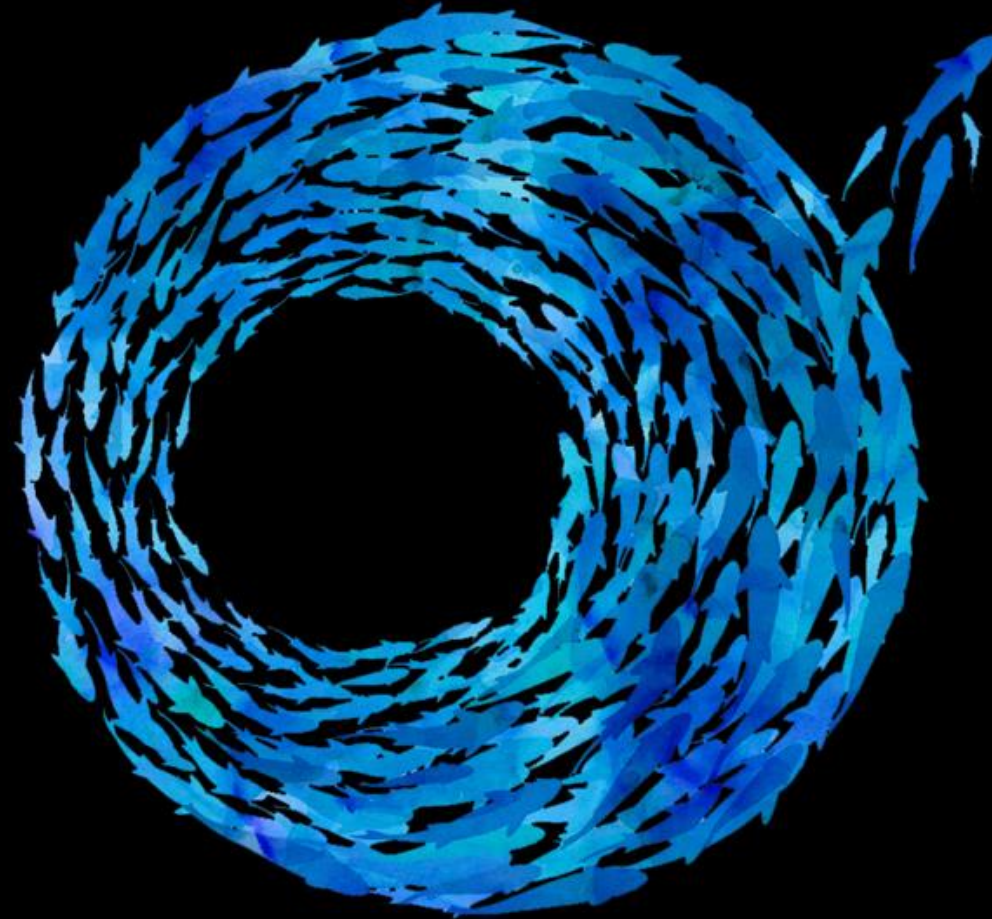


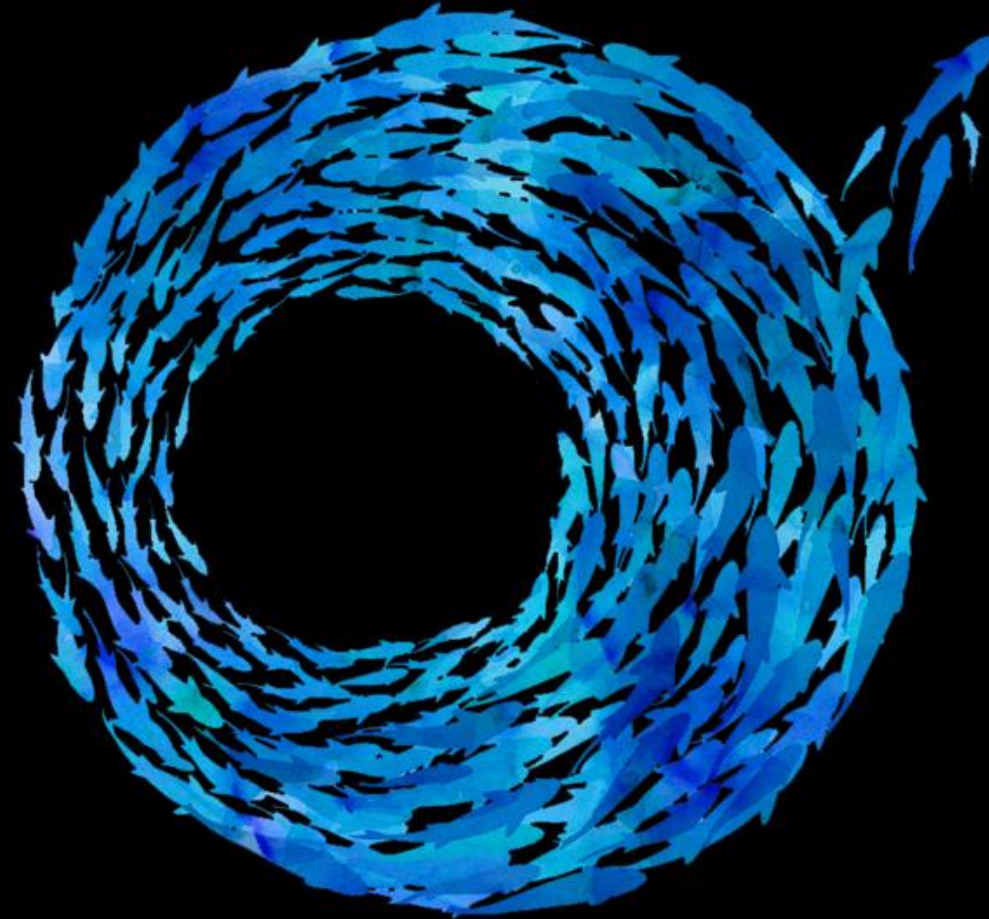
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**The 2018 National
Multistate Tax Symposium**

Take the lead—Tax reform and fortifying state positions

February 7-9, 2018



Pass-through entity structures: State tax issues for today and tomorrow

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Agenda

- Multistate trends
- Unitary/non-unitary issues
- Intercompany transactions
- State pass-through considerations
- Entity level taxation
- Federal tax reform – state tax implications
- Impact of new federal partnership audit rules

Multistate trends

Economic presence nexus

A growing number of states have statutes or rulings that assert nexus over taxpayers that have an economic presence in the state, even those that lack a physical presence in the state.

- *Geoffrey* nexus – Geoffrey nexus applies when licensed intellectual property is used in a state. (*Geoffrey, Inc. v. South Carolina Tax Commission* 437 S.E. 2d 13, cert. den. 114 S.Ct. 550 (1993)).
- Maine’s explanation of economic nexus
 - “Economic nexus is a short-hand term for the principle that a taxpayer's purposefully directed business activity in a State (other than solicitation of sales activity protected by P.L. 86-272) may be sufficient to subject that taxpayer to income tax in that State regardless of the level – or absence – of physical presence in that State”
- Michigan – “Active solicitation”

Factor-based nexus standards

Under a bright-line “factor-based” standard, nexus is created with a state when a minimum amount of property, payroll or sales in the state is met.

States adopting “bright-line” nexus tests

Alabama (2015)	Colorado
California	New York state (2015)
Connecticut	Tennessee (2016)
Ohio	
Washington (B&O tax)	

Multistate tax commission model “factor nexus” statute

Substantial nexus is established if any of the following thresholds are exceeded during the tax period: \$50,000 of property; or \$50,000 of payroll; or \$500,000 of sales; or 25% of total property, total payroll or total sales.

Is a pure “sales-based” nexus threshold constitutional? Consider due process cases involving goods put into stream of commerce.

What is market-based sourcing?

States approaches to interpreting the “market” can vary:



“Market” for services

- Customer location
- Where the benefit of the service is received by customer
- Where the service is received
- Where the service is delivered



“Market” for intangibles

- Where the intangible is used
- Where the intangible has a business situs
- Where the intangible is domiciled



Look-through approach

- Based on location of the customer’s customer

States recently changing to market-based sourcing rules

Nearly thirty states have currently adopted market-based sourcing rules for sales other than of tangible personal property. States that have recently transitioned to market-based rules include:

- Arizona (elective phase-in 2014-2017)
- California (elective in 2011 and 2012, mandatory in 2013)
- Connecticut (2016)
- Louisiana (2016)
- Massachusetts (2014)
- Missouri (effective August 28, 2015)
- Montana (2018)
- Nebraska (2014)
- New York City (2015)
- New York State (2015)
- Oregon (2018)
- Pennsylvania (2014)
- Rhode Island (2015)
- Tennessee (July 1, 2016)
- Washington D.C. (2015)

Market based sourcing – may not apply to all taxpayers

Louisiana

- Corporate tax applies market-based sourcing starting 1/1/2016.
- Individual rules have not changed and apportions using a 2 factor formula of payroll and sales.

New York State

- Corporate Franchise Tax applies market-based sourcing starting 2015
- Individual Income Tax statute was not changed

New York City

- Corporate Tax applies market-based sourcing starting 2015
- Unincorporated Business Tax applies market-based sourcing for “registered broker dealer

Michigan

- Individual Income Tax applies cost of performance sourcing
- MBT (repealed as of 12/31/2011) applied market-based sourcing
- Corporate income tax (imposed on C corporations effective January 1, 2012) applies market-based sourcing

Market based sourcing – may not apply to all taxpayers (cont'd)

New Jersey

- Corporate Income Tax statute and regulation for “Asset Management Services” applies market-based sourcing.
- No apparent individual tax counterpart

Rhode Island

- Individual Income Tax statute was not changed
- Corporate Income Tax applies market-based sourcing starting in 2015

Pennsylvania

- Corporation Income Tax and Capital Stock Tax apply market-based sourcing as to sales of services starting 2014
- Individual Income Tax regulation was not updated

Some states with special sales factor rules for advisors to RICs

- California
- Colorado
- Connecticut
- Delaware
- Georgia
- Kentucky
- Maine
- Maryland
- Massachusetts
- Michigan
- Minnesota
- New Jersey
- New York State & City
- Pennsylvania
- Rhode Island
- Texas

Unitary/non-unitary issues

Apportionment of pass-through income

Two most common methods

1. No flow-through of apportionment factors (non-unitary/allocation method)
 - Partnership apportions business income to states
 - Corporate partner treats partnership business income as allocable
 - Subtracts partnership income from corporation's apportionable income
 - Allocates partnership business income to the states based on partnership's apportionment factors
2. Flow-through of apportionment factors (unitary method)
 - Corporation includes its share of partnership's apportionment factors in computing its own apportionment factors
 - Partnership business income is apportioned using corporation's apportionment factor

Non-unitary/allocation method (no flow-through of factors)

Non-unitary/allocation method explained:

- Partnership's business income is apportioned to the state using only the partnership's own apportionment factors
- Owners of the partnership then allocate their distributive share of post-apportionment income to the state
- Example:
 - Corporate partner has a 30 percent interest in a partnership that earns \$100 of business income
 - Partnership apportionment is calculated at the partnership level and the partnership computes a 50 percent apportionment factor in a state
 - Partner would include \$15 of partnership income in its tax base in state
 - $\$100 \times 50\% = \50 apportioned to state and corporate partner's share is $\$50 \times 30\% = \15

Unitary Method (flow-through of factors)

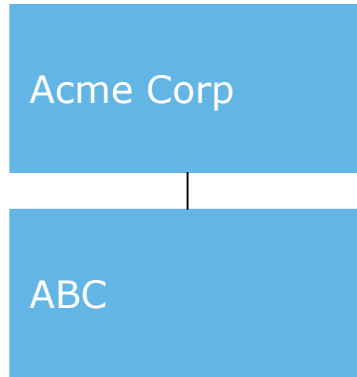
Unitary method explained:

- Partners combine their share of the partnership's apportionment factors with their other apportionment factors
 - Referred to as "flow-through" or "flow-up" apportionment
 - Majority view
- Example
 - If a corporation has a 30 percent interest in a partnership then the corporate partner would calculate its own apportionment factor by including 30 percent of the partnership's receipts, property, and payroll (assuming that the state uses a three-factor apportionment formula).
- Some states require allocation of partnership income even if partner and partnership are unitary.

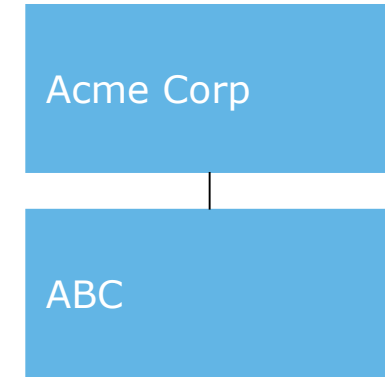
Comparison of different structures

Structure 1 unitary subsidiary

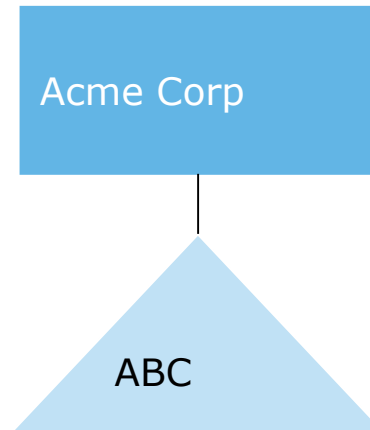
Must have >
50% ownership



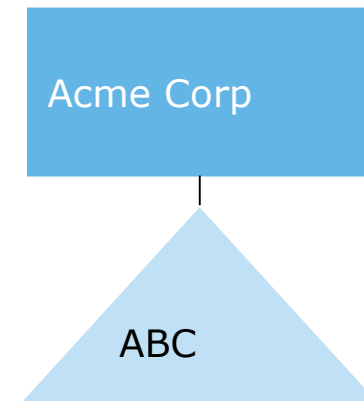
Structure 2 Non-unitary subsidiary



Structure 3 Partnership—factors flow up



Structure 4 Partnership—allocation method



Pennsylvania example

Pennsylvania

- 72 P.S. 7402.2 61 Pa. Code Section 153.29(a)(1)
 - A corporate taxpayer's interest in a partnership is considered a direct interest in the assets of the partnership rather than an intangible interest.
- 61 Pa. Code Section 153.29(a)(1)
 - The taxpayer's share of the partnership's property, payroll, and sales shall be included in the apportionment factors of the taxpayer unless otherwise excluded.

Massachusetts example

Massachusetts

- Corporate limited partners - 830 C.M.R. 63.38.1(4)(d) & (12)
 - Own less than 50 percent
 - Presumption of unrelated business activity
 - No factor flow-through
 - Own 50 percent or more or related business activity
 - Factor flow-through
- Tiered partnerships - 830 C.M.R. 62.5A.1(3)(b)2, (6)(b)
 - Partnerships are not engaged in unitary business
 - No factor flow-through
 - Partnerships are engaged in unitary business
 - Factor flow-through

Illinois example

Illinois has five different methods of reporting partnership income:

1. Non-unitary partnership (no factor flow-through/allocation)
 - 35 ILCS 5/305 (a) and (b)
2. Unitary partnership (factor flow-through)
 - 86 Ill. Admin. Code 100.3380(d)
3. Partnership complete member of unitary group
 - 86 Ill. Admin. Code 100.3380(d)(4)
4. Investment partnership under general rule
 - 35 ILCS 5/305(c-5)
5. Investment partnership income treated as business income
 - 35 ILCS 5/305(c-5)

LP nexus in New Jersey

Background - Regulations (N.J.A.C.)

- 18:7-7.6(c) – Discusses when a foreign corporate limited partner of a limited partnership is doing business and subject to tax;
- 18:7-1.9(b) - Discusses the factors that are taken into consideration to determine when a foreign corporation is doing business in New Jersey;
- 18:7-1.6(a) - Discusses when corporations that are not expressly exempted are required to file a return and pay tax;
- 18:7-7.6(g)3. - Discusses the facts that either singly or in combination may suggest that the corporation and partnership are part of a unitary business;

LP nexus in New Jersey

Three New Jersey cases involving ownership in limited partnership and whether it results in a taxable presence in New Jersey

- *BIS LP* (App. Div. 2011)
- NJ Tax Court decision (2013)
- NJ Tax Court decision (2017)

Intercompany transactions

Tax treatment of intercompany transactions

California rule - sales factor

- CCR section 25137-1(f)(3) (emphasis added)
 - “(A)...Intercompany sales between the partnership and the taxpayer shall be eliminated from the denominator and numerator of the taxpayer's sales factor as follows:
 - **Sales by the taxpayer to the partnership** to the extent of the taxpayer's interest in the partnership.
 - **Sales by the partnership to the taxpayer** not to exceed the taxpayer's interest in all partnership sales.
 - (B) Notwithstanding any intercompany eliminations described in subparagraph (A) above, **sales made to nonpartners shall be included in the denominator of the taxpayer's sales factor** in an amount equal to such taxpayer's interest in the partnership.
- CA listed transaction – FTB Notice 2011-01 (Jan. 6, 2011)

Tax treatment of intercompany transactions

Illinois rule - sales factor

- 86 Ill. Admin Code 100.3380(d)(2)(A) (emphasis added)
 - “In determining the business income of the partnership, transactions between the unitary partner (or members of its unitary business group) and the partnership shall not be eliminated. However, **all transactions between the unitary business group and the partnership** shall be eliminated for purposes of computing the apportionment factors of the partner and of any other member of the unitary business group.”

State pass-through considerations

State withholding overview

- Most states require a pass-through entity to withhold on its nonresident partners (either on distribution or state sourced income).
- Withholding by a partnership does not satisfy a nonresident partner's filing requirement in most states.
- A nonresident partner must file a state return to receive a refund of amounts over withheld.
- Withholding rates are oftentimes lower than the marginal rates
 - California – the nonresident domestic partner withholding rate is 7%, which the highest marginal individual rate is 13.3%
 - Georgia – the nonresident partner withholding rate is 4% while the individual and corporate rates are 6%
- Common withholding exceptions
 - Affidavits
 - De minimus
 - Publicly traded partnerships
 - Qualified investment partnerships
 - Composite returns

Common withholding issues

- How does the partnership handle reserves for potential withholding issues (certain and uncertain)?
- How does the partnership account for withholding payments allocated to its partners?
- When is withholding treated as a federal itemized deduction and how is that communicated to partners?
- How does a partnership treat state refunds of withholding overpayments?
- Does the state allow the partnership to tier withholding?
- How does the partnership account for withholding payments from its underlying investment(s)?
- At which level is withholding required by the partnership?

Composite return considerations

01



How does partnership account for composite return payments?

02



When does partnership make adjustments to partner capital accounts?

03



When are composite return payments treated as federal itemized deductions and how is amount of itemized deduction communicated to partners?

04



How is information regarding credit of taxes paid to other states communicated to partners?

05



How are refunds on composite returns accounted for and reported to partners?

Entity level taxation

Entity-level state taxes

Various states impose an entity-level tax, and in many of these states the entity-level tax is in addition to imposing an owner-level income tax.

Some examples include:

Alabama	New Hampshire	Texas
California	New Jersey	Vermont
Connecticut	New York	Washington
District of Columbia	Nevada	West Virginia
Illinois	Ohio	City taxes, including NYC
Kentucky	Oregon	
Massachusetts	Rhode Island	
Minnesota	Tennessee	

Entity-level state taxes examples

- **California:** Imposes an LLC Tax and Fee -- Annual Limited Liability Tax (\$800) plus LLC fee if total California income is greater than \$250k (ranges from \$900 to a maximum of \$11,790).
- **Illinois:** Passthrough entities (except investment partnerships) are subject to a 1.5% personal property replacement tax, based on net income.
- **New Hampshire:** Imposes an 8.5% tax on business taxable profits on every business organization having gross income in excess of \$50,000.
- **New York City:** Unincorporated business tax is imposed at a rate of 4% on any unincorporated entity engaged in business within New York City.
- **Texas:** Franchise tax, also referred to as the business margin tax, which is calculated upon an entity's gross receipts after limited deductions (compensation, cost of goods sold, etc.)

Federal tax reform – state tax implications

Federal tax reform - state tax implications

State adoption issues

- **State conformity to Internal Revenue Code** - Does state adopt the IRC "as currently in effect," or as of a specific date that may lag Tax Reform amendments?
- **20% domestic qualified business income deduction**
 - Does not reduce "Adjusted Gross Income" so won't impact states that start with AGI
 - States that start with "Taxable Income" may seek to decouple if deemed too great a revenue loss
 - Deduction applied at partner level, therefore may not impact the following:
 - Entity level taxes
 - Nonresident withholding
 - Composite returns
- **Interest expense limitation**
 - Increases AGI, so many states can be expected to follow
 - Applied at the entity level, therefore may impact the following:
 - Entity level taxes
 - Nonresident withholding
 - Composite returns
 - Carryforward of excess interest expense creates issues/opportunities because applied at the partner level

Federal tax reform - state tax implications

State adoption issues (cont'd)

- **Immediate federal expensing – many states already decouple from bonus depreciation**
- **Transition tax**
 - Individuals may not get dividend received deduction or subtraction for Subpart F income
 - State may not spread transition tax over 8 years
- **GILTI**
- **Repeal of technical terminations**
- **ECI on the sale of a partnership interest**
- **Carried interest**

Federal tax reform - state tax implications

State modeling

State taxes often impact entity choice decisions

- State *corporate* tax rates can be significant. Consider the following:
 - Iowa = 12%
 - Pennsylvania = 9.99%
 - Minnesota = 9.8%
 - Illinois = 9.5%
 - Alaska = 9.4%
 - New Jersey = 9%
 - California = 8.84%
- Differences between *individual* rates and *corporate* rates can be significant – AK 9.4% difference, PA 6.92% difference, IL 4.55% difference
- Entity-level taxes (including net income taxes) are levied on partnerships in certain states
- State modeling is complicated, and should consider each of the following:
 - States where business is operating
 - States where owners reside
 - Credits for taxes paid to other states

Tax reform – Pennsylvania 100% expensing decoupling

PA DOR issued Corporation Tax Bulletin 2017-02 on Dec. 22, 2017:

- Requires addback of federal 100% expensing deduction under IRC 168(k)
- But provides **NO DEPRECIATION OR OTHER RECOVERY** until the property is sold or disposed
- Reverses prior policy of allowing full recovery of 100% bonus in the year placed in service
- May result in PA tax being greater than federal tax
 - Example assuming \$20 million of qualified property for 168(k) deduction and 100% apportionment:
 - FTI of \$10 million X 21% = \$2.1 million federal tax
 - PA income of \$10 million + \$20 million = \$30 million X 9.99% = \$3 million PA tax

Application considerations:

- This is representative of the many nuances through which states adopt or decouple from federal rules, causing unforeseen results
- Does not apply for Personal Income Tax purposes, which decouples from bonus but allows a regular depreciation deduction
- Partnerships may need to report different information for corporate vs. individual partners

Impact of new federal partnership audit rules

BBA – IRS changes to partnership audit rules

HR 1314 – Bipartisan Budget Act of 2015 (P.L. 114-74 signed by Pres. Obama Nov. 2, 2015)

- Includes federal partnership audit “reform”
- Generally applies to partnership taxable years beginning after December 31, 2017
 - Confusing, complex body of law imposing administrative burdens for the IRS and for taxpayers
 - Amendments are intended to streamline and simplify the partnership audit rules, and raise over \$9.3 billion in revenue at just the federal level
- Can elect into the new rules for certain earlier years.

BBA – new terminology

BBA amends IRC secs. 6221 through 6241

Reviewed year	The tax year of the partnership that was under audit
Adjustment year	The year in which partnership return adjustments are finally determined
Adjusted K-1	New IRS form that partnerships will use to report adjustments to the partners
NOPPA	IRS “notice of proposed partnership adjustment” – initial adjustment notice setting forward the imputed understatements –triggers a 270 modification period
Pay-up election	Not a true election, but an option during the 270 day modification period for partners to amend their returns and pay their tax due resulting in a modification to the NOPPA.
Final Partnership Adjustment	Final Adjustment after modifications during the 270 day modification period.

BBA – New Terminology

BBA amends IRC secs. 6221 through 6241

NOFPA	Notice of Final Partnership Adjustment – triggers the 45 day and 90 day periods.
Push out election	Election made by the partnership within 45 days of the Notice of Final Partnership Adjustment to push out adjustments to the partners.
Push out statement	Form of information required to be provided to partners if a push out election is made. Must be provided to partners within 90 days of NOFPA.
Date of final determination	Expiration of 90 days from date of NOFPA, unless a petition for readjustment is filed, in which case the date of final determination is the court's decision becomes final.
Partnership representative ("PR")	Substitute for the former Tax Matters Partner (but way more powerful ... we'll get to that.)

BBA – IRS changes to partnership audit rules

Partnership-level assessment and payment of tax

- The **partnership will pay** the tax, interest, and penalties on any imputed underpayments **in the adjustment year**.
- The tax due is calculated by multiplying the net of the partnership adjustments by the **highest statutory corporate or individual rate in place**.
- Imputed underpayments can be reduced during the **270 day modification period**:
 - If **reviewed year partners file amended returns** properly taking into account all partnership adjustments properly allocable to each such partner (***pay-up election***);
 - If partnership demonstrates that a portion of imputed underpayment is allocable to a **tax-exempt entity**; or
 - If partnership demonstrates that a portion of imputed underpayment is allocable to C corporations or individuals with a **lower tax rate**.
- Any partnership adjustments not causing underpayments (*e.g.*, reallocation of partnership distributive share from one partner to another) will flow through to the partners in the year of the adjustment.

BBA – IRS changes to partnership audit rules

- Push out election for reviewed year partners to pay tax
 - After receipt of a NOFPA, Partnerships may elect to issue adjusted information returns **(adjusted K-1)** to the **reviewed-year partners**, who would then **take the adjustments** into account on their returns **in the adjustment year** through a simplified amended return process.
- Other changes
 - Audits will be handled by a designated **partnership representative (PR)**, who can be a partner or non-partner with a substantial presence in the U.S. The partnership representative is granted broad authority to resolve any partnership audit and any such resolution would be binding on all partners.
 - If no PR is designated by the partnership, the IRS will designate a PR.
 - Partners are not subject to joint and several liability for liabilities determined at the partnership level.

Complexities for states adopting partnership audit rules

Complexities for states adopting rules similar to BBA – partnerships computing underpayment

Partnerships might not have sufficient information or ability to properly compute and report the underpayment adjustment for state tax purposes

- **Resident Individual Partners**

- Resident Individuals are taxed on entire income (not state sourced income as is reported by the partnership)
 - Credit for taxes paid to nonresident states
 - Complicated calculation with potential Constitutional issues (*Wynne* case)
 - Timing issues between reviewed year and adjustment year, especially for states that do not adopt BBA
 - Changes in Partner’s resident state - calculation based on reviewed year or adjustment year?
- How to collect resident partner’s tax from partnerships not doing business in state?
 - Only approximately a dozen states require a partnership filing when the only connection to the state is a resident owner.

Complexities for states adopting rules similar to BBA – partnerships computing underpayment (cont'd)

Partnerships might not have sufficient information or ability to properly compute and report the underpayment adjustment for state tax purposes

• Trust Partners

- Most states tax resident Trust Partners on all income and allow credit for taxes paid to other states (presents the same issues as with resident individual partners)
- Trust residency rules more complex than individual residency rules, greater risk of dual resident
- Some income may flow to beneficiaries (Trust receives DNI deduction)
- Lack of information needed to calculate tax on ultimate owners
- Trusts are excluded from composite return by many states, because of complexity

Complexities for states adopting rules similar to BBA – partnerships computing underpayment (cont'd)

- **Corporate partners**

- Corporate partners are excluded from composite return by most states, because of complexities
- States offer alternative methods for corporate partners to source income
 - Flowing up of apportionment factors
 - Determination of sourced income can vary by corporate partner
- Tax positions taken by corporate partners not generally communicated to partnership

- **Tiered partnerships**

- Partnerships excluded from composite return by most states, because of complexities
- Lack of information needed to calculate tax on ultimate owners
- States offer alternative methods for tiered partnerships to source income

- **Tax-exempt partners**

- Tax-exempt partners are excluded from composite return by many states, because of complexities
- Many states follow federal unrelated business taxable income rules

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