28th ANNUAL
PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM
VANDERBILT UNIVERSITY LAW SCHOOL

Backstage Pass to State Tax Treatment of Pass-Through Entities

Courtney Clark
Partner, Deloitte Tax LLP; Columbus, OH
Caragh DeLuca
Partner, PwC; Chicago, IL
Bruce Ely
Partner, Bradley LLP; Birmingham, AL
Steven Wlodychak
Client Serving Contractor, EY; Vienna, VA

Agenda

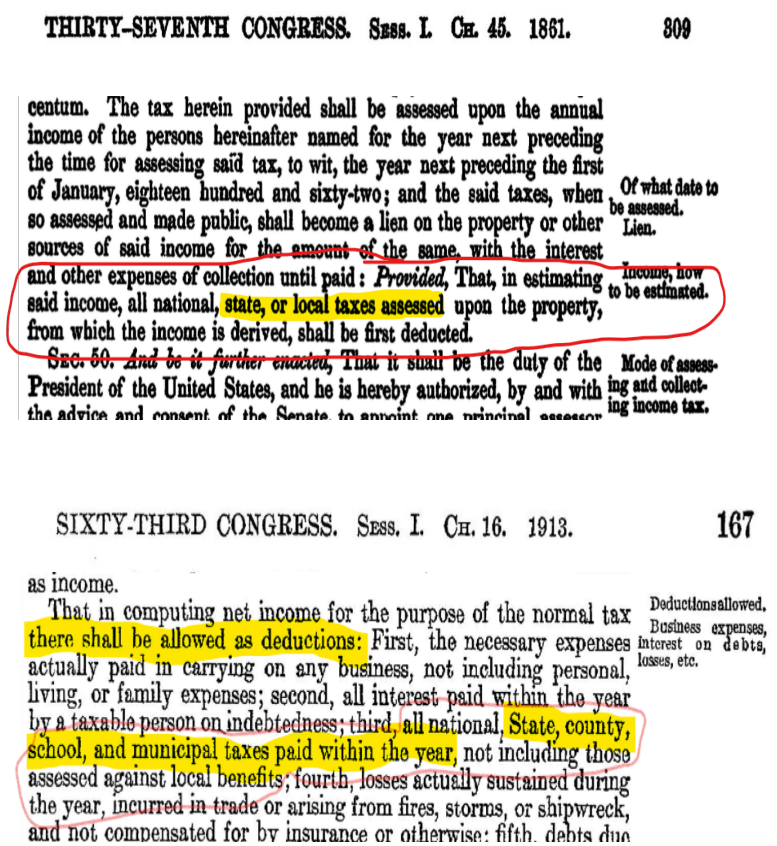
- The New Genre of PTE Taxes: Here to Stay?
- The MTC's Ambitious New Partnership Tax Project- Goals and Predictions
- Apportionment of Pass-Through Entity Income: Gain from the Sale of Entity Interests
- Miscellaneous

AGENDA: The New Genre' of PTE Taxes - Here to Stay?

- Pass-Through Entity Tax Overview
  - Pass-Through Entity Tax Overview - **Illinois**
    - Illinois Pass-Through Entity Tax Considerations: Potential Tax Benefits
  - Pass-Through Entity Tax Overview – **California**
  - Pass-Through Entity Tax Overview – **New York**
- Other Considerations and Elective Pass-Through Entity Tax Regimes

Legislative Background

- Prior to the Tax Cuts and Jobs Act (P.L. 115-97) ("TCJA"), the IRC allowed individuals to claim a deduction for state and local taxes (if itemizing).
- In 2017, the TCJA added section 164(b)(6), limiting the state and local tax deduction for individuals to not more than $10k annually, ($5k, if married filing separately) for taxable years 2018 through 2025.
  - State and local taxes are not deductible when computing the Alternative Minimum Tax.



THIRTY-SEVENTH CONGRESS. SESS. I. CH. 45. 1861. 309

centum. The tax herein provided shall be assessed upon the annual income of the persons hereinafter named for the year next preceding the time for assessing said tax, to wit, the year next preceding the first of January, eighteen hundred and sixty-two; and the said taxes, when so assessed and made public, shall become a lien on the property or other sources of said income for the amount of the same, with the interest and other expenses of collection until paid: *Provided*, That, in estimating said income, all national, state, or local taxes assessed upon the property, from which the income is derived, shall be first deducted.

Of what date to be assessed. Lien. Income, how to be estimated.

SEC. 50. *And be it further enacted*, That it shall be the duty of the President of the United States, and he is hereby authorized, by and with the advice and consent of the Senate, to appoint one principal assessor

Mode of assessing and collecting income tax.

SIXTY-THIRD CONGRESS. SESS. I. CH. 16. 1913. 167

as income.

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due

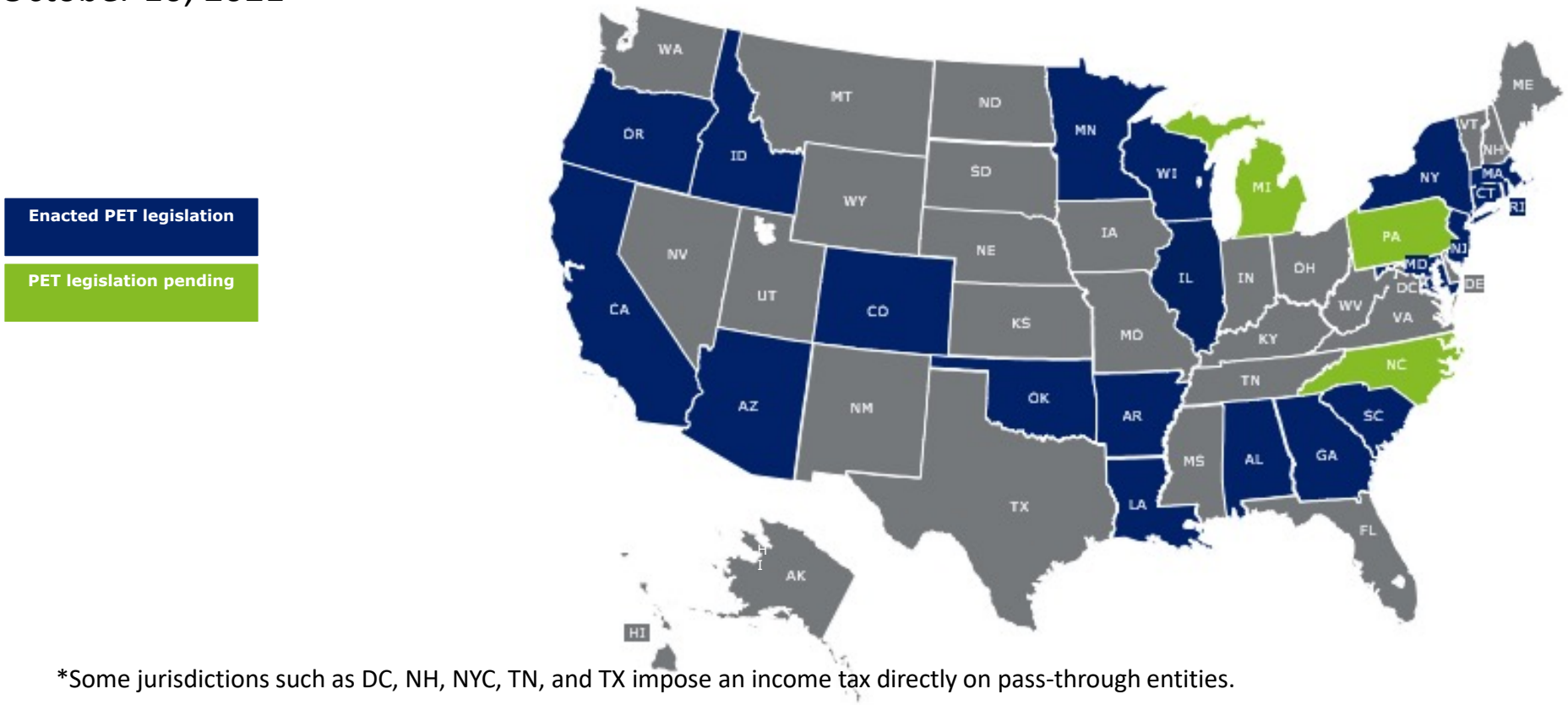
Deductions allowed. Business expenses, interest on debts, losses, etc.

IRS Notice 2020-75

- On November 9, 2020, IRS issued Notice 2020-75.
  - Treasury and IRS intend to issue proposed regulations to clarify the deductibility of certain state and local income tax payments.
  - "Specified income tax payments" are deductible by partnerships and S corporations in computing their non-separately stated income or loss.
- Specified Income Tax Payment – "any amount paid by a partnership or S corporation to a State, a political subdivision of a State or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or S corporation."
  - Applies regardless of whether the passthrough entity tax ("PET") is:
    - Mandatory or elective; or
    - If the owners receive a deduction or credit reducing the owners' individual income tax liabilities in their Domestic Jurisdiction.
  - Applies to payments made on or after November 9, 2020, but taxpayers can apply to payments in a taxable year of the pass-through entity ending after December 31, 2017 and can rely on the notice prior to the issuance of the proposed regulations.

States with Enacted and Proposed Pass-through Entity Taxes ("PETs")

As of October 10, 2021



*Some jurisdictions such as DC, NH, NYC, TN, and TX impose an income tax directly on pass-through entities.

Disclaimer: *Slide to be used for illustrative purposes only. Not to be used as a substitute for research into application of rules.*

Illinois Pass-Through Entity Tax ("IL PET")

- **Legislative Update**
  - As enacted, the election can be made by partnerships and S corporations for tax years ending on or after December 31, 2021, and beginning prior to January 1, 2026, provided that a $10,000 limitation for state and local tax deduction under section 164(b)(6) still applies
    - Annual election required
    - Election is irrevocable once filed
- **Tax Credit**
  - Partners can claim a credit against their individual Illinois income tax equal to 4.95% times the partner's distributive share of net income
    - Excess is treated as an overpayment and is refundable
    - Credit can only be claimed against the Income Tax, not Replacement Tax
  - Tax paid by the pass-through entity to another state that is substantially similar to the IL PET will be considered tax paid by the partner for the purpose of credit for taxes paid to other states

Illinois Pass-Through Entity Tax ("IL PET") (cont.)

- **Tax Computation**
  - The IL PET tax base includes all income allocable to the state
    - Guaranteed payments and income distributable to all partners, including tax exempt partners, are included in the tax base
    - The IL PET is in addition to the existing Replacement Tax and does not impact the Replacement Tax calculation
    - Items disallowed for the IL PET that may be allowed for Replacement Tax include:
      - Standard exemption under 35 ILCS 5/204
      - Net loss deduction under 35 ILCS 5/207
      - Deduction for income distributable to replacement taxpayers under 35 ILCS 5/203(b)(2)(S) and (d)(2)(I)
      - Deduction for reasonable compensation for partnerships under 35 ILCS 5/203(d)(2)(H)
- **Tax Rates**
  - 4.95% on net income of the pass-through entity

Illinois Pass-Through Entity Tax ("IL PET") (cont.)

- **Special Considerations for Quarterly Estimated Payments**
  - Estimated payments are required if the IL PET amount payable can reasonably be expected to exceed $500
  - Estimated payments are generally due on April 15, June 15, September 15, and January 15 of the following taxable year
  - The fourth estimated payment is due on December 15 for S corporations
- **Additional Considerations**
  - Tax exempt partners' share of income, some of which may not be subject to Illinois tax, will be taxable under the IL PET
  - Nonbusiness income allocated to Illinois by the pass-through entity is subject to the IL PET even though it may otherwise have been sourced outside Illinois if a partner's commercial domicile is not in Illinois. For purposes of the IL PET the pass-through entity is the taxpayer
  - As nonresident withholding will not apply to entities electing into the IL PET, partners or shareholders whose nonresident withholding was previously sufficient to cover tax due may now need to make additional payments
    - If a pass-through entity makes the PET election, there is not a waiver for any types of partners. Entity partners that provided withholding waivers will have tax paid on their income
  - Similar to nonresident withholding, if the PET credit equals or exceeds the partner's tax liability, the partner may not be required to file an individual Illinois income tax return
  - Foreign partner implications
  - Retired partner implications

Illustrative Example: Potential Impact on Illinois Residents

	Without PET	With PET	Benefit
Partnership Income	2,000,000	2,000,000	
IL PET (4.95%; 20% Apportionment)	-	19,800	
Partnership Income After PET	2,000,000	1,980,200	
Federal Income Tax (37%)	740,000	732,674	7,326
Illinois Income (100% of Income)	2,000,000	2,000,000	
Illinois Tax (4.95%)	99,000	99,000	
IL PET Credit	-	(19,800)	
Net IL Tax Due (Refund)	99,000	79,200	
2021 Cash After Taxes	1,161,000	1,168,326	7,326
Net Benefit			7,326

Illustrative Example: Potential Impact on Illinois Non-Residents – Lost Credit for Taxes Paid

	Without PET	With PET	Benefit
Partnership Income	2,000,000	2,000,000	
IL PET (4.95%; 20% Apportionment)	-	19,800	
Partnership Income After PET	2,000,000	1,980,200	
Federal Income Tax (37%)	740,000	732,674	7,326
Illinois Income (20% apportionment)	400,000	400,000	
Illinois Tax (4.95%)	19,800	19,800	
IL PET Credit	-	(19,800)	
Net IL Tax (Refund)	19,800	-	
Credit for Taxes Paid	19,800	-	(19,800)
2021 Cash after Taxes	1,240,200	1,247,526	7,326
Net Benefit (Detriment)			(12,474)

Illustrative Example: Potential Impact on Illinois Non-Residents – Credit for Taxes Paid

	Without PET	With PET	Benefit
Partnership Income	2,000,000	2,000,000	
IL PET (4.95%; 20% Apportionment)	-	19,800	
Partnership Income After PET	2,000,000	1,980,200	
Federal Income Tax (37%)	740,000	732,674	7,326
Illinois Income (20% apportionment)	400,000	400,000	
Illinois Tax (4.95%)	19,800	19,800	
IL PET Credit	-	(19,800)	
Net IL Tax (Refund)	19,800	-	
Credit for Taxes Paid	19,800	19,800	
2021 Cash after Taxes	1,240,200	1,247,526	7,326
Net Benefit (Detriment)			7,326

California Pass-Through Entity Tax ("CA PET")

- **Election**
  - Effective for tax years beginning on or after January 1, 2021 and before January 1, 2026 for qualifying entities (pass-through entities including S corporations) that are required to file a California return
    - Annual election required to be made on an original, timely filed return as prescribed by the California Franchise Tax Board ("FTB")
    - Irrevocable for that year once election is filed
    - Partners/shareholders must consent to the taxation of their distributive share of income
    - A nonconsenting partner/shareholder does not preclude the pass-through entity from making the election
  - Partnerships with a partnership as a partner may not make the CA PET election
- **Tax Computation**
  - The CA PET tax base includes the following:
    - California Residents – the partner's share of pre-apportioned taxable income
    - Non-Residents – the partner's share of California apportioned income
    - Corporations, disregarded entities and other non-qualified taxpayers – none of the partner's share of income
- **Tax Rate - 9.3%**
- CA PET is in addition to and does not replace other taxes. Taxpayers participating in a CA PET Return are still required to file

California Pass-Through Entity Tax ("CA PET") (cont.)

- **CA PET Credit**
  - Partners can claim a dollar-for-dollar credit for CA PET paid by the pass-through entity
  - The amount of the credit is equal to 9.3% of the qualified taxpayer's pro rata or distributive share of qualified net income subject to the PTE election
  - The credit is non-refundable. Excess CA PET credit may be carried over five years
  - CA PET credit cannot reduce the tax below the tentative minimum tax
  - Credit limits
- **Estimated Payments**
  - Tax Year 2021
    - The partnership is required to remit the tax payment by the original due date excluding extensions
  - Tax Years Subsequent to Tax Year 2021
    - The partnership is required to remit estimated tax payments
      - First payment due June 15, greater of $1,000 or 50% of the prior year CA PET
      - Remaining tax for the election year must be made by the original due date excluding extensions
      - Failure to make timely payments precludes the pass-through entity from making the CA PET election
  - Federal tax deduction may impact the timing of payments (i.e., payments may need to be made during the tax year to get the federal tax deduction in the tax year)

Illustrative Example - Potential Impact on California Residents

Potential Tax Benefits

	Without CA PET	With CA PET - CA Only Operations	With CA PET - Multistate
FTI from Partnership - Excluding CA PET Deduction	1,000,000	1,000,000	1,000,000
CA PET Deduction	-	(93,000)	(93,000)
FTI After CA PET Deduction	**1,000,000**	**907,000**	**907,000**
Federal Income Tax - 37%	**370,000**	**335,590**	**335,590**
California Individual Income Tax*	93,246	93,246	93,246
California Tentative Minimum Tax - 7%	70,000	70,000	70,000
California PET Credit $93,000 - Limited to Tenative Minimum Tax	-	(23,246)	(23,246)
Remaining Tax Due Before Other State Tax Credit		70,000	70,000
Other State Taxes Paid and Creditable**	-	-	(56,000)
Net California Tax Due After Credits	**93,246**	**70,000**	**14,000**
California PET Credit Carryover		69,754	69,754
Tax year 2021 Cash After Taxes	536,754	501,410	501,410
Current Year Cash **Savings/(Cost) of CA PET Election**		(35,344)	(35,344)
Potential Tax Savings Assuming PET Credit Carryover is Fully Utilized* **		**34,410**	**34,410**

* It should be noted that the 1% Mental Health Tax may not be reduced by credits.
** Assumes 80% of income is apportioned to other states with a blended 7% tax rate
***Excess PET credits may be carried over five years

New York Pass-Through Entity Tax ("NY PET")

- **Election**
  - Effective for tax years beginning on or after January 1, 2021, for eligible entities (pass-through entities include S corporations) that are required to file a New York return
  - Annual election required by the 1st quarterly due date of the tax year (generally March 15th). The initial year election was due October 15, 2021
    - Fiscal year filers follow the same deadlines, using the calendar year that the fiscal year ends in (e.g., a fiscal year ended 1/31/2022 would follow the calendar year dates)
  - Irrevocable once election is filed
- **Tax Computation**
  - The partnership NY PET tax base includes the following for includable partners (i.e., individuals, trusts, and estates):
    - New York Residents – the partner's share of federal income adjusted for New York rules under Article 22
    - Non-Residents – the partner's share of New York apportioned income
  - S corporation tax base
  - The S corporation NY PET tax base for includable shareholders (i.e., individuals, trusts, and estates) includes only the shareholder's share of New York apportioned income regardless of the shareholder's residency
  - Tax Rates
    - Graduated tax rate ranging from 6.85% - 10.90% based on total NY PET tax base of the pass-through entity
      - New York individual income tax rates ranging from 5.85% - 10.90%
  - The highest rate of 10.9% is for pass-through entities with income in excess of $25 million

New York Pass-Through Entity Tax ("NY PET") (cont.)

- **Credit**
  - Partners can claim a credit for NY PET paid by the pass-through entity. To the extent the NY PET exceeds the NY liability the excess is refundable to the partner
  - New York residents will now be allowed to claim a credit for taxes paid to other states, bearing certain limitations, for other state's pass-through entity taxes
  - The PET does not alleviate the partners obligation to file a tax return in NY
  - NY PET credit cannot be claimed on a composite/group return
- **Estimated Payments**
  - Tax Year 2021
    - The partnership is not required to remit estimated tax payments
    - The partners are required to continue to remit estimated tax payments without regard to the NY PET election
  - Tax Years Subsequent to 2021
    - The partnership is required to remit estimated tax payments
    - The partners are not required to remit estimated tax payments
    - Partners may take NY PET credit into account in making estimated tax payments

Illustrative Example - Potential Impact on New York Residents

	Without NY PET	With NY PET	Savings/(Cost)
FTI from Partnership (Excluding NY PET Deduction)	1,000,000	1,000,000	
NY PET Deduction		(109,000)	
FTI after NY PET Deduction	1,000,000	891,000	
Federal Income Tax (37%)	370,000	329,670	
New York Individual Tax (6.85%)	68,500	68,500	
New York PET Credit	-	(109,000)	
New York Tax Due/(Overpaid)	68,500	(40,500)	
Tax Year 2021 Cash After Taxes	561,500	601,830	40,330
Tax Year 2022 Tax on NY PET Refund	-	(14,985)	(14,985)
Net Savings/(Cost) of NY PET Election			25,345

Illustrative Example - Potential Impact on Non-New York residents

1: States that do **not** allow residents to take credit for PET

- VA residents lose $10,000 PET credit for NY tax
- VA resident has net federal benefits of $3,700 (10K x 37%)

NY liability based on NY Sourced Income	10,000
New York PET Credit	10,000
Without NY PET Election	
Net of Federal Benefits	-
Credits for Tax Paid to other states	10,000
With NY PET Election	
Net of Federal Benefit	3,700
Credit for NY Tax	-
Net Benefit/(Loss) of Electing PET	(6,300)

2: States that **do** allow residents to take credit for PET

- NJ residents can utilize $10,000 PET credit against NJ income tax (subject to limitation)
- NJ resident has net federal benefits of $3,700 (10K x 37%)

NY liability based on NY Sourced Income	10,000
New York PET Credit	10,000
Without NY PET Election	
Net of Federal Benefits	-
Credits for Tax Paid to other states	10,000
With NY PET Election	
Net of Federal Benefit	3,700
Credit for NY Tax	10,000
Net Benefit/(Loss) of Electing PET	3,700

Partnership Agreement Considerations

Cash Distribution Provisions

- Treatment of equity partners - distributable earnings to be reduced by partner's share of NY PET expense
- Treatment of non-equity partner (recipients of guaranteed payments and/or special income only) – guaranteed payment and/or special income to be reduced by partner's share of NY PET expense

Allocation Provisions

- Pass-through entity taxes, whether mandatory or elective, should be allocated to each partner to reflect each partner's share of the economics of the pass-through entity tax (e.g., to match the allocation of the NY PET credit)
- Assess whether the allocations would meet substantial economic effect or would be supportable under the partners' interest in the partnership

Potential Issues for PETs

- **Federal Income Tax Issues:**
  - Taxability of refund relating to PET credit
  - Reporting of state tax deduction for federal income tax purposes (e.g., Line 1 or 13)
  - Timing of payment when deducting for federal purposes
  - S corporations – Disproportionate distributions
- **State Income Tax Issues:**
  - Be conscious of election requirements and due dates when evaluating whether to make these elections
  - Understand facts and residency of partners
  - Credits in other states may not be available (i.e., resident state credits for taxes paid)
  - Ability to transfer PET credit to composite returns and/or satisfy partner's filing requirement
  - Potential increased tax liabilities under elective tax
  - Treatment of income to entity and tax-exempt partners
  - Applicability of corporate rules for electing pass-through entities in certain states
- **Other Issues:**
  - Partnership agreement provisions need flexibility in allocating PET expense to partners
  - ASC 740 Considerations

Partner Implications

- Partners who reside in certain states may be worse off under the PET because they are losing credits in their resident state
- Foreign partner implications
- Retired partner implications
- Other
  - Benefit for self-employment tax deduction (2.9%)
  - Benefit for additional Medicare tax – subject to limitations (0.9%)
  - Impact of future rate changes
    - Deduction at 37%
    - Refund at 39.6%

The MTC's Ambitious New Partnership Tax Project- Goals and Predictions

Areas of Focus

- Taxation of Partnership Income and Items
  - Jurisdiction and Nexus Issues
  - Tax Base
  - Sourcing of Partnership Income
  - Credit for Taxes Paid

Areas of Focus

- Taxation of Gains/Losses from Sale of Partnership Interest
  - Jurisdiction and Nexus Issues
    - Taxes on Exchange of Partnership Interests
    - Effects of State Adjustments on Basis
    - Distributions in Excess of Outside Basis
    - Reorganization
  - Sourcing of Gain/Loss
  - Credits for Taxes Paid

Areas of Focus

- Administrative and Enforcement
  - Reporting and Withholding
  - Federal Procedural Type Rules
  - Composite and Entity Level Taxes

Apportionment of Pass-Through Entity Income:

Gain from the Sale of a PTE Interest

Gain from the Sale of a PTE Interest General Principles & Deviations

- **Increasing Variation**
  - "*Mobilia sequuntur personam*," generally taxed to state of domicile
  - Some states have specific rules for nonresident PTE owners
    - Corporate – States Vary:
      - Unitary – Apportionable business Income
      - Non-Unitary – Allocable nonbusiness income
- **Outlier – Ohio**
  - According to R.C. 5747.212:
    - Taxpayer owning 20% or more of a PTE
    - At any point in preceding 3 years
    - Must apportion capital gain from the sale of PTE interest to Ohio
    - Using the entity's average apportionment factors for the preceding 3 years
- **Outlier – New York** (later)

Gain from the Sale of a PTE Interest – Ohio

***Corrigan v. Testa*, 149 Ohio St.3d 18, 2016-Ohio-2805 (2016)**

- Nonresident individual sold his 79% membership interest in LLC, sourced gain to his state of individual domicile
- Ohio DOT assessed tax under R.C. 5747.212; TP paid part and sought refund
- Ohio Supreme Court held statute "as applied" to Corrigan violated Due Process Clause of 14th Amendment to U.S. Constitution where:
  - He was not actively involved in day-to-day management of the business and
  - Not clear taxing gain "as if it were business income" actually related to the values giving rise to the gain (emphasis added)
- Due process requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." 2016-Ohio-2805, quoting *Quill* and *Miller Bros.*; no connection to this transaction
- Ohio DOT argued unitary business principle was irrelevant; Court rejected that argument.

Gain from the Sale of a PTE Interest – Idaho

***Noell Industries, Inc. v. Idaho State Tax Commission*, 470 P.3d 1176 (ID 2020), cert. denied, 209 L. Ed. 2d 130 (U.S. S.Ct. 2/22/21)**

- **Issue** - Was $120 million capital gain Noell Industries, Inc. ("Noell") realized from selling its entire 78.54% interest in Blackhawk Industries Products Group Unlimited, LLC ("Blackhawk") business income under Idaho Code section 63-3027?
- Idaho Supreme Court holds that the unitary business test is "part and parcel" of business income question; Idaho rule defining "business income" incorporates the unitary business concept, so no failure to plead the argument/defense.
- Idaho's definition of "business income" incorporates both transactional and functional tests.

Gain from the Sale of a PTE Interest – Idaho

***Noell Industries, Inc. v. Idaho State Tax Commission* (cont.)**

- Transactional test failed: Noell's business was "investments" and it owned two entities. In the 7 years between the date Noell was formed and when it sold Blackhawk, there was only one purchase and one sale – Blackhawk. Thus, Blackhawk's sale was not in the regular course of Noell's trade or business.
- Functional test can be satisfied:
  a) By finding the intangible interest serves an operational function; was not a passive investment, or
  b) By satisfying the unitary business test.

Gain from the Sale of a PTE Interest – Idaho

***Noell Industries, Inc. v. Idaho State Tax Commission* (cont.)**

- Sale of principal asset did not serve an operational function to Noell; it resulted in its operational function of being a holding company to Blackhawk ceasing.
- Noell and Blackhawk lacked "substantial mutual interdependence" [i.e., not unitary].
  - Mike Noell's founding the companies and serving as CEO of Blackhawk was not the level of functional integration, centralized management, or economies of scale necessary where there was a six-member management team.
  - He was a high-level executive who did not run day-to-day operations.

Gain from the Sale of a PTE Interest – Idaho

Noell Industries, Inc. v. Idaho State Tax Commission (cont.)

- Noell paid tax on the gain to Virginia, its state of commercial domicile, though apparently on an apportioned basis.
- **Dissent argues**:
  - Noell and Blackhawk were functionally integrated because Mike Noell created both entities and provided "know-how" necessary for their success.
  - Entities had centralized management because Mike Noell was intimately involved with both entities; majority ignores the extent of his involvement.
- Idaho State Tax Commission files cert. petition with U.S. S.Ct.
  - MTC files amicus brief urging grant.
  - U.S. S. Ct. denies without comment Feb. 22, 2021

Gain from the Sale of a PTE Interest – Mass.

VAS Holdings & Investments LLC v. Comm. of Rev., Dkt. Nos. C332269 and C332270 No. DAR-28258 (Mass. App. Tax Bd. Oct. 23, 2020)

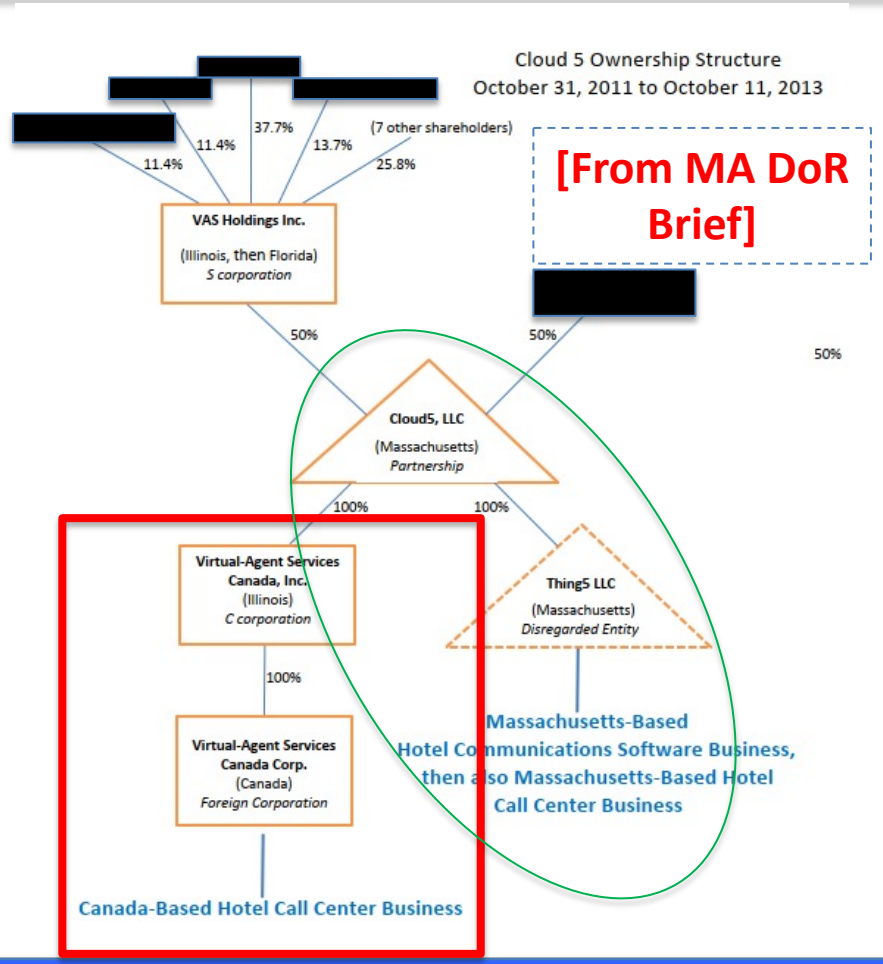
- **Relevant Law**:
  - Mass. ***CORPORATE*** Tax Regulation (830 CMR 63.38.1(9)(d)3.e), as in effect for the tax year at issue (under the cost of performance regime and former property/payroll factor apportionment formula), required an S corporation to apportion gain from the sale of an interest in a partnership (including an LLC) to Massachusetts if "the sum of the partnership's Massachusetts property and payroll factors for the taxable year in which the sale occurred exceeds the sum of its property and payroll factors for any other one state."
    - Regulation promulgated in 1995 and "interprets" Mass. corporate tax statute under Mass. Gen. Laws ch. 63, sec. 38
    - Promulgated in 1995 while the Mass. Dept. of Rev. litigated a similar issue **which it lost** in *Comm. of Rev. v. Dupee*, 670 N.E.2d 173 (Mass. 1996)

Gain from the Sale of a PTE Interest – Mass.

VAS Holdings & Investments LLC v. Comm. of Rev. (cont.)

Facts:

- VAS Holdings & Investments, Inc. (VASHI), was an Illinois S corporation that reincorporated to Florida and essentially operated as a holding company
  - VASHI's only asset was a 50% membership interest in an operating LLC (taxed as a partnership), Cloud 5, LLC, based in Massachusetts.
- Nearly all of the LLC's U.S. property and payroll were in Massachusetts although both Mass. DOR and ATB disregarded substantial Canadian operations.
- Mass. DOR concedes that VASHI and Cloud 5 were not "unitary" under 3-factor test (no centralized management, economies of scale, or functional integration)
- VASHI sells its 50% membership interest and realizes a gain of $37 million.



Gain from the Sale of a PTE Interest – Mass.

VAS Holdings & Investments LLC v. Comm. of Rev. (cont.)

- **<u>Arguments</u>**:
  - VASHI argued that Mass. couldn't tax the gain realized from selling the LLC interest where the S corp. and partnership are (admittedly) not unitary, citing *Allied-Signal, Inc. v. Director, N.J. Div. of Tax.* (U.S. S.Ct. 1992) and *MeadWestvaco Corp. v. Ill. Dept. of Rev.* (U.S. S.Ct. 2008) ("*MWV*").
  - Commissioner responded that the gain was taxable by Mass. because the regulation was an "investee apportionment" rule, and therefore a unitary relationship was not required, citing *Allied-Signal, Inc. v. Commissioner of Finance*, 79 N.Y.2d 73 (1991) (which was decided ***BEFORE*** the U.S. Supreme Court rulings in *Allied-Signal* and *MWV*) and *International Harvester Co. v. Wisc. Dept. of Tax.* (1944).

Gain from the Sale of a PTE Interest – Mass.

VAS Holdings & Investments LLC v. Comm. of Rev. (cont.)

- **ATB Holding**:
  - The Appellate Tax Board issued a one page ruling on Apr. 29, 2018 upholding the assessment.
  - Subsequently, on Oct. 23, 2020, it issued a formal opinion holding that investee apportionment is constitutional on these facts, without even citing, much less attempting to distinguish, *MWV*, and worse yet, as a result of its former Reg., upholds apportioning **100% of the gain to Mass**.
  - S corp's gain was "inextricably connected to and in large measure derived from property and business activities in Massachusetts" conducted by the LLC, citing another case.

Gain from the Sale of a PTE Interest – Mass.

VAS Holdings & Investments LLC v. Comm. of Rev. (cont.)

- **ATB Holding** (cont.):
  - To treat the Sale Gain as arising solely from the discrete act of selling the LLC membership interest would "'trivialize the years of work and business effort that developed the value" of the LLC.
  - But see, e.g., *Corrigan v. Testa* (Ohio (2016) above); *Noell Industries, Inc. v. Idaho State Tax Commission* (Idaho (2020) above U.S. S.Ct. cert. denied (2021)); and many others.
  - VASHI appeals and Mass. Supreme Judicial Court quickly grants application for direct appeal, bypassing the Mass. Court of Appeals.
    - Mass. DOR, in an unusual letter to the Court, does not oppose the direct appeal to the Mass. SJC, admits this is a case of first impression in Massachusetts and that investee apportionment "is undoubtedly less common among the states…"
  - Oral argument set for early January.
    - MTC to file amicus brief?

Miscellaneous

- Corporate Transparency Act
- Partnership BBA Model Language Update
- NJ Unapportioned Per Partner “Fee” Ruling
- Tennessee DOR – Franchise Tax Effect of Basis Adjustment

The Corporate Transparency Act (31 USC §5336)

- These new reporting requirements were enacted as part of the National Defense Authorization Act of 2021 ("NADA") and also amended the Anti-Money Laundering Act of 2020. Significant [if not frightening] addition to the most comprehensive legislative crackdown on money laundering in recent history.
- Somewhat like the partnership audit rules, these registration rules apply not only to newly-formed corporations, LLCs, limited partnerships, etc. but to existing entities, and the burden of proof for an exemption is on the company and its advisers. Trickle-down effect on the states?

The Corporate Transparency Act (31 USC §5336)

- **Start with the general rule:**
  - A "reporting company" includes a corporation, LLC or "other similar entity" that is created by filing a document with a secretary of state or similar office or formed under the laws of a foreign country and registered to do business in the US.
- **To whom must a reporting company report?**
  - FinCEN, otherwise known as the Financial Crimes Enforcement Network of the U.S. Treasury Dept.
- **What must be reported?**
  - Specified information on the entity's "beneficial owners"- the individual natural persons who own or control them – as well as specified information about the persons who form or register these companies.

The Corporate Transparency Act (31 USC §5336)

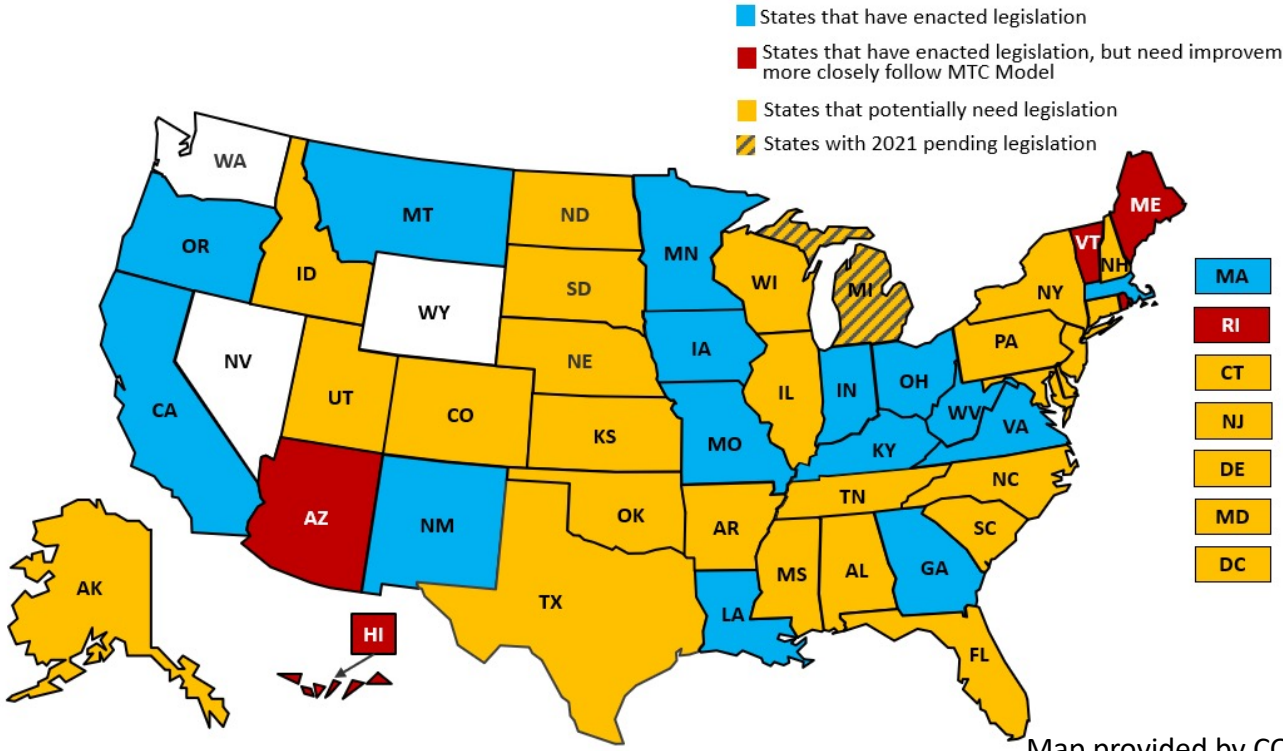
- **Exemptions:**
  - Publicly-traded companies subject to SEC oversight;
  - Companies:
    a) Employing more than 20 full-time employees in the US,
    b) Operating from a physical office in the US, AND
    c) Having filed a federal tax return reporting more than $5 million in gross receipts or sales.
- Also exempt are dormant companies not owned either directly or indirectly by a non-US individual as well as certain financial institutions, charitable trusts, and pooled investment vehicles
- **Penalties are significant**:
  - An individual who fails to meet the reporting requirement faces **civil penalties of up to $500 per day**.
  - If the individual willfully provides or attempts to provide false or fraudulent information or willfully fails to provide FinCEN with requested information faces criminal fines up to $10,000 and/or imprisonment for up to two years.
  - Steep penalties for unauthorized disclosure, too.

The Corporate Transparency Act (31 USC §5336)

- Preliminary questions for you:
  - Who will file the initial registration with FinCEN (which subsumes deciding whether the entity qualifies for one of the exemptions)?
  - Who will monitor ongoing compliance (e.g., ownership of the reporting company) and filing requirements?
  - Reporting companies formed prior to the effective date of the final regulations will have two years in which to comply. But reporting companies formed on or after the effective date will be required to report the beneficial ownership information at the time of formation or registration.
  - Any change in reported information must be reported to FinCEN within one year after the change.
- Monitor the issuance of final regs closely…

Partnership Audit – Adoption of Model Language

- States' enactment of legislation to adopt the MTC Model



Map provided by COST on September 29, 2021

NJ Unapportioned Per Partner "Fee" Not a Tax

***Ferrellgas Partners, LP v. Director, Div. of Tax*., Dkt. No. A-3094-18T1, 2021 WL 115643 (N.J. Tax Ct. (Jan. 13 , 2021)), cert. denied, N.J. S. Ct. (June 4, 2021)**

- Appeal of lengthy NJ Tax Court ruling in favor of the N.J. Div. of Tax. (NJ DOT)
- NJ statute imposes an annual filing "fee" on any entity classified as a partnership for federal income tax purposes that has more than two partners that have NJ sourced income
  - Fee is $150 per partner (applies to both residents and nonresident (NR) partners) but is capped at $250,000 annually.
- Statute doesn't require apportionment but NJDOT regulation did:
  - Apportionment only required if the partnership had an office located outside NJ and NR partners without "physical nexus" to the state.
  - If so, the REGULATION (not the statute) provided that the partnership's corporate allocation factor is used to apportion the "fee".

NJ Unapportioned Per Partner "Fee" Not a Tax

***Ferrellgas Partners, LP v. Director, Div. of Tax.* (cont.)**

- Taxpayer (or the "feepayer?") is a publicly traded partnership with tens of thousands of partners.
- Challenged application of the "per partner fee" based on multiple Commerce Clause violations:
  - Was this a fee or tax?
  - Revenue-raising measure, not a regulatory fee?
  - At least three prongs of the *Complete Auto Transit* test are arguably violated:
    - Discrimination
    - Lack of fair apportionment
    - Not fairly related to the services provided by the state
  - Internal consistency big issue (if every state had one of these fees, it'd be pretty expensive!)

NJ Unapportioned Per Partner "Fee" Not a Tax

- *Ferrellgas Partners, LP v. Director, Div. of Tax.* (cont.)

- **Ruling**:
- N.J. appeals court rejects all challenges:
  - "NJ statute . . . is facially neutral. Therefore, absent disparate impact or undue burden on plaintiff's investment activity, the (Tax Court) was not required to apply the internal or external consistency test or to determine whether the [per partner fee] amount is fairly related to the services provided by the State…
  - "Plaintiff failed to present a prima facie case that the statute discriminates against, or imposes an excessive burden on, interstate commerce. Nor did it demonstrate that the [per partner fee] was not fairly related to the [NJDOT's] (cost of) processing and review of partnership and partner returns." Tax Court affirmed.
- Correct analysis? Implications for other states?

TN Dept. of Rev. Ruling of Interest

- In Letter Ruling 21-06 (6/10/21), the Tennessee Department of Revenue addressed the franchise and excise tax implications when a partnership makes an IRC Sec. 754 election to step up the adjusted basis of its assets for federal income tax purposes, and the partnership elects to "push down" the purchase accounting adjustments resulting from the purchase that gave rise to the IRC Sec. 754 election.
  - For franchise tax purposes, the taxpayer must calculate its taxable net worth using the fair market value adjustments that resulted from the push-down election.
  - For excise tax purposes, the taxpayer must exclude from its net earnings the basis adjustments and associated amortization and depreciation deductions that resulted from the IRC Sec. 754 election.
- Because Tennessee taxes the partnership itself, the question frequently arises whether the partnership can claim the benefit of the stepped-up basis when reporting its net earnings. As the ruling opines, for federal income tax purposes, the election does not affect the taxable income of the partnership itself, but rather is only taken into consideration when determining the partner's taxable income from the partnership.

Thank you!

- Questions and Discussion

- General Disclaimer
  - Views expressed in this presentation are those of the speakers and do not necessarily represent the views of Bradley LLP, Deloitte Tax LLP, EY, PwC.
  - This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide accounting, tax, or other professional advice because it does not take into account any specific taxpayer's facts and circumstances.
  - Bradley LLP, Deloitte Tax LLP, EY, PwC nor any member firm thereof shall bear any responsibility whatsoever for the content, accuracy, or security of any third-party websites that are linked (by way of hyperlink or otherwise) in this presentation