition, electronic filing has helped reduce the deforestation of the globe required to comply with pass-through entity tax filing requirements. It is probably not a stretch to say that the growth in the number of pass-through entities would not have occurred without the development of computer-assisted-tax-preparation software because it would have been prohibitively expensive to prepare Schedule K-1s manually for a large group of owners. Moreover, it is unlikely that Congress would have authorized the increase in the number of permissible S corporation shareholders to the current level without the availability of sophisticated computer tax-preparation software to handle the resulting increased tax compliance load.

[267] While C corporations are required to issue Form 1099-DIV to shareholders with respect to dividend payments, those forms are much simpler than the Schedule K-1 forms required to be issued to pass-through entity owners. Moreover, if a C corporation pays no dividends in a given year, it is not required to issue any specific tax forms to its shareholders, while pass-through entities are required to issue Schedule K-1s to their owners even if no distributions to owners are made during the year.

[268] *See* I.R.C. § 6031(b) (partnerships); I.R.C. § 6037(b) (S corporations).

[269] For example, a pro rata share of charitable contributions made by a pass-through are deductible by the entity's owners. However, because of the individualized tax situation of owners, an owner may not be able to utilize the deduction currently if, for example, the owner's other charitable contributions have already exceeded the applicable contribution limit for the owner. The particularized nature of the use of the deduction at the individual level therefore requires separately stating the amount of the deduction which passes through to the entity's owners.

[270] The current Schedule K-1 forms for partnerships have 20 separate line entries and the current Schedule K-1 forms for S corporations have 17 separate line entries. In addition, often additional schedules must be attached to the Schedule K-1 because of the possible differential effect of a particular pass-through item to a particular owner.

Many of the same issues present with federal tax compliance for pass-through entities indirectly affect the size of state tax returns for such businesses. While C corporations and similarly situated pass-through entities will be required to file returns in the same states, many states require pass-through entities to prepare and attach state specific Schedule K-1s.[271] These state Schedule K-1s add to the bulk of the state returns significantly.[272] State specific depreciation schedules will also need to be maintained, and in some cases a state specific depreciation form must be attached to the entity's state return. Moreover, to the extent that the entity has business income within a state and has minimum contacts so as to require the filing of a return in that state, each owner who is not a resident of that state is generally also required to file a state return.[273] In contrast, multistate individual tax filings are not required for shareholders of C corporations who receive dividends.

Fortunately, as noted previously, most states permit tax compliance on behalf of pass-through entity owners in one of three ways discussed above in lieu of the requirement for each nonresident to file nonresident individual income tax returns in each state in which the pass-through entity does business: (1) composite state tax return filing by the pass-through entity on behalf of owners who are nonresidents of that state, (2) withholding of state income taxes with respect to distributions by the pass-through entity to owners who are nonresidents of that state, or (3) treatment of the pass-through entity as a C corporation for state income tax purposes regardless of the method of taxation of the entity for federal tax purposes. In most cases, if tax compliance for the nonresident is accomplished through one of these methods, no nonresident state return will be required for the nonresident owner.[274] However, while these alternatives do mitigate the burden of individual tax compliance by pass-through entity owners, they also add to the compliance burden of the pass-through entity as compared to the compliance burden of a C corporation. Additional state tax returns not required of C corporations will be required to be filed by the pass-through entity under the composite tax return regime, and pass-through entities may also be required to withhold

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[271] California, Illinois, Iowa, Kentucky, Missouri, New Jersey, New York, Pennsylvania, and Virginia all require the preparation and filing of state specific Schedule K-1s. Other states generally rely on the federal Schedule K-1s but often require attaching a copy of the federal tax return with Schedule K-1s to the state tax return.

[272] Consider, for example, a multistate pass-through entity that has 50 owners and which is required to file income tax returns in ten states which require separate state Schedule K-1s. That pass-through entity would issue 50 federal Schedule K-1s plus 500 state Schedule K-1s. If the average length of a Schedule K-1 were only three pages, that entity's Schedule K-1s alone would consume nearly four reams of paper.

[273] Each owner of that same multistate entity referenced in note 272, *supra*, would have to file tax returns in ten states (plus their state of residence, if different), resulting in more than 500 state individual tax returns being required to be filed by the entity's owners.

[274] While in some cases a nonresident return is still technically required, the payment of state taxes in one of these three ways eliminates the incentive for states to aggressively pursue nonresident nonfilers.

state income taxes on distributions to nonresident owners even though a C corporation paying dividends would not have a similar requirement.

A tax advisor to a multistate pass-through entity will need to advise the entity and its owners whether the owners should each file nonresident returns in the various states in which the entity does business or to instead rely on withholding, the filing of composite returns, or an election for an S corporation to be taxed as a C corporation in a particular state. While the compliance costs involved may support filing alternatives to individual nonresident state filings, the tax generated by the filing alternative may be substantially more than if the nonresident filed a separate state return.[275] If the entity decides to utilize one of the alternative methods of entity owner tax compliance, the advisor will also need to advise the entity concerning the particular method of compliance that is easiest to accomplish and which minimizes tax liability for the owners.[276]

The added complexity of state tax return compliance for pass-through entities is also complicated by a myriad of other state tax issues that preparers of pass-through business returns have to face. Some of these issues are also present with preparation of state C corporation returns, but many are present only with state pass-through tax compliance. Moreover, the application of state business tax principles to pass-through entities is often less clear than their application to C corporations. The challenge of keeping up with the ever-changing tax rules of the various jurisdictions is also a daunting task for pass-through entities and their advisors.

Since pass-through entities generally tend to be smaller than their C corporation counterparts and often do not have in-house tax professionals as many larger C corporations do, much of the work involved in tax compliance has to be delegated by pass-through entities to outside professionals. Since the complexity of the pass-through returns is often greater than for C corporation returns and since pass-through entities tend to be smaller than C corporations, the cost of tax compliance for pass-through entities will often be a greater relative burden for pass-through entities than for C corporations.

Because each state tenaciously asserts its sovereign rights to impose taxes in the manner it chooses, multistate entities are undoubtedly destined to navigate through an ever-changing morass of disparate and sometimes conflicting state tax rules and regulations. C corporations are used to this and many have

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[275] This would be the case, for example, in a state with a graduated rate schedule and applicable deductions, exemptions, and credits that required withholding or imposition of taxes on a composite return at the highest marginal income tax rate of the state.

[276] Unfortunately, in many states the due dates of the entity return and of the state composite return are often prior to the due date of the nonresident's individual return for fiscal year entities. As a result, the entity and its owners must often make this decision prior to the time the individual nonresident is required to file his or her state return, which makes the evaluation of which filing route is preferable difficult. The decision is further complicated in states that permit a standard deduction and personal exemptions, since the entity will often not know the filing status and exemptions available to each particular owner.

built up large tax staffs, a major focus of which is to manage state tax compliance. Pass-through entities are increasingly faced with these same challenges plus many others that do not burden C corporations.

It is no doubt unrealistic to expect uniformity amongst the states with respect to their state income tax treatment of pass-through entities and their owners. This is particularly true with respect to state income tax bases and state apportionment methodology, both of which have significant revenue and economic development impacts on the states. However, uniformity with respect to withholding regimes and composite return filings should be sought and should be a focus of the Multistate Tax Commission in future years because of the growing significance of pass-through entities to state taxation of business income.