



CPAMERICA TAX CONFERENCE PASS-THROUGH ENTITY TAXATION

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PRESENTED BY

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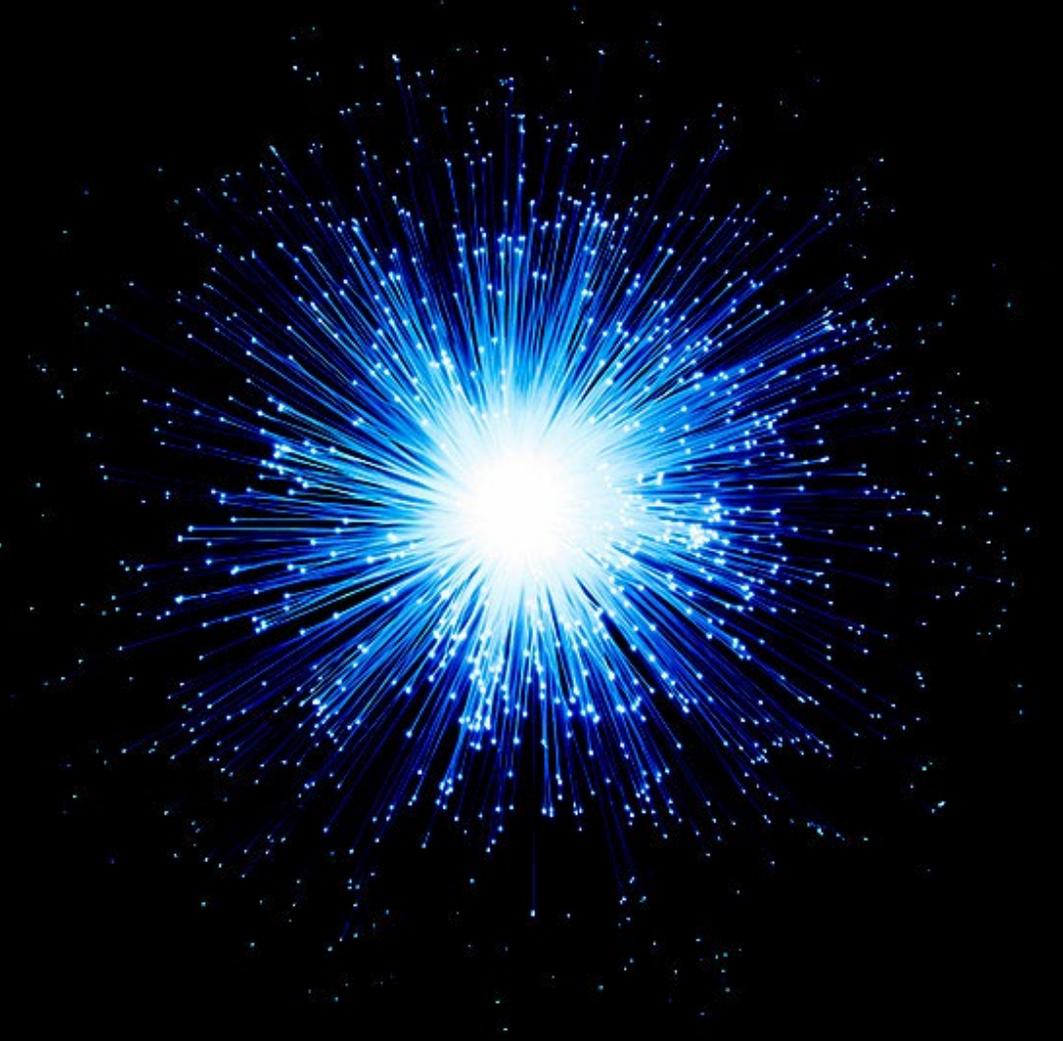
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AGENDA

- The MTC's project on the state taxation of partnerships and LLCs.
- State taxation of partnerships
- State tax issues from the sale of partnership interests
- Common issues of making the PTE Election

MTC STATE TAXATION OF PARTNERSHIP UNIFORMITY PROJECT



MTC STATE TAXATION OF PARTNERSHIPS UNIFORMITY PROJECT

Project began at the April 2021 meeting.

The project work group outlined a general approach to the project:

1. Identify and generally describe a comprehensive list of potential issues.
2. Note the important relationships between those issues.
3. Select a particular issue and develop generally recommended practices or positions.
4. Repeat step 3 until all major issues have been addressed and reconcile any differences.
5. Agree on overall set of recommended practices/ positions for all issues.
6. Begin creating draft models, etc., to carry out the recommended practices/positions.

COMPREHENSIVE ISSUE OUTLINE

The work group has finished steps 1 and 2 with the draft of the comprehensive issue outline that is available at:
<https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>

The outline divided issues into 5 main subgroups –

- Jurisdiction and nexus
- Tax base – operating income
- Sourcing of operating income
- Sourcing of gain (loss) from sale of a partnership interest
- Administration and enforcement

MTC STATE TAXATION OF PARTNERSHIPS UNIFORMITY PROJECT

The work group began step 3 by addressing sourcing for investment partnerships.

- The majority of states have a specific rule for the sourcing of income from certain types of partnerships that are primarily engaged in investment activities.
- While states may have a different basis for these rules—they follow from the principle that partnership income retains its character—as if it were earned directly—as it flows through and is taxed to the partners.
- So, investment income that would be sourced to residence if earned directly will be sourced to residence if earned through a partnership.

MODEL – INCOME FROM INVESTMENT PARTNERSHIPS

The purpose of the model is to provide a safe harbor for the sourcing of investment income or loss by certain nonresident partners where that income or loss would have been sourced to the nonresident partner's state of residency had the partner directly engaged in the activities of the entity that generated the income or loss. In cases where the requirements of the model are met the income or loss is properly sourced to the nonresident partner's state of residence.

Would apply only when all three of the following are satisfied:

- The nonresident partners (individuals and taxable trusts and estates) meet certain requirements
- The partnership meets certain requirements
- The income meets certain requirements

Recently received comments from the AICPA

Waiting on comments from the ABA

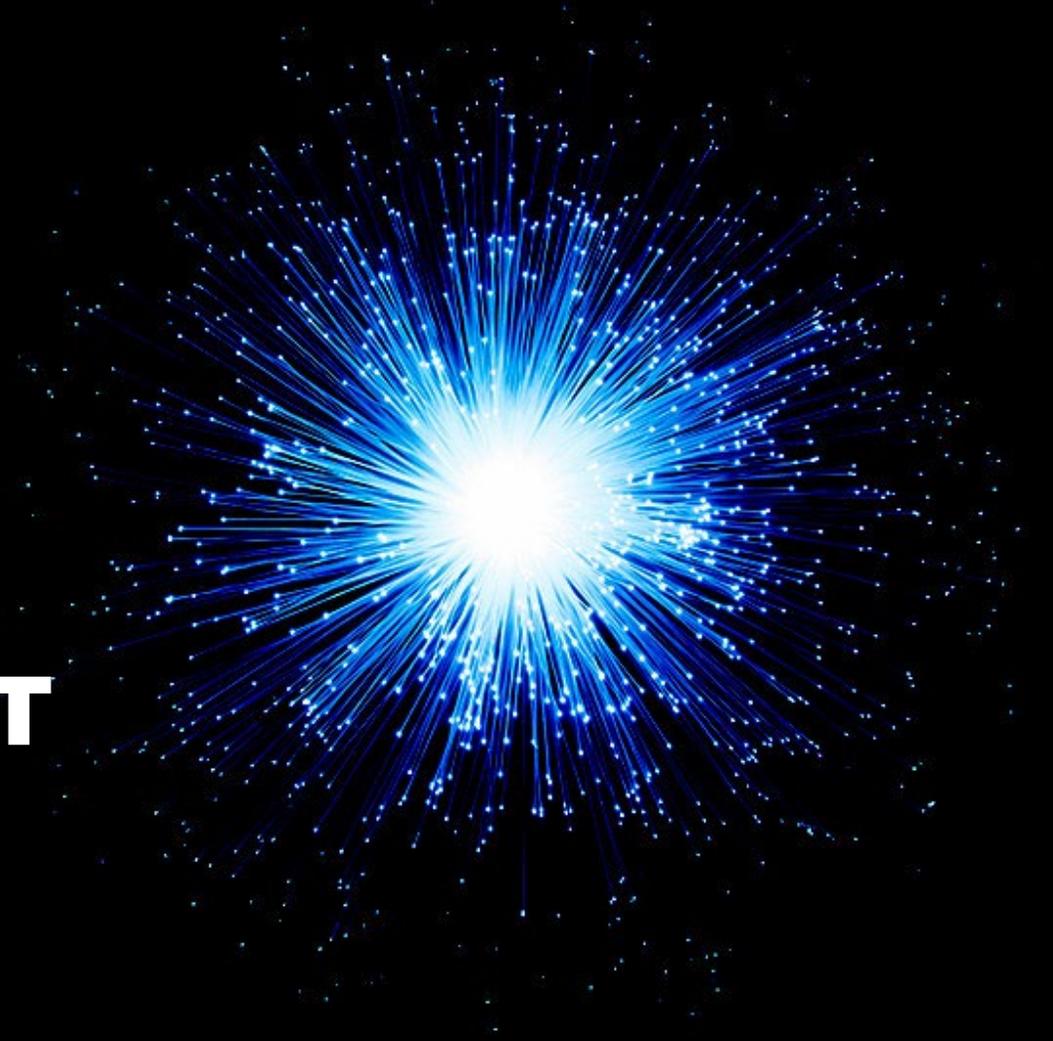
Latest version of the model is available on the MTC website on the project page

MTC STATE TAXATION OF PARTNERSHIPS – NEXT STEPS

Sourcing of Partnership Income

- Differences between corporate and individual partners
- Application of constitutional and general principles to partnership sourcing alternatives
- Different sourcing methods – use of partnership and partner information
 - Differences in types of partnerships
 - Differences in types of partners (passive vs active, etc.)
 - Differences in character of partnership items
 - Differences in the way partnership items are allocated
- Effect of tiered partnership structures on sourcing
- Credits for taxes paid – individual partners

STATE TAX ISSUES INVOLVING THE SALE OF A PARTNERSHIP INTEREST



State Issues Involving Sale of Partnership Assets

- Disposition of a Partnership can occur by selling the partnership's assets or the sale of partnership interest.
- Selling Assets of Partnership
- Sellers will be taxed in the states where the assets are located. Not good if the seller is an individual that is resident in no tax or low tax state.
- Big issue here is state sourcing of goodwill, which in many cases is the highest valued asset sold. Must look at state rules to see if there are rules or guidance for how the receipts/gain from goodwill should be sourced.

State Issues Involving Sale of Partnership Assets

- Sourcing of Gain From Goodwill – Two Approaches
- **Louisiana Regulation 1134.D.4.c. (Source to States where Intangible Has Been Used in Connection With the Business)**

“The net profit from the sale of other intangibles shall be attributed to the state or states in which the intangible has acquired a business situs if the intangible has been so used in connection with a business as to acquire a business situs, or, in the absence of such a business situs, shall be at the commercial domicile of the taxpayer.”
- **Virginia Regulation 23 VAC10-120-210.D.2.a (Source to State of Commercial Domicile).**

“The net gain portion of the sales proceeds shall be included in the sales factor to the extent and in the year recognized for federal income tax purposes. The net gain portion of the sales proceeds shall be included in the numerator of the sales factor if a greater proportion of the recordkeeping, collection and other income producing activity in the year of receipt is performed in Virginia.”

State Issues Involving Sale of Partnership Interests

- Selling Interest in Partnership
- First Question: Is Seller an Individual or Entity (i.e., another PTE or corporation)
- Seller of Partnership Interest is an Individual
 - Gain is typically sourced to individual's state of residence
- But beware of a few states that subject a portion of non-resident's gain based on
 - PTE's apportionment in the state (i.e., "investee" apportionment rules)

State Issues Involving Sale of Partnership Interests

- Example of States that tax Non-Resident on Sale of Partnership Interest

- **Maine Regulation 806.02.E.**

“Income from the sale of a partnership interest. The income from the sale of a partnership interest on or after July 1, 2005, by a nonresident is sourced to Maine to the extent of the ratio of the partnership's tangible property located in Maine to the partnership's tangible property located everywhere in the United States, determined based on original cost.”

- **Iowa Rule 701-40.16(9)b**

“Capital gains from sales or exchanges of interests in partnerships. When a nonresident of Iowa sells or exchanges the individual's interest in a partnership, the nonresident is actually selling an intangible . . . In the situation where a partnership conducts business both in and out of Iowa, the capital gain from the sale or exchange of an interest in the partnership would be allocated or apportioned in and out of Iowa based upon the partnership's activities in and out of Iowa in the year of the sale or exchange.”

- Other states with similar “investee” apportionment rules for Non-Residents That Sell Partnership Interests:
Idaho, Massachusetts, Minnesota, and Oregon

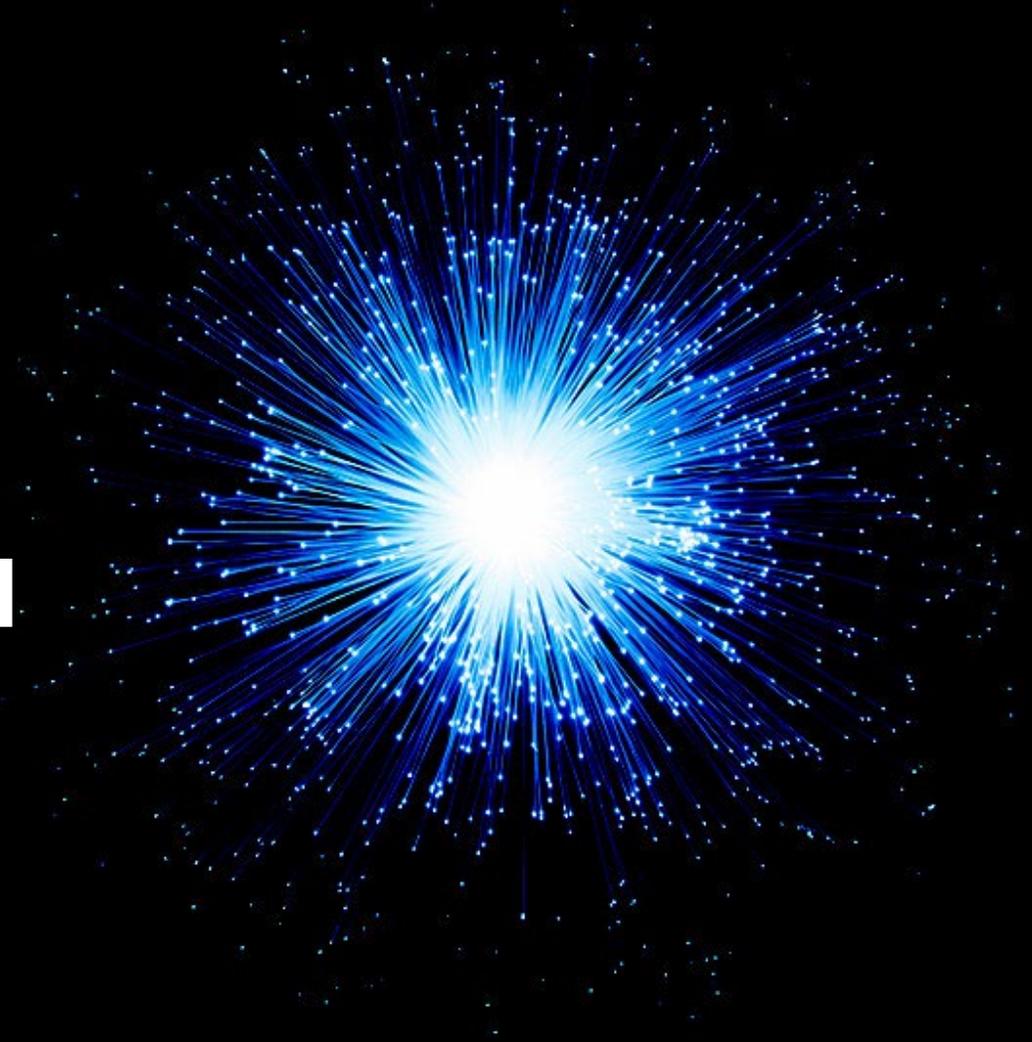
State Issues Involving Sale of Partnership Interests

- In many cases the selling entity is a holding company with no activities.
Question: How should the entity treat the gain for state tax purposes?
- First Question: Should the gain be treated as business (apportionable) or non-business income (allocated)?
 - **Illinois 35 ILCS 5/1501(a)(1)**
“Business income. The term "business income" means all income that may be treated as apportionable business income under the Constitution of the United States.”
 - **Indiana Rule 45 IAC 3.1-1-29 (traditional “transactional & functional” business income definition)**
"Business Income" is defined in the Act as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business.”
- Assuming the corporation or PTE with the gain is a holding company, should they treat the gain from the sale of the partnership interest as business or non-business income?

State Issues Involving Sale of Partnership Interests

- Second Question: Is the partner (selling entity) and the partnership “unitary” or “non-unitary”?
 - If “unitary”, then most states (but certainly not all) require the “aggregate” method in computing the partner’s state taxable income in states where the partnership operates (partnership’s income and apportionment factors plus partner’s share of partnership income and factors)
 - If “non-unitary”, then most states (but certainly not all) require the “entity” method in computing the partner’s state taxable income in states where the partnership operates (only use partnership’s income and apportionment

STATE TAX ISSUES FROM A PASS-THROUGH ENTITY ELECTION



THE SALT DEDUCTION AND PTE TAXES: WHY THE NEED FOR A PTE TAX

TCJA – SALT Cap

- SALT deduction for individuals temporarily limited to an aggregate deduction of \$10,000 (\$5,000 for a married taxpayer filing a separate return).
- Applies to tax years beginning after December 31, 2017 and before January 1, 2026.

THE SALT DEDUCTION AND PTE TAXES: RELEVANT EXCEPTIONS TO THE SALT CAP

- Code section 164(b)(6): State, local, and foreign real property taxes paid or accrued in carrying on a trade or business or an activity described in Code section 212 (relating to expenses for the production of income) are not subject to the SALT Cap.
- JCT Explanation: “Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner’s or S corporation shareholder’s distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner’s or shareholder’s distributive or pro-rata share of income as under prior law.”

THE SALT DEDUCTION AND PTE TAXES: STATE TAXATION OF PASS-THROUGH ENTITIES PRE-TCJA

- Before passage of the Tax Cuts and Jobs Act (“TCJA”), P. L. 115 – 07, most states conformed to the federal pass-through tax treatment of pass-through entities, with certain outliers:
 - Previously existing or “legacy” entity level taxes: New York City, District of Columbia, Illinois, New Hampshire, Tennessee, Texas
 - Gross receipts, annual fees or flat taxes, composite returns

THE SALT DEDUCTION AND PTE TAXES; STATE TAXATION OF PASS-THROUGH ENTITIES POST-TCJA

Since the passage of TCJA, 27 states + NYC have enacted various forms of Pass-Through Entity Taxes (“PTET”). Other states (IA, PA) considering enactment.

Concept: Instead of passing income through to PTE owners, the law requires a PTE to pay tax on its income at the entity level, similar to a tax on a C corporation.

- Shift the tax on PTE income from the owner to the PTE to allow the PTE to deduct the entity’s state and local income taxes as a tax on the business at the federal level, allowing a deduction in the tax base for the PTE tax in the distributive share of the PTE owner’s income.
- At the state level, owner claims a credit on the owner’s state income tax return for the amount of the owner’s distributive share of the taxes paid by the PTE or the owner excludes from its state tax base the income that was subject to the PTET tax.

THE SALT DEDUCTION AND PTE TAXES: CONSIDERATIONS

- A state PTET may not apply to all owners equally
- A state PTET may increase overall tax liability
- A state PTET may have an adverse impact on nonresident individual owners whose own state law will not provide an offset for the taxes deductible at the individual level
- How to handle differing tax results for owners
- Simplified nexus and administrative burdens
- Impact of PTET election on composite returns

THE SALT DEDUCTION AND PTE TAXES: HOW MUCH BENEFIT

How much benefit PTETs will yield in federal tax benefits depends on:

- The states in which the PTE does business
 - Composition of its owners (individuals, corporate)
 - Tax rates
 - Impact of a credit for taxes paid by the entity against the state personal income tax of the state in which the PTE tax is levied and the state of residence of the owner
- All of these issues must be considered in determining whether to make a PTET election BUT the issue of resident credits might be the most critical

PTE Tax Elections

ELIGIBLE PASS-THROUGH ENTITIES

- ▶ Any entity taxed as a partnership or S corporation for federal tax purposes - most states
- ▶ Only PTEs 100% owned by individuals, trusts or estates (e.g., NC, OR)
- ▶ Only PTEs 100% owned by persons eligible to be S corporation shareholders (e.g., GA)
- ▶ PTPs excluded

See calculation of the PTE's tax base

ELIGIBLE OWNERS

- ▶ No distinctions (e.g., AL, ID, IL, MD)
- ▶ Individuals only (e.g., AZ, GA, MN, NC)
- ▶ C corporation distributive share excluded (e.g., CA, CO, NYS)
- ▶ DREs (e.g., CA, MA, NYS)

THE TAX BASE

- ▶ PTE-level apportioned/allocated (e.g., AL, GA, IL)
- ▶ 100% resident owner distributive share; apportioned/sourced non-resident owner distributive share (e.g., AZ, CA, CO, NC)
- ▶ S corporations/partnerships distinguished (e.g., NJ, NY)
 - S corporation: all shareholders' sourced as non-residents
 - Partnership: resident/non-resident sourcing
- ▶ "As if" a C corp (e.g., LA, MI)

THE TAX BASE - EXCLUSIONS

- ▶ Opt-out/non-consenting owners' distributive shares excluded (e.g., AZ, CA)
- ▶ Entity owners' distributive shares excluded (e.g., CA, NY)

PTE Tax Elections

THE TAX BASE - NOLS & ATTRIBUTES

- ▶ State may allow the electing PTE NOL carryforwards or credits (e.g., WI, exception for OSTC)
- ▶ Other states allow NOLs and credits at PTE level (e.g., LA, OK)
- ▶ NOL carryforwards allowed as long as election is made (e.g., ID)

THE TAX RATE

- ▶ Single/fixed - most states will impose highest individual rate
- ▶ Graduated rate structure (e.g., LA, NJ, NY, OR)
- ▶ Different rates for different owners (e.g., MD, OK)

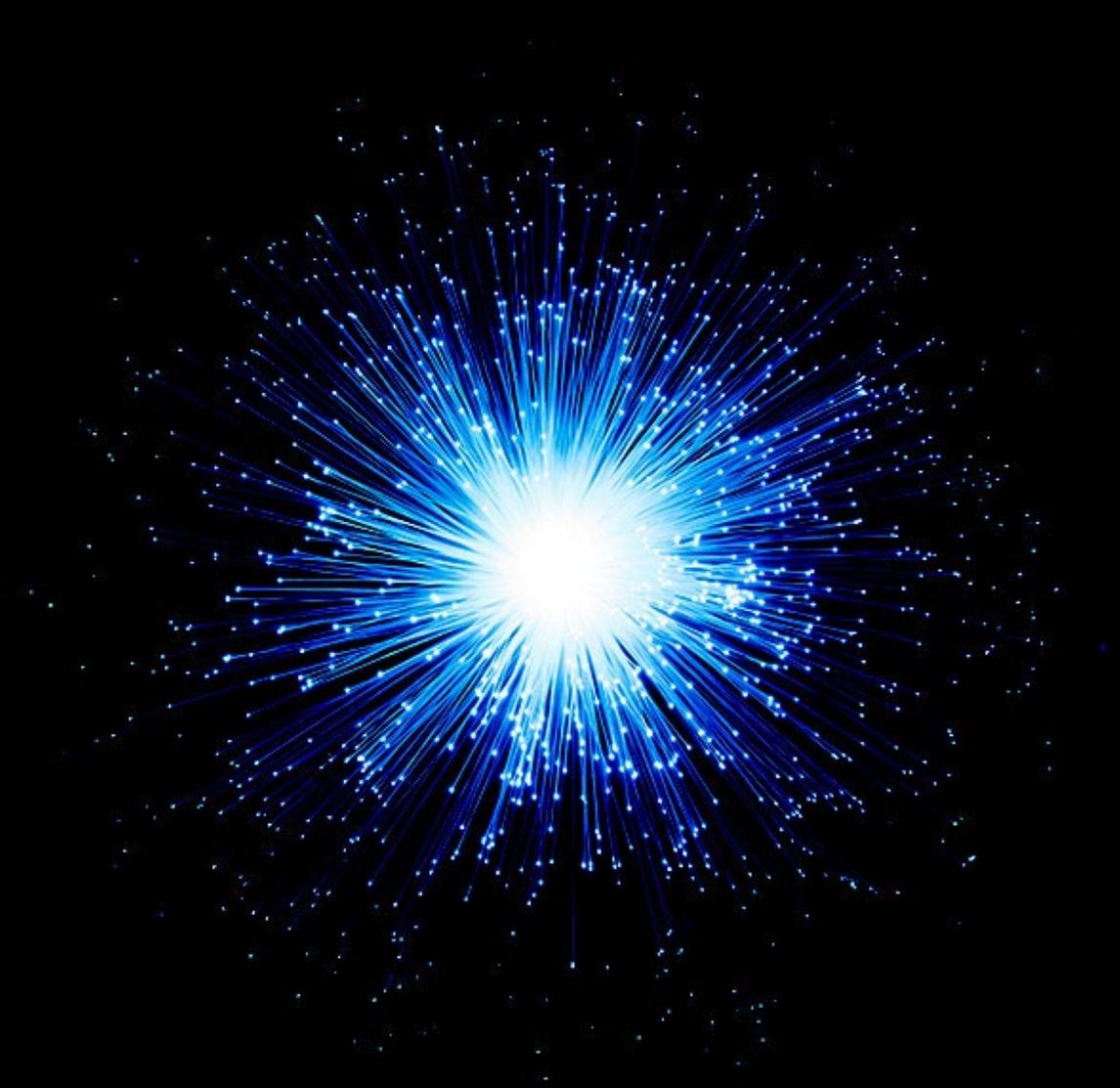
THE PTE TAX CREDIT

- ▶ States require owners to include their distributive share in their personal/corporate income, but provide a pro rata PTE tax credit
- ▶ Is the credit refundable or excess carried forward?
- ▶ Is the credit full or partial (e.g., CT 87.5%, MA 90%)
- ▶ S corporation resident shareholders - how is the PTE tax base calculated?
- ▶ Is an owner's state tax refund included in income?

THE ELECTIONS

- ▶ Annual, irrevocable - most states
- ▶ Binding, until revoked - AL, LA, OK
- ▶ Other - MI (binding for tax year + 2 years)
- ▶ Ability to revoke election prior to filing PTE tax return?

RECENT DEVELOPMENTS



TAXATION OF THE SALE OF A PARTNERSHIP INTEREST

Matter of Goldman Sachs Petershill Fund Offshore Holdings (Del.) Corp. v. New York City Tax Appeals Tribunal, 204 A.D.3d 469 (NY App. Div., 1st Dep't., 2022)

Issue: Taxation of gain of out-of-state partner on sale of partnership interest

Petershill master fund purchased 9.9% limited liability interest in Claren Road Asset Management, LLC.

- The master fund was never a managing member of Claren and it was not engaged in a unitary business with Claren.
- The fund reported and paid general corporation tax (GCT) on its share of Claren's income, deductions, gains, and losses.
- Aside from the master fund's investment in Claren, neither the fund nor the master fund conducted any business activities in New York City.

Held: The corporation failed to demonstrate that the city impermissibly sought to impose the tax on income attributable to activities outside its borders.

TAXATION OF THE SALE OF A PARTNERSHIP INTEREST

VAS Holdings & Investments LLC v. Commissioner of Revenue, 489 Mass. 669 (Mass. 2022)

Taxpayer (S Corp) argued that gain on the sale of a 50% interest in LLC operating in Massachusetts was not taxable in Massachusetts.

Stipulated: Taxpayer and the LLC not unitary; LLC did not serve an operational function.

Held: Massachusetts lacked statutory authority to tax the gain because the Massachusetts statute does not authorize the assessment of tax on an out-of-state business when the unitary business principle does not apply.

Supreme Court also determined, even though it did not need to, that it would have been constitutionally permissible for Massachusetts to tax the gain because the Taxpayer reaped the benefit afforded to the LLC by Massachusetts, and the use of the LLC's apportionment for the gain was constitutionally permissible.

Massachusetts filed for reconsideration on June 13, 2022.

PARTNERSHIP FILING FEES

Ferrellgas Partners LP v. New Jersey Division of Taxation, No. A-3904-18T1, 2021 BL 10778 (N.J. Super. Ct. App. Div. Jan. 13, 2021)

New Jersey imposes a flat \$150-per-partner filing fee on every partnership that has New Jersey income and more than two partners, up to a maximum of \$250,000.

Ferrellgas Partners LP had 67,000 partners and owed the \$250,000 maximum.

The partnership challenged the constitutionality of the fee, arguing that it violates the Dormant Commerce Clause.

Held: The fee is imposed on the activity of processing/regulating returns, which is a purely intrastate activity and is not commerce, let alone interstate commerce.

Ferrellgas petitioned U.S. Supreme Court for certiorari, arguing that the filing fee fails to meet internal consistency.

The Court requested a response from New Jersey, but ultimately denied cert. without comment.



THANK YOU!

Questions?