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Recent SALT Developments in the PTE World

October 25, 2023

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Agenda

I. State PTE Taxes- an Update/Timing of Deduction of PTE Taxes
II. The MTC's Partnership Tax Project- an Update
III. Apportioning Gain on the Sale of PTE Interests (Other Than Investee Apportionment)
IV. Federal Partnership Audit Rules and State Implications
V. Miscellaneous Recent SALT Developments Affecting PTEs

I. State PTE Taxes – An Update/Timing of Deduction of PTE Taxes

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PTE Taxes: A Refresher

As we become more comfortable with PTE taxes, the same questions remain…

- Timing and treatment of deduction
- Eligibility
- When to make election and how
- Tax base, income exclusion, credit available
- Credit for taxes paid
- Estimated payments

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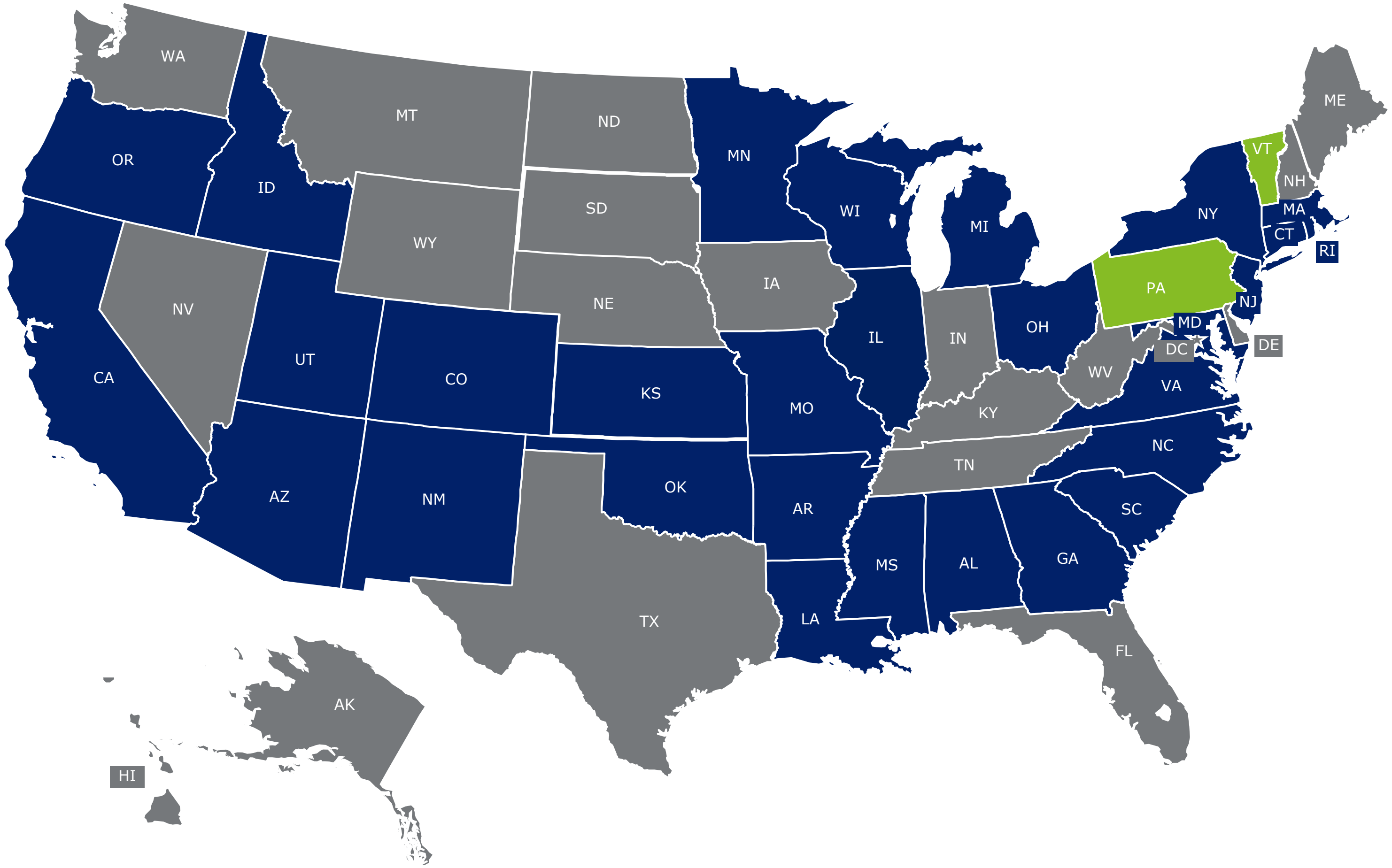
Where we were last year:

Pass-through Entity Taxes – as of August 15, 2022

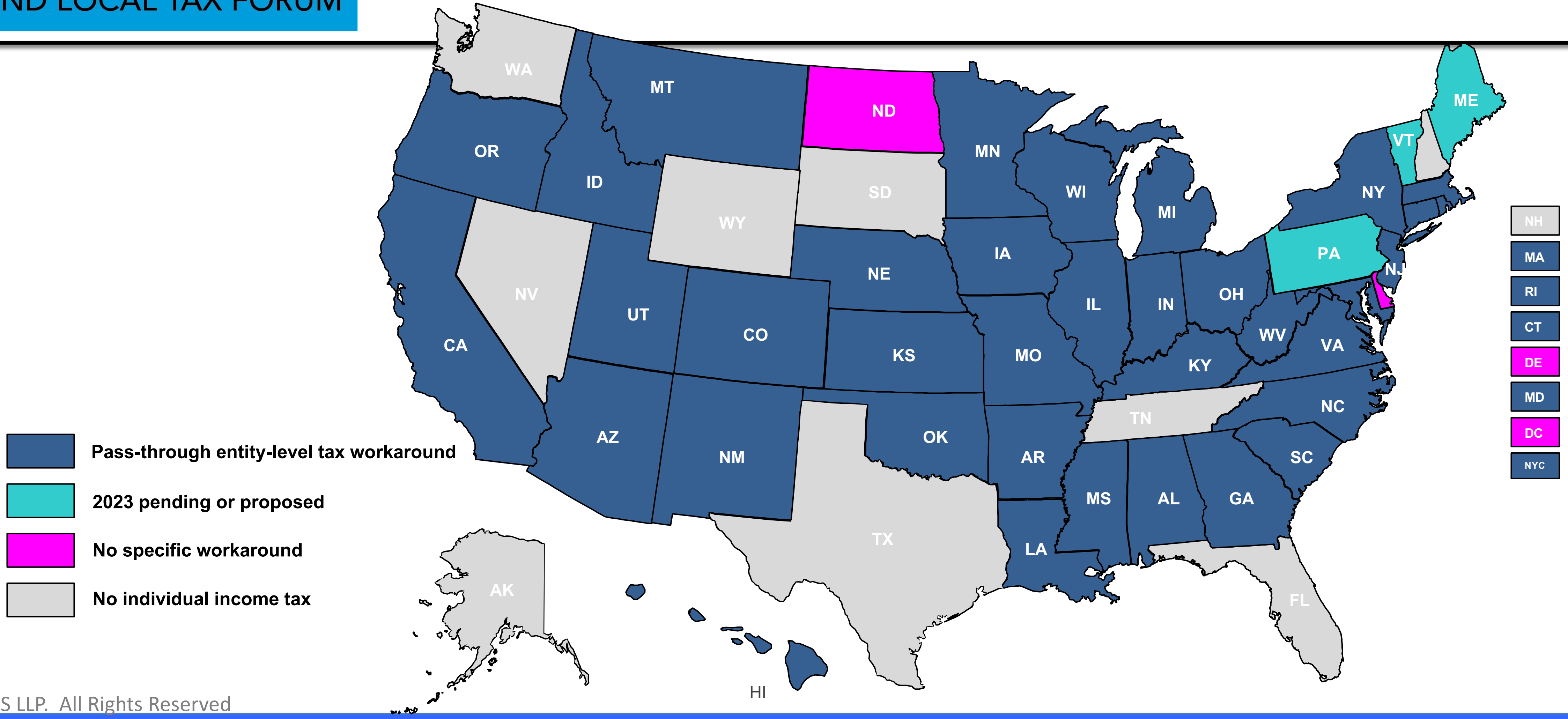
Enacted PET legislation

PET legislation pending



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

Pass-through Entity Taxes – as of September 15, 2023



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Current PTE tax workarounds (36 states and NYC)

State	Effective Year
Alabama	2021
Arizona	2022
Arkansas	2022
California	2021
Colorado	2018 (retroactive)
Connecticut	2018 (mandatory until 2024)
Georgia	2022
Hawaii	2023
Idaho	2021
Illinois	2021
Indiana	2022 (retroactive)
Iowa	2022 (retroactive)
Kansas	2022
Kentucky	2022
Louisiana	2019
Maryland	2020
Massachusetts	2021
Michigan	2021
Minnesota	2021

State	Effective Year
Mississippi	2022
Missouri	2022
Montana	2023
Nebraska	2018 (retroactive)
New Jersey	2020
New Mexico	2022
New York	2021
New York City	2022
North Carolina	2022
Ohio	2022
Oklahoma	2019
Oregon	2022
Rhode Island	2019
South Carolina	2021
Utah	2022
Virginia	2021
West Virginia	2022
Wisconsin	2018

Maps and lists and matrices, oh my!

https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-links-to-pass-through-entity-pte-taxes-states-legislation-and-tax-authorities-information-and-guidance.pdf

AICPA

Links to States' Pass-Through Entity (PTE) Tax
Legislation and Tax Authorities' Information and Guidance

as of August 4, 2023

State	Legislation (effective date)(see note below)	Information and Guidance	Restrictions on Owners	Owner Treatment	Credit for Other State PTETs	PTE Tax Rate
AL	Acts 2021-1 (p 43) amended by Acts 2021-423	Updated Temporary Guidance for Electing Pass-Through Entities	None. 2021 Ala. H.B. 170, §10(b)(1)	Refundable credit	Ala. Code § 40-18-21	5.00%
AR	HB 1209 (2021)	Pass-Through Entity Tax	None. A.C.A. § 26-65-102	Income exclusion. Owners can be held liable for unpaid PTET	S shareholders only? A.C.A. § 26-51-504	4.90% 2.45% on cap gains
AZ	SB 1783 (2021)	Arizona Estimated Tax Notice for Partnerships and S Corporations Making the Pass-Through Entity Tax Election	All owner types allowed, but only individuals, trusts and estates are included in computation of tax. A.R.S. § 43-1014	Non-refundable credit with 5-year carryover	A.R.S. § 43-1071(G)	2.98%
CA	AB 150 (2021) amended by SB 113 and SB 851	Pass-through entity (PTE) elective tax	All owner types allowed, but only individuals, trusts and estates are included in computation of tax. Cal. Rev. & Tax. Code § 19902.	Non-refundable credit with 5-year carryover	CRTC § 18006	9.30%
CO	HB 1237 (2021)	Supplemental Instructions for Partnerships and S Corporations	All owner types allowed, but unitary C corporations are excluded from computation of the tax. C.R.S. § 39-22-342	Refundable credit	PTE claims the credit. C.R.S. § 39-22-346	4.40%
CT	Ch. 228z (2018) HB 6941 (2024)	Pass-Through Entity Tax Information	None C.G.S. § 12-699	Refundable credit of 87.5% of PTET	C.G.S. § 12-699(g)(1)(B)	6.99%
GA	HB 149 (2021)	HB 149 Pass Through Entity Tax FAQ Rule 560-7-3-.03 Election to Pay Tax at the Pass-Through Entity Level	None O.C.G.A. §48-7-23(b) as amended by HB 412 (2023)	Income exclusion to the extent PTET was paid	Taxed PTE income excludable. O.C.G.A. §48-7-27(d)	5.75%

2023 PTE Developments

Hawaii

- Act 050, signed by Gov. Green on June 1, 2023, introduces an election to pay tax at the entity level effective 1/1/2024 for taxable years beginning after 12/31/2022.
- Annual election required; binding for the year once made.
- Tax base includes distributive share of taxable income, including guaranteed payments, for all owners except corporate owners.
- Tax rate imposed is highest individual rate; nonrefundable credit.
- Losses may be carried forward as long as election continues to be made.
- Tax Information Release No. 2023-01
  - 2023 election due by April 20, 2024;
  - 2023 estimates not required (required 2024 and after)
  - Electronic filing and payment are required

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2023 PTE Developments

Iowa

- House File 352 signed by Gov. Reynolds on May 11, 2023, provides for a retroactive PTE election for tax years beginning on or after January 1, 2022.
- The tax election remains in effect as long as the federal cap exists.
- Tax rate imposed is the highest graduated rate for the applicable tax year; tax rate decreased from 8.53% to 6% in 2023.
- Refundable credit allowed at 91.47% (2022); 94% (2023).
- 2022 election available by October 1, 2023 online only; must be made by the later of January 2, 2024, or the due date for filing the 2022 IA return including extensions.
- 2023 election seemingly more simple? May be made on the entity’s IA return.

2023 PTE Developments

North Carolina

- Gov. Roy Cooper announced in September 2023 that the budget, the 2023 Appropriations Act, will become law without his signature:
  - Personal income tax rate lowered from 4.75% to 3.99% over a 3-year period,
  - Eligible owners of taxed partnership expanded to include certain trusts and any entitles “classified as a corporation for federal income tax purposes,”
  - Allowed for extension of time to make 2022 election by filing an amended return on or before Oct 15, 2023.
- The September change comes after NC had already updated eligible owners of taxed PTEs in May with SB 174:
  - When introduced, only PTEs owned by individuals, estates, trusts, and certain tax exempts were eligible to make the NC PTET election.
  - SB 174 retroactively allowed tiered partnerships to make the election, only the partnership owner share was not included in the tax base. No change to this treatment.
  - Beginning January 1, 2023, NC resident share of income not attributable to NC is not included in taxable income.

2023 PTE Developments

Ohio

- HB 200 specifies that owners of passthrough entities can receive a credit against Ohio personal income tax for other entity-level taxes paid to other states.
- No mention of "substantially similar" when defining eligible creditable taxes, only references Notice 2020-75.
- Still in the House, not yet enacted.

Oregon

- HB 2083 extended the sunset date of the elective PTET and related personal income tax credit through tax years beginning on or before January 1, 2026 (previously January 1, 2024). Effective September 24, 2023.

Unforeseen Impacts?

- Federal revenues taking a hit -- $10-15B less revenue per year.
- Virginia having trouble predicting revenue impact.
- New York guidance a moving target?
- Pennsylvania slow and steady wins the race.

II. Update on MTC Partnership Tax Uniformity Project

[Thanks to MTC Counsel Chris Barber for allowing us to borrow heavily from his latest slide deck]

Project began at the April 2021 Uniformity Committee 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 or positions for all issues.
6. Begin creating draft models, etc., to carry out the recommended practices or positions.

Comprehensive Issue Outline – Ongoing

- Nexus and Jurisdiction
- Tax Base
- Sourcing
- Gain on Sale of (PTE) Interest
- Administrative and Enforcement

Comprehensive Issue Outline – Ongoing

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– Tax Base
– Sourcing
– Gain on Sale of Interest
– Administrative and Enforcement

Investment Partnerships

– White Paper
– Draft Model
– Converted to the Form of a Regulation

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Guaranteed Payments

– Draft White Paper
– Differences in State Treatment
– Discussion of a Possible Model

State Tax Sourcing Principles – Growing Consensus

- Items are not simply "re-sourced" when they pass through tiered partners.
- Only if the partner is also separately engaging in another trade or business *may* the activities of that partner be considered in the sourcing of partnership income or items.

State Tax Sourcing Principles – Apparent Majority View

Business/Nonbusiness Rules and Unitary Business Principle Apply to Activities of a Single Partnership –

- Items that are part of the partnership's "business income" are sourced together using apportionment, and
- Items that are "nonbusiness income" are sourced applying allocation or specific attribution rules.

Sourcing investment partnership income

- Applies ONLY to Nonresident Individual Partners –
  - Resident partners pay tax on 100% of their income (with a credit for taxes paid to other states).
  - Corporations and pass-through partners source income applying state allocation and apportionment rules at the entity or unitary business level.
  - In comparison, states have specific rules for sourcing the income of nonresidents which look to the type of income and the type of asset.

Why Regulation Form vs. Model Statute

Treatment is supported by existing state law.

The goal here is to provide greater certainty in certain fact-specific situations, which is what regulations are typically used for.

States that currently have explicit statutory provisions could also adopt the rule in regulation form.

And, unlike statutes, regulations may include examples, which would be very useful here.

“(a) General Rule.

Under the [reference to state’s individual income tax], a nonresident partner’s distributive share of partnership income is generally allocated and apportioned to this state at the partnership level based on the partnership’s business or other activities in this state. See [insert reference to applicable statutes and regulations, including UDITPA if applicable, and to IRC § 702]. But the investment related activities of a **qualified investment partnership** in this state do not affect how certain nonresident partners source their distributive share of that partnership’s investment income. Rather, the sourcing rules for nonresidents apply to the items of income making up the partner’s distributive share from the qualified investment partnership **as though the partner earned (or incurred) the items directly.**

See [reference to applicable statutes and regulations governing sourcing of income for nonresidents].

Guaranteed Payments

IRC § 707(c) - Guaranteed payments

To the extent **determined without regard to the income of the partnership**, payments to a partner **for services or the use of capital** shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

Two Sourcing Options

"Compensation"

- Same as wages, which are generally sourced to where the services are performed by the individual partner.
- Used by a minority of states.

"Distributive Share"

- Same as other partnership income – which is generally allocated and apportioned at the partnership or business level.
- Used by the majority of states.

Compensation Approach – Pros and Cons

Pros

- Similar to federal treatment.

Cons

- Have to distinguish guaranteed payments from special allocations of distributive share.
- Have to distinguish guaranteed payments for services from guaranteed payments for capital.
- Need guardrails, otherwise there may be income shifting.
- May not be consistent with PTE tax treatment.

Distributive Share Approach– Pros and Cons

Pros

- Do not have to distinguish guaranteed payments from special allocations of distributive share.
- Do not have to distinguish guaranteed payments for services from guaranteed payments for capital.
- Don’t need guardrails.
- May be more consistent with PTE tax treatment.

Cons

- Different from federal approach.

Problem – Potential multiple taxation

- Could be solved with a uniform rule.
- Could also be solved with a generous credit given by state of residency for taxes paid on certain guaranteed payments to other states on a different sourcing basis.

MTC Partnership Tax Project – Next Steps

- Coming year – general sourcing issues –
    - How state sourcing rules are applied at the entity level.
    - How intercompany or related tiered partnership transactions are treated.
    - How the unitary business principle applies to partnerships generally.
    - Looking at how PTE taxes have focused states on sourcing issues—and what has changed.

Multistate Tax Commission Project

- Work Group Info:
  - Project page - https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/
  - Reach out to hhecht@mtc.gov, jstosberg@mtc.gov, or cbarber@mtc.gov.

MTC Model Act on "Investment Partnerships"

- Issued in draft form in July 2022, based in large part on the *Alabama Investment Partnership Act of 2009* (2009 Ala. Acts ch. 144, §10, (codified at Ala. Code §40-18-24.2 to 24.3)), and designed to address the "trillions of dollars flowing through investment partnerships … [which is] not a very transparent industry…"
- Stated goal is to create a safe harbor for qualified investment partnerships ("QIPs") and their non-resident qualified partners so the partners' distributive shares of income/loss from the QIP are sourced to their respective states of residency or domicile (vs. apportioned)
- Helpful drafters' notes, including this roadmap: "This draft model is designed to impose three independent qualifications for the safe-harbor sourcing. First, the partnership must be a Qualified Investment Partnership. Second, the partner must be a Qualified Investment Partner. Third, the income or loss subject to the sourcing rules must be Qualified Investment Partnership Income (or Loss).
- As with any complicated tax statute, the definitions are the key…

MTC Model Investment Partnership Act

- Certain commentators accused the MTC Partnership Work Group/staff of cherry-picking the most restrictive provisions from the Alabama and certain other state investment partnership statutes and tightening them even further.
- After some discussion, latest draft [as of 8/18/22] defines QIP Partners to include only non-resident individuals and taxable estates and trusts (not corporations or financial institutions)
- The draft model has undergone several iterations, and in our unofficial opinion, is much improved over the initial draft, especially in terms of anti-abuse and self-dealing prohibitions

III. APPORTIONMENT OF GAIN FROM THE SALE OF PTE INTERESTS (OTHER THAN INVESTEE APPORTIONMENT)

Gain from the Sale of a PTE Interest

- There is increased state scrutiny, as evidenced by recent cases, developments at the Multistate Tax Commission and administrative guidance in CA, MA, and NY.
- Determination of state tax treatment can be a factually intensive exercise.
- Risk areas might include:
  - Fact driven unitary vs. non-unitary analysis
  - Business vs. non-business treatment
  - Apportionment factor inclusion
    - General exclusion provisions
    - Occasional sale rules
  - Section 751 gains
- Mitigation of state tax apportionment impact of gain from sale of a PTE interest may be realized through efforts, to include:
  - Pre- or post- transaction restructurings
  - Contemporaneous documentation of basis for reporting positions taken
  - Consideration of potential offsetting federal benefits of elective pass-through entity taxes

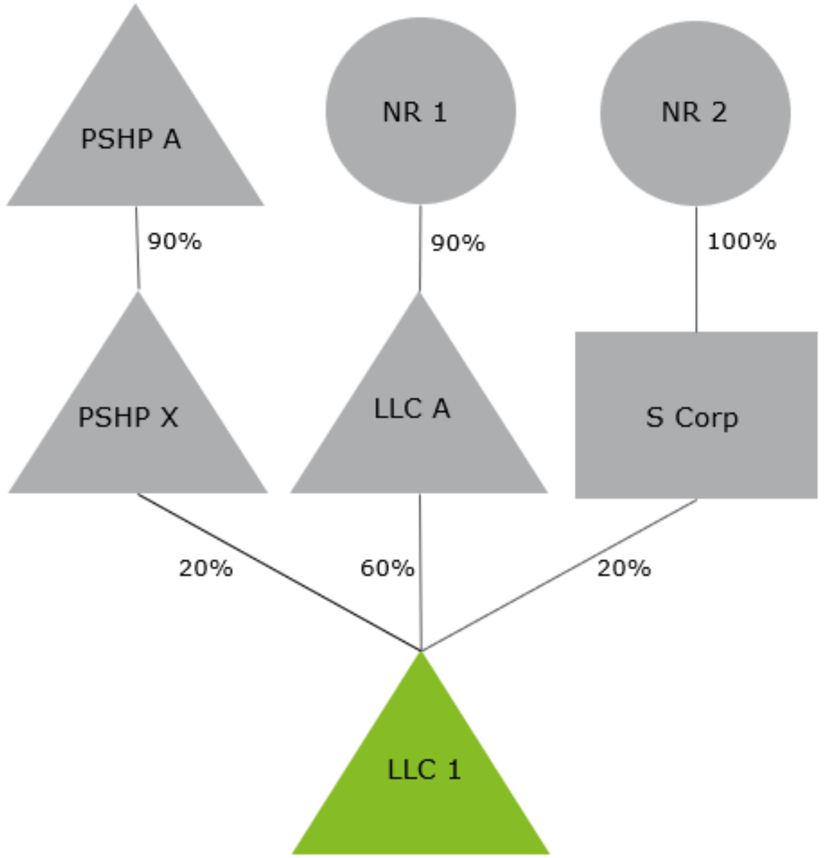
Gain from the Sale of a PTE Interest – California Legal Ruling 2021-01

FTB issued Legal Ruling 2021-01: FTB provides its view regarding circumstances in which pass-through holding companies may be considered unitary with pass-through operating companies.

- **Key takeaways from Ruling:**
  - Limited partners are generally not considered unitary with a limited partnership, because limited partners are typically passive investors with no managerial or operational control over the operations of the limited partnership.
  - General partners of a limited partnership are presumed unitary with the limited partnership, because they have control over the partnership's operations.
  - If a pass-through holding company has majority ownership and control (e.g., by way of voting rights) over the LLC, that fact alone is sufficient to support a finding of unity.
  - Actual exercise of control by a pass-through holding company (including through an unrelated third-party hired by that pass-through holding company) over the day-to-day operations of an LLC is sufficient to support a unitary determination, even if the holding company holds a minority interest and minority voting rights in the LLC.
  - If a pass-through holding company holds a minority interest and minority voting rights in the LLC, and there is no evidence that the holding company has any control over the LLC and its managers and operations – the holding company is not unitary with the LLC.

California Legal Ruling 2021-01 – Unity of Pass-Through Holding Companies With Other Pass-Through Entities

Legal Ruling 2021-01 – Situations 1 – 3



Situation 1

- All direct owners of LLC 1 are holding companies with no other operations, employees, or assets
- PSHP X is the managing member of LLC 1
- LLC A and S Corp and their respective owners are not involved in the day-to-day operations of LLC 1
- Holdings:
  1. PSHP X is unitary with LLC 1
  2. LLC A is unitary with LLC 1
  3. S Corp is not unitary with LLC 1

Situation 2

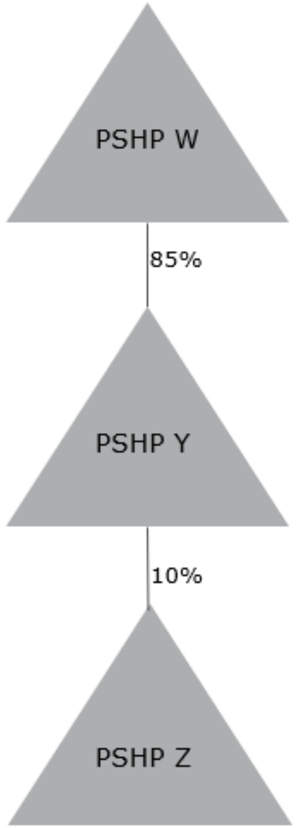
- Same as Situation 1 except PSHP X hires unrelated third-party manager
- Holding: PSHP X is unitary with LLC 1

Situation 3

- Same as Situation 1 except NR 2 is the co-founder and CEO of LLC 1 and conducts day-to-day operations of LLC 1
- Holding: S Corp is unitary with LLC 1

California Legal Ruling 2021-01 – Unity of Pass-Through Holding Companies With Other Pass-Through Entities

Legal Ruling 2021-01 – Situation 4

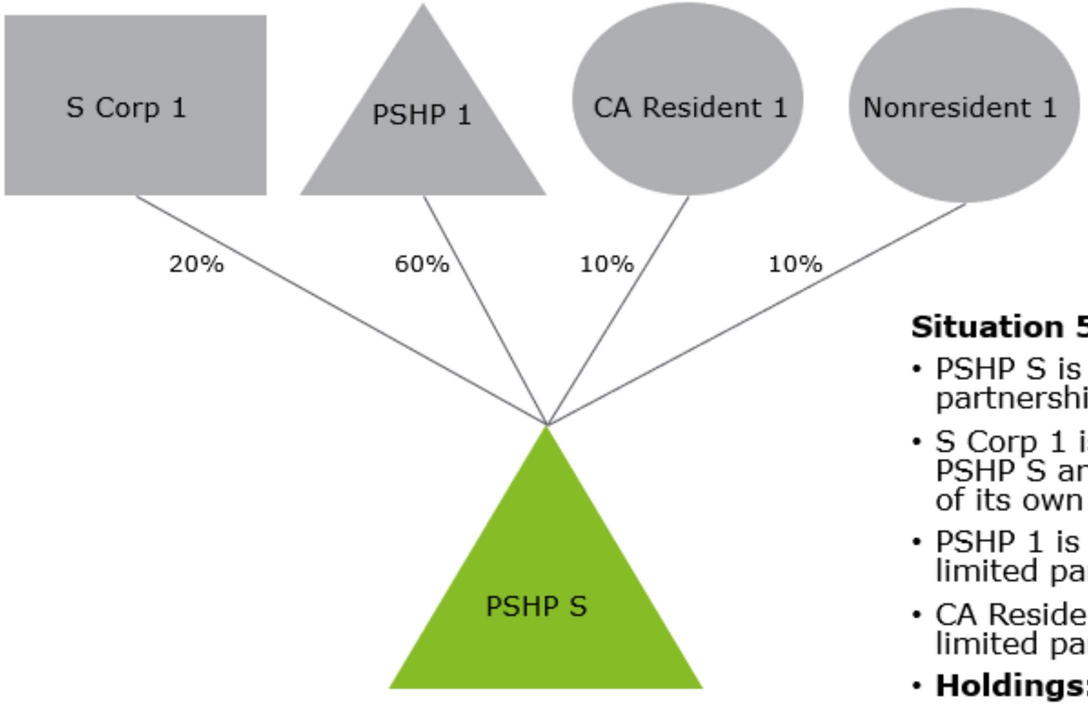


Situation 4

- PSHP W is a real estate development company
- PSHP Y is a holding company with no employees or assets outside of its interest in PSHP Z and is not involved in the day-to-day operations of PSHP Z
- PSHP Z is a software development company
- PSHP W and PSHP Z have distinct businesses with no operational integration
- **Holdings:**
  1. **PSHP W is not unitary with PSHP Y**
  2. **PSHP W is not unitary with PSHP Z**
  3. **PSHP Y is not unitary with PSHP Z**

California Legal Ruling 2021-01 – Unity of Pass-Through Holding Companies With Other Pass-Through Entities

Legal Ruling 2021-01 – Situation 5



Situation 5

- PSHP S is an operating limited partnership
- S Corp 1 is the general partner of PSHP S and does not have operations of its own
- PSHP 1 is a holding company and limited partner of PSHP S
- CA Resident 1 and Nonresident 1 are limited partners of PSHP S
- **Holdings:**
  1. **S Corp 1 is unitary with PSHP S**
  2. **PSHP 1 is not unitary with PSHP S**

Gain from the Sale of a PTE Interest – Recent State Tax Decisions

Michigan

- In a case on appeal from the Michigan Court of Appeals regarding the application of the standard apportionment formula to the gain on sale of an out-of-state business pursuant to an Internal Revenue Code (IRC) section 338(h)(10) election, the Michigan Supreme Court held that applying the standard formula to the circumstances in the case did not run afoul of the US Constitution's Due Process and Commerce Clauses because the MBT formula, as applied, did not impermissibly tax income outside the scope of Michigan's taxing powers.
- The Court reversed the Michigan Court of Appeals ruling that the taxpayer had demonstrated by clear and cogent evidence that the statutory apportionment formula created a grossly disproportionate result when applied to the one-time asset sale given that, arguably, a majority of the activities making up the underlying business's fair market value at the time of the sale occurred outside Michigan's borders.

Minnesota

- Minnesota Tax Court held that a nonresident individual's income from goodwill generated by the sale of her stock ownership interests in two S corporations pursuant to an election under IRC section 338(h)(10) to treat the stock sales as sales of the underlying corporate assets constituted income of a unitary business subject to apportionment at the entity level

Gain from the Sale of a PTE Interest – Recent State Guidance

Massachusetts

- *TIR 22-14: Apportionment of Gain from the Sale of a Pass-through Entity (PTE) Interest Based Entirely Upon the Attributes of the PTE, Mass. Dept. of Rev. (11/30/22), Massachusetts Department of Revenue*
- The Technical Information Release (TIR), issued November 30, 2022, explains the Commissioner's interpretation of a 2022 Massachusetts Supreme Judicial Court case which ruled that using the apportionment factors of an underlying partnership to source the sale thereof, regardless of the existence of a unitary business, was constitutionally permissible. The DOR will not consider the holding of the case to apply:
    - Where a pass-through entity (“PTE”) and its non-domiciliary corporate owner are engaged in a unitary business, either directly or through "tiers" of PTEs
    - Where the taxable gain is includible in the unitary business income of the non-domiciliary corporate seller because the investment in the PTE served an operational function with respect to the business of such seller
    - Where the seller of the PTE interest is an individual and, though a non-resident, the individual was actively engaged in the in-state business of the PTE, either in the year of the sale or in a prior year
    - To gain derived by a non-domiciliary corporation or a non-resident individual from the sale of a PTE interest where the gain is allocable to Massachusetts, such as situations in which the PTE did business only in Massachusetts
- The DOR will consider the case to apply to gain derived by a corporation that is commercially domiciled in Massachusetts from the sale of a PTE interest. In such cases, if the corporate seller is engaged in a unitary business with the PTE, the gain must be apportioned using the attributes of the PTE and the seller. If the corporate seller is not engaged in a unitary business with the PTE, such seller must allocate the gain to Massachusetts.

IV. FEDERAL PARTNERSHIP AUDIT RULES AND STATE IMPLICATIONS

Federal Partnership Audit Rules — IRS Audits

- IRS issued IRC-2023-166 announcing that it will focus its compliance efforts on increasing scrutiny on partnerships, among other corporate and high-income taxpayers.
  - IRS announcement states it plans to use Artificial Intelligence to aid in its identification of compliance risks
    - IRS indicates that it plans to open examinations on 75 of the largest partnerships in the US
  - IRS announcement also states it plans to utilize compliance letters to quickly address balance sheet discrepancies reported with a focus on partnerships with over $10 million in assets.

Federal Partnership Audit Rules—Background

- The Bipartisan Budget Act of 2015 (“BBA”) Adopted New IRS Audit Procedures for “Large” Partnerships (including Multi-Members LLCs) effective for taxable years beginning after December 31, 2017
- The BBA contains special procedures to correct partnership returns called an Administrative Adjustment Request (“AAR”)
  - To file an AAR, a partnership must:
    - File either (i) Form 1065X (if eligible to paper file) or (ii) Form 8082 along with Form 1065
    - Determine whether the requested adjustments result in an imputed underpayment (IU)
      - If the requested adjustments result in an IU, the partnership can pay the IU or push out the adjustments to reviewed year partners
      - If any requested adjustments do not result in an IU, those adjustments must be pushed out to reviewed year partners
  - If a push-out election is made, the partnership must furnish statements to its reviewed year partners using Form 8986 and file partnership adjustment tracking reports using Form 8985
  - An AAR may not be filed for a partnership tax year after the IRS mails a notice of administrative proceeding for that tax year

Partnership Audit Rules – State Implications: MTC Model Statute

- Multistate Tax Commission (MTC) drafted a model statute for reporting final federal adjustments from federal partnership examinations and from administrative adjustment requests (AARs)
- The MTC received comments on the proposed model from multiple organizations, including ABA, AICPA, TEI, and COST
- One of key differences in MTC Model versus federal rules is default payment method:
  - MTC Model = Partners pay the adjustment
  - BBA (federal) = Partnership pays the adjustment
- MTC model adopts concept of partnership representative for state purposes
  - The state partnership representative will default to the federal partnership representative unless otherwise specified

Federal Partnership Audit Rules – State Implications

As of August 2023, the following States have adopted specific rules relating to reporting federal adjustments pursuant to a BBA partnership audit:

Arizona	California	Colorado (Adjustments made on and after 1/1/2024)
Georgia	Hawaii	Indiana
Iowa	Kentucky	Louisiana
Maine	Massachusetts	Michigan
Minnesota	Missouri (Adjustments made on or after 1/1/2021)	Montana (Adjustments made after 3/31/2021)
New Jersey	New Mexico	Ohio
Oregon	Rhode Island	Vermont (Adjustments made on and after 7/1/2022)
Virginia	West Virginia	Wisconsin

- Statute of limitations and reporting deadlines for states may be different than BBA rules and procedures
- States that have adopted the federal provisions for BBA may have different state filing methods and procedures (i.e., states require partner and partnership to file amended returns)

Partnership Audit Rules – MTC Model Rules: Default

Default Reporting Timing and Payment Method:

- **Within 90 days** of final partnership determination:
  - Partnership files a partnership adjustment report
  - Partnership notifies the direct partners
  - Partnership files amended composite/withholding tax return (if required) and pays applicable tax
- **Within 180 days** of final partnership determination
  - Direct partners file adjustment report reporting distributive share of adjustments
  - Direct partners pay any applicable tax, which is calculated as if properly reported
- Special reporting provisions for tiered partnerships
- Tiered direct partners or indirect partners shall make required reports and payments no later than 90 days after the time for filing and furnishing statements to tiered partners and their partners as established under IRC section 6226 **(*i.e.*, 90 days after the extended due date of the audited/AAR partnership's adjustment year tax return)**.

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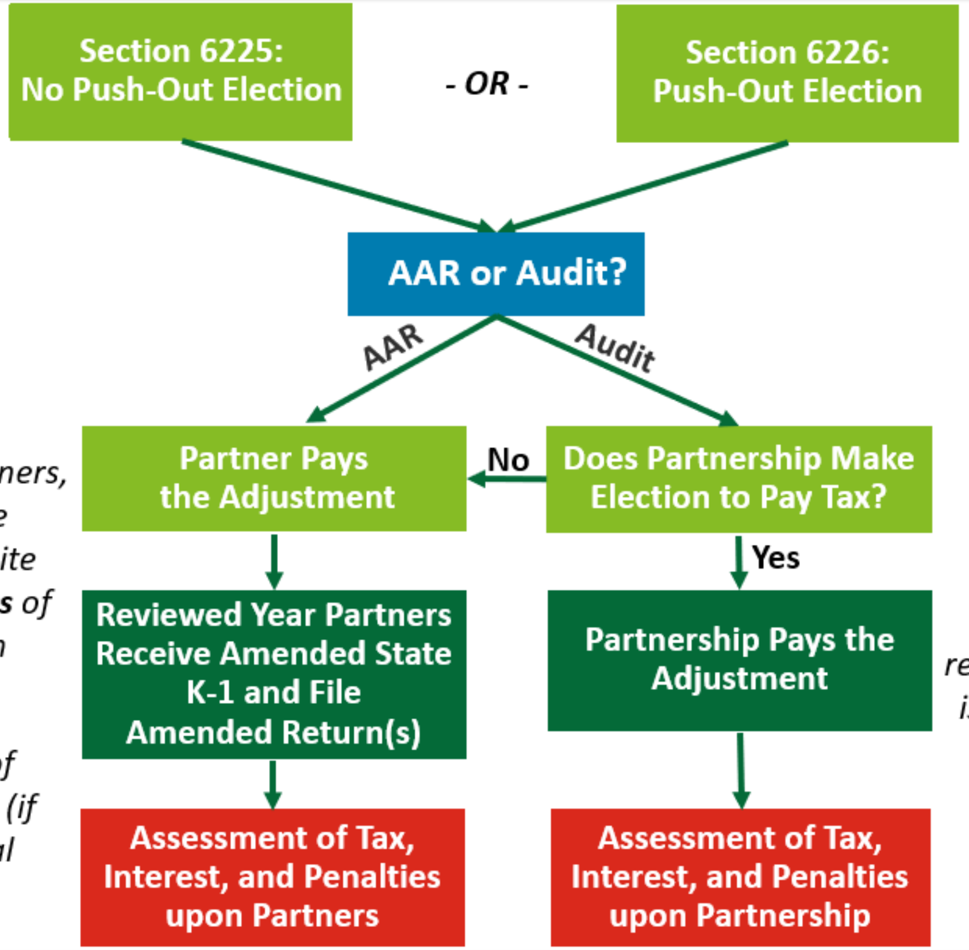
Partnership Audit Rules – MTC Model Rules: Partnership Pays Election Available for Final Federal Adjustments from Examinations

Reporting Timing and Payment Method—Affirmative Election for Partnership to Pay

- Within 90 days–Partnership files adjustment report and notifies the state that it is making the election
- Within 180 days–Partnership pays the amount of the adjustment
- Computing partnership-level adjustment:
    - Exclude amounts attributable to direct exempt partners
    - Distributive shares to direct corporate partners: Apportion and allocate adjustments and multiply by highest tax rate
    - Distributive shares to non-resident direct partners: State sourced income and multiply by highest tax rate
    - Distributive share to resident direct partners: Amount by highest tax rate
    - Distributive share to tiered partners: Three step process
    - The partnership may not elect to pay an amount stemming from an AAR

Partnership Audit Rules – MTC Model Rules Illustrated

Federal



State

Partnership *must notify direct partners, file an amended return, and file amended withholding or composite returns (if required) within **90 days** of final partnership determination*

Partners *file an amended return reporting their distributive share of adjustments and pay applicable tax (if applicable) within **180 days** of final partnership determination*

Partnership *must file adjustment report and notify the state the election is being made within **90 days** of final partnership determination*

Partnership *must pay applicable tax within **180 days** of final partnership determination*

V. MISCELLANEOUS – RECENT SALT DEVELOPMENT AFFECTING PTEs

2023 Tennessee PTE Developments

Tennessee

- On May 11, 2023, Gov. Bill Lee signed into law the Tennessee Works Tax Act with sweeping tax changes:
  - Single sales factor phase in over three years, to be fully phased in for tax years beginning on or after December 31, 2025,
  - Bonus depreciation conformity for assets purchased on or after January 1, 2023,
  - Standard deduction for excise tax introduced for tax years ending on or after December 31, 2024: lesser of net earnings or $50,000,
  - Beginning with tax years ending on or after December 31, 2024, up to $500,000 property exclusion from franchise tax base.

2023 Tennessee PTE Developments

Tennessee Letter Ruling #23-08, Aug 2023

Parent Contractor Corp forms SMLLC:

→ SMLLC to fabricate goods at a plant currently owned and operated by Parent,
→ Parent to transfer all plant M&E to SMLLC,
→ SMLLC to enter into new lease at fabrication facility,
→ Goods fabricated by SMLLC to be sold to Parent and unrelated entities.

Franchise & Excise Tax

We know that SMLLCs are generally not disregarded for TN purposes unless owned by a corporation.

Pretend SMLLC *does not* "check the box" to be classified as a corporation.

FAE return would be filed by Parent Contractor Corp and include SMLLC income & activities.

What about other tax types? Where else does federal classification matter?

2023 Tennessee PTE Developments

Tennessee Letter Ruling #23-08, Aug 2023

Industrial Machinery Exemption – Sales & Use Tax

Tennessee provides an exemption from sales and use tax for entities whose principal business is the fabrication or processing of tangible personal property for resale or consumption off the premises.[1]

Principal business exists when the activity represents more than 50% of the taxpayer's revenues – the "51% test."[2]

Manufacturer Classification – Tennessee Business Tax

Manufacturers, generally as defined the same for Business Tax as defined for Sales & Use Tax, are exempt from the Tennessee Business Tax.[3]

With no "check-the-box" election, the SMLLC is disregarded and treated as a division of Parent Contractor Corp:

- **SMLLC sales to Parent don't exist; 51% test can't be met,**
- **Other activities performed by Parent (installation) are included in the revenue test,**
- **Taxpayer doesn't qualify as a manufacturer for either exemption.**

[1] Tenn. Code Ann. § 67-6-102(46)(A)(i); Tenn. Code Ann. § 67-6-206(b)(2))

[2] *Tenn. Farmer's Coop. v. State ex rel. Jackson,* 736 S.W.2d 87, 91-92 (Tenn. 1987); see also *Beare Co. v. Tenn. Dep't of Revenue,* 858 S.W.2d 906, 908 (Tenn. 1993).

[3] Tenn. Code Ann. § 67-4712(b)(2)

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STATE AND LOCAL TAX FORUM

2023 Tennessee PTE Developments

Tennessee Letter Ruling #23-08, Aug 2023

But…if SMLLC elects on Form 8832 to be taxable as a corporation, the SMLLC is no longer disregarded and will be treated as a separate entity:

- **SMLLC activity is now looked at separate from Parent,**
- **Sales to Parent that are derived from fabricating or processing TPP for resale exceed 51%,**
- **Parent activities (installation) don't dilute the revenue test pool,**
- **SMLLC qualifies as a manufacturer and is exempt from both sales & use tax and the TN business tax.**

Franchise & Excise Tax

FAE returns would be filed by Parent Contractor Corp **and** *SMLLC.*

Corporate Transparency Act of 2021

- **Part of federal anti-money laundering effort (31 U.S.C. §5336)**
  - Final rule on beneficial ownership reporting requirements released on September 29, 2022, and amended August 3, 2023 (effective Jan. 1, 2024)
  - Preliminary questions for you/your clients:
    - Who will file the initial registration with the Financial Crimes Enforcement Network ("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 one year in which to comply. But reporting companies formed on or after the effective date will be required to report the beneficial ownership information within 90 days (30 days after 2024) after formation or registration.
    - Any change in reported information must be reported to FinCEN within one year after the change.

More on CTA: Will States Follow Suit?

- By default many small businesses (or their advisers) will be forced to register – and file periodically – with FinCEN (IRS). Estimated to be 32.6 million filings in 2024 and 5-6 million filings each year thereafter (conservatively).
- AICPA leading a large coalition of professional service organizations and tax prep firms to at least delay the effective date.

More on CTA: Will States Follow Suit?

- Pending New York legislation, The New York LLC Transparency Act (AB 3484A, June 20, 2023), mimics CTA in many ways but goes beyond its basic tenet of taxpayer confidentiality. Ultimate beneficial owners (UBO) information would be posted on a searchable data base – available for all to see UNLESS a waiver is requested/granted. Only applies to LLCs, does not become effective until one year after Gov. signs bill into law (maybe that's why it is taking her so long?), and penalties are relatively small.
- Assuming Gov. Hochul signs the bill into law, will other states follow?

State Against the Ropes in PTE Challenge But Keeps Swinging

- *North Carolina Farm Bureau Mutual Ins. Co., Inc. v. NC Dep't of Revenue*, NC Business Court Dkt. No. 20 CVS 10244 (April 3, 2023)(on appeal to N.C. S. Ct.)
- Tandem case: *McCabe v. NC Dep't of Revenue*, Dkt. No. 21 CVS 5724 (April 3, 2023)
- NC offered initially an income tax credit for investing in the construction, leasing or purchase of qualified renewable energy projects in the state.
- Credit was (now sunset) equal to 35% of the cost of the property up to a cost of $2.5 million per facility.
- Statute amended to also grant the credit against the NC gross premiums tax. As a result, NCFB invested almost $25 million over three years – and received an allocation of credits of $37.8 million – through a tiered partnership. Investment facilitated by national partnership syndicator, Monarch Tax Credits LLC.

State Against the Ropes in PTE Challenge But Keeps Swinging

- Numerous favorable private letter rulings issued by NCDOR to taxpayers, including to another Monarch/NC partnership. Published but not precedential for non-recipients.
- NCDOR disallows the credit not only to NCFB but to several other investors in other tiered partnerships, resulting in business community/NC Chamber of Commerce outcry to the Governor. NCDOR argues that NCFB really wasn't a bona fide "partner" for tax credit purposes because it didn't receive any material benefit from the partnerships other than the tax credits and didn't bear any entrepreneurial risk.
- ALJ affirms assessment but on wrong grounds. So both parties appealed to the specialized Business Court. Court issues 37 page opinion – well-reasoned.

State Against the Ropes in PTE Challenge But Keeps Swinging

- About-face by NCDOR after having issued and published numerous favorable private letter rulings (binding of course only on the recipient). Although not mentioned in the ruling, that seemed to trouble the Court.
- Numerous amicus briefs filed in favor of the TP not only by well-respected state business associations but by the indefatigable Professor Rick Pomp, who pulled no punches.
- NCDOR attacks allocations of the tax credit first on the ground that the recipients of the credits really weren't "partners," ala' the IRC definitions of "partner" and "partnerships" and the IRS anti-abuse regs. Court rejects the federal conformity arguments. "(NCFB) need not show that it is a bona fide partner under federal law to claim a distributive share of the tax credit … [It] qualifies as a partner since it is a member of a limited liability company, which it indisputably is."

State Against the Ropes in PTE Challenge But Keeps Swinging

- Secondly, NCDOR argued that the LLC was a sham and lacked business purpose (other than state tax minimization). Again, the Court swats that down, often citing (among other cases) a newly-issued 4th Circuit Court of Appeals ruling in *Cross Refined Coal, LLC v. Comm'r*. "A partnership's pursuit of after-tax profit can be a legitimate business activity for partners to carry on together . . .especially . . .in the context of tax incentives which exist precisely to encourage activity that would not otherwise be profitable."
- Thirdly, Court rejects NCDOR's assertion that these "cash for credit deals" were disguised sales under IRC section 707(a). Lack of federal conformity and the rules wouldn't apply anyway.

State Against the Ropes in PTE Challenge But Keeps Swinging

- Thorough and decisive opinion but the NCDOR has appealed to the NC Supreme Court. For a detailed (and somewhat biased) review of the ruling, see B. Ely and J. Long, “The Continuing Saga of the North Carolina Renewable Energy Tax Credit,” *Tax Notes State 999* (June 19, 2023). For a detailed summary of the ruling by the taxpayer’s lead counsel, see W. Nelson, “Major Taxpayer Win in North Carolina Renewable Energy Tax Credit Dispute,” *Tax Notes State* (May 8, 2023).

The Long and Winding Road of Partners "Doing Business" in California

- **California**
  - "Doing business" cases
    - $800 minimum tax
      - Cal. Rev. & Tax. Code §23101
        - » Two alternative tests
          - Historic "qualitative" test
          - Since 2011, "bright-line" test (e.g., greater than $50k "in-state" payroll or property or $500k "in-state" sales?
    - Addresses "nexus" under California STATUTE, not constitutional "nexus"
    - Iterative judicial and administrative analysis over the years
    - LATEST CASE addresses "tiered partnerships"
      - How do property, payroll and sales flow up from underlying partnerships "doing business" in California to upper tier partnerships for purposes of "doing business" statute?

The Long and Winding Road of Partners "Doing Business" in California

- *I/M/O MJK Real Estate Fund II, LLC*, 2022-OTA-247P (May 26, 2022) (precedential as of August 2022)
  - QUESTION? What ownership measure is used to determine the "bright-line" "doing business" factors of a pass-through entity that itself owns interests of other pass-through entities that are "doing business" under the California "bright-line" standard:
    a) Profits interest percentage;
    b) Loss interest percentage; OR
    c) Capital interest percentage?

The Long and Winding Road of Partners "Doing Business" in California

- *I/M/O MJK Real Estate Fund II, LLC*
  - Minnesota LLC with no other contacts to California had direct and indirect interests in partnerships owning real estate in San Diego
    - Cal. Rev. & Tax. Code §23101(d) only states that the "sales, property, and payroll of the taxpayer include the taxpayer's pro rata or ***distributive share*** of pass-through entities"
      - Citing to both California statutes and federal income tax law on taxation of partnerships, OTA finds "ambiguity in the [statutory] language" as to which ownership percentage measurement to use.
      - Despite FTB position that the partnership income apportionment regulation was not relevant to nexus, OTA cites to FTB Reg. 25137-1(f)(4) assigning income from partnership to partners for determining a partner's interest in a partnership for "doing business" bright-line test.
        - » Since Jan. 1, 2019, that regulation cites to **"[partner's] interest in profits of the partnership"**
        - » FTB fails to convince OTA that it had previously used "capital interest" – still ambiguous

The Long and Winding Road of Partners "Doing Business" in California

- *I/M/O MJK Real Estate Fund II, LLC*
  - OTA finds that because of the ambiguity, there should be consistency between the standard for assigning partnership income (Cal. Code Regs. tit. 18, 25137-1) and the "doing business" standard for purposes of "nexus" (Cal. Rev. & Tax Code §23101) – supporting use of "**Profits Interest**" (taxpayer position)

Taxpayer	FTB
Profits Interest: 6.9872% X 5.21% (indirect interest) = 0.3640%	**Capital Interest: 52.35% X 5.21% (indirect interest) = 2.7274%**
Partnership property (***original cost***): **$13,000,000**	
$47,343	**$354,567**
Cal. "doing business" property thresholds TY2013 = **$51,816** TY2014 = **$52,956**	

NOTE: Taxpayer's interest in California property were accumulated through a series of partnership interests

The Long and Winding Road of Partners "Doing Business" in California

- *I/M/O MJK Real Estate Fund II, LLC*
  - In TY2015 and TY2016, taxpayer acquired all the interests of an intermediate tiered partnership that owned the partnership doing business in California and thus, that entity became a "disregarded entity" as if taxpayer owned the interests directly.
    - When factoring in increase in ownership percentage to 100%, using the profits interest, taxpayer's property factor ($677,300) far exceeded the property thresholds for "doing business" in those years (TY2015 = $53,644 and TY16 = $54,771).

Credit for State Taxes Paid - California

California Office of Tax Appeals ("OTA") holding:

- A California resident's income tax paid to Massachusetts from the sale of his membership interest in a limited liability company doing business in Massachusetts was not eligible for California's other state tax credit.
- The OTA acknowledged this conclusion results in income from the sale of the membership interest "being double taxed."
- The OTA focused on the language of California's other state tax credit, which applies to income taxes paid to another state on "income derived from sources within that state."
  - The OTA stated, "in order for a California taxpayer to be entitled" to a credit, "income taxes paid to the nonresident state must be based on income sourced to that nonresident state using California's nonresident sourcing rules."
- The OTA determined that under California law, the LLC interest was not sourced to Massachusetts because the taxpayer's LLC membership interest had not acquired a "business situs" in Massachusetts.
  - While the taxpayer's "services" for the LLC connected him to the LLC's Massachusetts business activities, that fact alone did not show that the taxpayer's membership interest was localized in Massachusetts.
  - OTA also rejected Taxpayer's alternative argument that his active involvement in the LLC caused him to "become unitary" with the LLC's business, allowing for combination and apportionment under California law.

Other State Developments

- **Illinois** modifieds partnership withholding requirements for tax years ending on or after December 31, 2023, defined “investment partnerships” must now withhold Illinois income and replacement taxes from certain non-retired nonresident partners based on the partner’s share of distributable income from in-state sources tax. Bill also modifies the definition of investment partnership. Illinois Senate Bill 1963 (June 2023) .
- **New Jersey** requires partnerships to source receipts based on a single sales factor rather than a three-factor formula, effective for tax years beginning on or after January 1, 2023. New Jersey Assembly Bill 5323 (December 2022).
- **New York** FY24 Budget Bill clarified the treatment of limited partners for New York Metropolitan Commuter Transportation Mobility Tax (MCTMT). The MCTMT now requires the distributive share of partnership income items of non-passive limited partners to be subject to the MCTMT. New York bills S.4009C/A.3009C; S.4008C/A.3008C (May 2023).

California Tax Basis Capital Account Reporting

Background

Federal Reporting

- Beginning taxable year 2020 and forward, for Federal income tax purposes, partnerships are required to report their partners' capital accounts using the tax basis method.

California FTB Notice 2023-01

- Supersedes and replaces FTB Notice 2022-01
- For tax years 2021 and 2022, California allows taxpayers to choose between reporting capital accounts using the tax basis method calculated under Federal law or California law.
- Beginning taxable year 2023 and forward, California will require a taxpayer who files Form 565 or Form 568 to report its partners' or members' capital accounts on the Schedule K-1 (565) and the Schedule K-1 (568) using the tax basis method as determined under California law.

California Tax Basis Capital Account Reporting

Considerations

To compute the beginning tax basis capital account balance under California law, one must take into account differences between Federal and California tax law. As a result, the Federal tax basis capital account may differ from the California tax basis capital account.

- Examples of Federal/California law differences that affect capital accounts:
  - Bonus depreciation
  - IRC Section 179
  - Qualified Improvement Property

Federal/California law differences do not always lead to differential impacts on a partner's tax basis capital account for Federal and California purposes, because the Federal and California treatment have the same ultimate impact on the tax basis capital account computation.

- Examples of Federal/California law differences that DO NOT affect capital accounts:
  - Income on US obligations
  - Interest Income on State and Local Obligations
  - State and Local Taxes
- A partner's tax basis capital account under California law is not impacted by residency

California Tax Basis Capital Account Reporting

Penalties

California may impose information reporting penalties on taxpayers that fail to comply with the tax basis capital account reporting:

- A $18 per partner per month penalty for failure to file a partnership return that shows the required information may be imposed under Cal. Rev. & Tax Code §19172
- An information reporting penalty for failure to furnish correct payee statements may be imposed under Cal. Rev. & Tax Code §19183(b)

Thank you!

Questions and Discussion

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