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■ STATE TREATMENT VARIES

Flow-through entities create complexity, opportunities

Flow-through entities such as partnerships, limited liability partnerships and limited liability companies, are often used in state income tax planning to reduce or even eliminate corporate income taxes in some states. But, in these times of state budget shortfalls and the resulting clamp down on corporations, are opportunities for tax planning still available through the use of these entities?

“The primary reason for limited liability companies is to get the benefits of limited liability without some of the negative consequences of having a separate corporate subsidiary,” explains **Craig Fields**, a partner with Morrison & Foerster in New York.

Entity classification

All states have adopted legislation governing the treatment of LLCs. Most states that impose a corporate income or franchise tax follow federal income tax law in their tax treatment of LLCs. Under federal check-the-box regulations (*see box on page 3*), certain types of business entities are classified for federal tax purposes as corporations. If a business entity is not required to be classified as a corporation under those provisions, the entity is eligible to elect its own federal income tax classification.

States that follow federal classification treat LLCs as partnerships under state law when the LLC is treated as a partnership for federal purposes. Among these are California, Delaware, Georgia, Illinois, Maryland, Michigan, Missouri, New York, North Carolina, Ohio and Oregon. States that do not conform to federal check-the-box regulations include the following:

- In Arkansas, domestic multi-member LLCs are taxed as partnerships and single-member LLCs as disregarded entities, even if they are taxed as a corporation for federal purposes. Foreign LLCs follow the federal classification.
- Massachusetts follows the federal classification for LLCs but not for limited partnerships and LLPs.
- In Texas, all LLCs are treated as corporations and subject to corporate franchise taxes.

Opportunities exist

Many companies are concerned that although converting a subsidiary to a flow-through entity may create tax advantages in a state, it might also result in nexus for the parent.

“There can be tremendous benefits from using pass-through entities and companies should not assume that it is a foregone conclusion that they will have nexus based solely on owning a pass-through entity in a state,” says **Mike McLoughlin**, a senior manager with KPMG in Houston.

Prentiss Willson, with Ernst & Young LLP in San Francisco, explains a situation in which a single-member LLC can be used to reduce its owner’s state taxes.

“Suppose you have an entity that you can predict is going to operate at a tax loss for awhile,” he says. “You convert that entity into a single-member LLC. You have left all the assets in a separate legal entity so the reasons that you had to separately incorporate those assets you have still accomplished. But since you have now elected to have that entity treated as a flow-through, all of a sudden its losses are picked up in the tax return of the member who owns it. What’s unrealistic about that of course is nobody is really able to predict the winners and losers very far in advance.”

Willson points out that although LLCs may be disregarded for income tax purposes, they are usually not disregarded for any other tax purpose.

“You have to consider all the other tax implications of setting up an LLC or partnership,” he warns.

Entity-level taxes

When an LLC is treated as a partnership at the state level, there may not be an entity-level tax imposed on it. Among states that do impose a tax at the entity level are Alabama, California, Delaware, District of Columbia, Illinois, New Hampshire, Pennsylvania, Tennessee, Texas and Washington.

“There are some states that include assets in the computation of the tax base for net worth but wouldn’t include an intangible,” Willson points out. “They also do not levy a net worth tax on an LLC or partnership. So if you put the physical assets into a partnership or LLC, those assets are no longer in the tax base for anybody.”

Fields notes that some states that in the past have permitted the use of a limited partnership where-by the corporate limited partners were not subject to tax have enacted legislation to change the ability to use such a structure. New Jersey and Ohio are two states that have done just that.

“Most of the other states where you could use this structure have changed their law to provide that either the corporate limited partner is taxable or the partnership is taxable,” Fields says.

McLoughlin notes that in Texas you can still avoid both the income and net worth tax by using a limited partnership, but the Texas Legislature is looking closely at eliminating this option.

Nonresident member/partner withholding

A number of states have enacted legislation requiring withholding for nonresident members and partners of flow-through entities, usually unless nonresident consent forms or composite returns are filed. (*See bonus insert in this issue of SITA.*)

“There appears to be a trend on the part of the states to enforce compliance against nonresident owners, and the MTC’s proposed rule requiring nonresident partner withholding is a good indication of where the states are going,” says **Bruce Ely**, a partner with Bradley Arant Rose & White in Birmingham, Ala. The Multi-state Tax Commission proposal Ely refers to calls for mandatory withholding on all distributions, both cash and property, to nonresident partners or LLC members unless the entity voluntarily files a composite income tax return on behalf of all its nonresident owners.

The American Institute of Certified Public Accountants supports a less stringent withholding requirement similar to one enacted for S corporations many years ago, Ely notes.

“Why do you have to go a notch further than you have gone with respect to S corps?” he asks. Ely was the principal author of the nonresident shareholder provisions of the model S corporation income tax act endorsed by both the AICPA and the MTC.

The next issue of SITA will discuss nexus and apportionment issues related to flow-through entities.

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Pennsylvania takes petition process on-line

The Pennsylvania Dept. of Revenue Board of Appeals has made the filing of petitions and intent to appeal forms as easy as getting on the Internet. The board’s On-line Petition Center is now operational. It can be accessed at www.boardofappeals.state.pa.us.

The on-line center offers several advantages to taxpayers, explains **Gerard J. Sallavanti**, Chairman of the Board of Appeals.

“It is obviously faster—you can file up to midnight Eastern Time for it to be considered filed on that date,” he says. “And it is a secure website so you don’t have to be concerned about filing documents over the Internet.”

Choose mail or email

Taxpayers can attach supporting documents and other information to Internet petitions using Microsoft Word, Excel or various other formats. Exhibits can also be sent via U.S. mail or express mail, even if the petition is filed electronically over the Internet.

Sallavanti notes that taxpayers can also opt to use email communications concerning their case.

“You can choose whether your decision be sent via U.S. mail or email,” he says. “If you opt to communicate via e-mail, you will be notified via email as the case progresses through the process so you know its status.”

Electronic signature required

If a taxpayer does not already have an electronic signature on file with the Dept. of Revenue, the electronic registration process must be completed from a link on the On-Line Petition Center page.

“It’s not a difficult process and they only have to do it one time,” Sallavanti notes. “Once they do that they can file as many appeals for as long as they want.”

Overall the new online process should make the petition process easier. But Sallavanti warns that instructions should be followed carefully.

“Some people just don’t bother reading them and want to get right into it,” he says. “We had a situation this morning where [a petition] came over the Internet and the gentleman didn’t read the instructions. It cannot be processed so we are going to have to get back to him.”

Taxpayers with procedural questions should contact Sallavanti at (717) 783-3666 or gsallavant@state.pa.us. Taxpayers with technical issues should contact Gary Schetrompf at (717) 783-3664 or gschetromp@state.pa.us. Questions regarding the electronic signature process should be directed to Dan Smith of the Office of E-commerce at (717) 772-9248 or dansmith@state.pa.us. ♦

■ BUSINESS/NONBUSINESS INCOME

Illinois court narrows functional test exclusion

A recent decision out of the Illinois Circuit Court of Cook County indicates the state intends to narrowly construe *Blessing/White Inc.* (2002)—a decision that classified income from a liquidation as nonbusiness income.

In *Blessing/White*, the Illinois Appellate Court upheld a determination that the complete liquidation of the capital assets of a corporation, followed by a distribution of the proceeds to shareholders, produced nonbusiness income. But in the recent case, the circuit court determined that gain from a taxpayer’s deemed sale of assets and liquidation pursuant to IRC §338(h)(10), and the subsequent distribution of the proceeds to a shareholder of the company’s parent, was business income under the functional test.

Section 338(h)(10) implications

American States Insurance Co., a foreign corporation licensed to transact business in Illinois, was sold by its parent to a third party. Rather than a stock sale, the parties made an irrevocable election under IRC §338(h)(10) to treat the transaction as a deemed sale of assets and complete liquidation of American States. American States filed a separate Illinois corporate income tax return and reported the gain on the transaction as nonbusiness income.

The Dept. of Revenue argued the transaction generated apportionable business income. It maintained American States failed to meet the functional test because there was no actual liquidation and the gain on the deemed asset sale benefited the company’s ongoing operation by receiving a stepped-up basis in the assets and entitling it to greater depreciation deductions.

The court noted, however, that since Illinois recognizes the §338(h)(10) election and permits the recognition of gain or loss on the sale of assets by the sold company, then the DOR must accept the concept of the deemed asset sale and the deemed liquidation. The court also noted that *Canteen Corp. v. Commonwealth of Pennsylvania* (2002), cited by the DOR, was inapplicable because Pennsylvania does not recognize a §338(h)(10) election for corporate net income tax purposes. In *Canteen*, the Commonwealth Court determined that a subsidiary’s gain from the sale of its parent’s stock to an unrelated corporation was business income. Pennsylvania’s tax code specifically provides that taxable income from a §338(h)(10) election is business income.

American States distinguished

Although the court required that the DOR recognize the §338(h)(10) election, it nevertheless found that the sale generated business income. This determination centered around the sequence of events. The court noted that the assets were technically transferred before the business operations ceased according to treatment under the federal tax code.

The functional test for business income is satisfied where the asset disposed of was used by the taxpayer as an integral part of its regular trade or business operations. The court determined that the assets were essential to American States' regular business operations. The disposition of the assets was equally important and integral to American States' business because under the 338(h)(10) election, the selling group needed assets to complete the sale of the American States stock it owned. This was the decisive factor that distinguished this sale and liquidation from the sale and liquidation in *Blessing/White*.

Marilyn Wethekam, a partner with Horwood Marcus & Berk in Chicago, says there is a good chance the decision, which is up on a petition for reconsideration, will be reversed.

"The way [the judge] thinks that a 338(h)(10) works is that the target is first liquidated up to its parent and then the parent sells the assets," Wethekam points out. "She has got it backwards. I think if she fully understands the sequence of a 338(h)(10) election, she will reverse herself."

Business/nonbusiness implications

The *American States* decision affects any company operating in Illinois that is planning to use the §338(h)(10) election, because it seems to close the door to a nonbusiness argument, notes **Mike Wynne**, a partner with Deloitte & Touche LLP in Chicago. But Wynne questions the reasoning of the court as compared to *Blessing/White*.

"In *Blessing/White* I think they got it right by looking at the intent and the proof of the intent to get out of the business," he says. "This court focused too much on the mechanics of how 338 operates and when gain is triggered and whether that tax outcome is integral to the business. In essence, it is transformed into a case of form over substance. I would rather the court focus on the other evidence of intent to get out of the line of business than the mechanics of how they got out of it."

Should this decision, if it stands, impact whether a company makes a §338(h)(10) election?

Probably not, Wethekam notes.

"At the federal level if someone thinks a 338(h)(10) is advantageous to the transaction it is going to occur and then it's going to be up to the state people to figure out how to deal with it," she says. "I do think, however, what the decision is going to do is narrow this exclusion to the functional test and that is where the impact is."

Wynne believes the decision, although not precedential, is significant.

"At this level it is certainly not persuasive to another court since it is a trial court decision, but there are so few cases out there on 338(h)(10) as it plays in a business/nonbusiness determination that it will certainly be noted," he points out.

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Philadelphia BPT revisions

Entities with business operations in Philadelphia should note that the Philadelphia business privilege tax scheme has changed retroactive to Jan. 1, 2002 due to HB2892 (Act 237, Laws 2002).

The BPT is based on the sum of two separate base calculations—allocated gross receipts and apportioned net income. Previously, it was a "prepaid" tax for the privilege of doing business in the current tax year. Receipts and income from the prior tax year were used to calculate the liability. A new entity was thus required to file two "new start" returns as well as a "regular" return during the first two reporting periods. However, activity from the final year of operations of a business was never included in the tax measurement base.

Significant revisions to the BPT include:

- elimination of confusing “new start” return filings,
- a requirement for taxpayers that terminate doing business in Philadelphia to file a *final return*, and
- a requirement for full estimated payments based on the prior year’s tax liability.

Taxpayers must file an “actual” 2002 BPT return or extension request by April 15, 2003. The return is based on the most recent fiscal or calendar year reported for federal tax purposes. Taxpayers may claim credits for taxes previously paid with the 2002 “prepaid” BPT return. In most cases, this should offset the actual 2002 liability. However, a cash payment—apparently equal to the 2002 tax—will also be due at this time as an estimated payment of the 2003 tax.

“The benefit to taxpayers is a simpler filing system that is more akin to the federal and state filing periods,” notes **Kenn Stoops**, senior manager of multistate tax services with Deloitte & Touche LLP in Philadelphia. “However, taxpayers will need to review their tax provisions to ensure that the liability is accrued in the appropriate accounting period.”

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