OPERATION AS A PARTNERSHIP OR LIMITED LIABILITY COMPANY – STATE INCOME TAX CONSEQUENCES TO THE ENTITY, ITS PARTNERS AND ITS MEMBERS

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PARTNERSHIPS

I. Classification as a "Partnership"

A. General Income Tax Classification.

For state income tax purposes, classification as a partnership generally is made by reference to the Internal Revenue Code and associated regulations.

B. Specific Jurisdictions.

1. California. Effective for taxable years beginning after 1996, California follows the federal "check-the-box" regulations for purposes of determining whether an entity is classified as a partnership or an association taxable as a corporation. Cal. Rev. & Tax Code section 23038; Cal. Code Regs. tit. 18 ("Franchise Tax Regulation"), section 23038(b)-1 - (b)-3.

2. Illinois. For income tax purposes, Illinois law provides that, "Any entity… shall be treated as a partnership if it is so classified for federal income tax purposes." Ill. Law section 35 ILCS 5/1501(a)(16).

3. New York State. For Business Corporation Franchise Tax purposes, New York State classifies as partnerships those entities classified as partnerships under Internal Revenue Code Section 761(a). N.Y. Comp. Codes R. & Regs. tit. 20 ("Business Corporation Franchise Tax Regulation"), section 1-2.6.

4. New York City. For Unincorporated Business Tax purposes and General Corporation Tax purposes, New York City follows the federal classification scheme (See N.Y.C. Adm. Code sections 11-126, 11-602.1).

5. Pennsylvania. Effective for periods beginning on or after January 1, 2001, for both corporate income and franchise tax purposes Pennsylvania treats as corporations all entities, including partnerships, which are treated as corporations for federal income tax purposes. Act of June 22, 2001, No. 23, amending Pennsylvania law sections 7401 and 7601.

II. Taxation of Partnerships.

A. Income Tax Nexus.

To be subject to state income tax, partnerships must have a tax presence in the state. Federal Public Law 86-272 applies to partnerships to the same extent that it applies to other forms of business organizations; therefore, partnerships having activities in a jurisdiction not exceeding those permitted under Public Law 86-272 are not liable for the jurisdiction's net income tax.

A partnership protected under Public Law 86-272 will not lose that protection by its partners' unrelated contacts or activities.

In addition, some states provide special rules providing that partnerships are not treated as doing business or having tax presence in a state. For example, in a 2003 bulletin the North Carolina Department of Revenue explained that a partnership will not be treated as doing business in the state, and would not be required to file an income tax return, if it is an "investment partnership." Directive PD-02-1 (November 6, 2002). The Directive defines an investment partnership as "a partnership that is not a dealer in securities, as defined in section 475(c)(1) of the Internal Revenue Code, and that derives income exclusively from buying, holding, and selling securities for its own account." (The Directive changed the Department's policy and is effective retroactive to tax year 2001. In 2004, the North Carolina Department of Revenue clarified the Directive as stating that a partnership will not be treated as an investment partnership if any of its income is from another type of activity. Directive P. D.-04-2 (November 4, 2004).)

B. General Income Taxation.

With the exception of the jurisdictions discussed below, the states do not impose net income taxes on partnerships. Nevertheless, most jurisdictions require partnerships having a tax presence to file information returns reporting the partnership's income and factors in the state, identifying the partners, and disclosing the extent of the partners' interests in the partnership.

C. Specific Jurisdictions' Income Taxation.

Illinois, New York City, the District of Columbia, Tennessee, Kentucky and Ohio impose net income taxes on partnerships.

1. Illinois. Illinois imposes its Personal Property Tax Replacement Income Tax ("Replacement Tax") on partnership net income. Ill. Law section 35 ILCS 5/201(c) and (d). The tax is imposed at a rate of 1.5 percent of the partnership's Illinois net income for the taxable year.

To alleviate the possible cascading of the tax, partnerships receive a deduction for distributions to partners that are subject to Replacement Tax and that provide to the partnership a completed Form IL-2569 certifying that they are subject to the tax. 35 ILCS 5/203(d)(2)(I). Such partners include corporations (including S corporations), other partnerships, and trusts. 35 ILCS 5/201(c). In addition, a deduction is permitted for distributions to entities exempt from federal income tax under Internal Revenue Code Section 501(a).

2. New York City. New York City imposes its Unincorporated Business Tax on partnerships. N.Y.C. Admin. Code section 11-502, et. seq. The tax is imposed at a rate of 4 percent of the partnership's total income apportioned to New York City. (In general, computation of a partnership's total income begins with the ordinary income or loss as shown on the partnership's federal Form 1065, with specified additions (including payments made to partners) and subtractions. Total income is classified as either business or investment income, with separate apportionment formulae for each.)

3. District of Columbia. The District of Columbia imposes its Unincorporated Business Franchise Tax on partnerships carrying on or engaging in a trade or business in the District. D.C. Code Ann. section 47-1810.1, et. seq. The tax is imposed on the partnership's total taxable income apportioned to the District. In March, 2006 a District of Columbia court held the tax to be invalid to the extent that it is imposed on nonresident partners. *Bender et al. v. District of Columbia*, Docket No. 8524-05, District of Columbia Superior Court, Tax Division (March 8, 2006). The Office of Tax and Revenue has appealed the decision to the District of Columbia Court of Appeals.

4. Tennessee. Effective for tax years beginning on or after July 1, 1999, Tennessee amended its franchise, excise tax law to tax limited partnerships, limited liability companies, and limited liability partnerships doing business in Tennessee. See Tennessee Law Section 67-4-2004 (16) (definition of "person" or "taxpayer").

5. Kentucky. Effective for tax years beginning on or after January 1, 2005, Kentucky includes limited partnerships within the definition of "corporation", and subjects such partnerships to the state's corporate income tax. KRS 141.010(24)(F) and (G).

6. Ohio. Effective July 1, 2005, Ohio imposes its Commercial Activity Tax (a gross receipts tax) on “persons” including partnerships and limited liability companies. This includes single member limited liability companies. Ohio Rev. Code Chapter 5751.

D. Other Direct Taxes on Partnership Business Earnings.

Alabama, Hawaii, Michigan, New Hampshire, Ohio, Tennessee, Washington, West Virginia and Wisconsin impose various types of business earnings taxes directly on partnerships.

1. Alabama. For tax years beginning after December 31, 1999, Alabama imposes its Business Privilege Tax on "limited liability entities", including limited partnerships. Ala. Stat. Secs. 40-14A-22 and 40-14A-1(k). The tax is based upon net worth and is imposed on a graduated scale ranging from $.25 to $1.75 for each $1,000 of net worth, up to a maximum tax of $15,250 ($15,000 for years after 2000).

2. Hawaii. Hawaii imposes its General Excise Tax on partnerships. Haw. Rev. Stat. section 237-1. The rate of tax varies according to the partnership's business activities.

3. Michigan. Michigan imposes its Single Business Tax on partnerships. Mich. Comp. Laws section 208.6(1). For periods beginning on or after January 1, 2005, the tax is imposed at a rate of 1.9 percent of the partnership's taxable income apportioned to Michigan. (The tax is scheduled to be eliminated for tax years beginning after December 31, 2009.)

4. New Hampshire. New Hampshire imposes its Business Profits Tax on partnerships. N.H. Rev. Stat. Ann. section 77-A:6, I. The tax is imposed at a rate of 8.5 percent of the partnership's net income apportioned to New Hampshire.

5. Ohio. Ohio generally imposes an entity level tax on partnerships to the extent of the distributive share of Ohio income of corporate partners not subject to Ohio's corporate income tax. Ohio Rev. Code sections 5733.40 -.41. The tax is imposed at an 8.5 percent rate. Law Section 5733.41 describes the purpose for the tax as being to "to complement and to reinforce" the corporate income tax.

6. Tennessee. Tennessee imposes its Stock and Bonds Income Tax on partnerships. Tenn. Code Ann. section 67-2-102. In general, the tax is imposed at a rate of 6 percent on dividend income from stocks and on interest income from bonds received by Tennessee partnerships.

7. Washington. Washington imposes its Business and Occupation Tax on partnerships. Wash. Rev. Code section 82.04.030. The rate of tax varies according to the partnership's business activities. The Business and Occupation Tax taxes the privilege of doing business in Washington and generally is based on gross income, gross proceeds of sale, or value of products, depending on the tax classification of the activity (e.g., gross proceeds of sale is applied to retail businesses).

8. West Virginia. West Virginia imposes its Business Franchise Tax on partnerships. W. Va. Code section 11-23-6. The tax is imposed at a rate of .7 percent of the value of the taxpayer's capital employed in the state.

9. Wisconsin. Wisconsin imposes a Recycling Surcharge on partnerships having at least $4 million in gross receipts for the taxable year. Wis. Stat. section 77.93(3) and 77.94(1)(b). The surcharge is imposed at a rate of .2 percent of net business income allocated or apportioned to Wisconsin, with a maximum surcharge of $9,800. Wis. Stat. section 77.94(1)(b).

10. California Tax on Limited Partnerships. Limited partnerships doing business in California are subject to an annual $800 tax. Cal. Rev. & Tax. Code sections 17935(a) and 23153. Other states also impose minimum taxes/fees on limited partnerships.

III. Taxation of Corporate Partners.

A. General Partners.

1. Income Tax. General. In general, jurisdictions in which a partnership has a tax presence treat general partners as having a tax presence and as being subject to income tax. The jurisdictions' treatment is justified under an application of the "aggregate" and "agency" theories of partnerships, which hold that partnerships are mere groupings of their partners, acting as agents for each other for purposes of partnership business, but that the partnership itself is not a distinct entity. Examples of such jurisdictions include the following:

a. New York State. N.Y. State Reg. section 1-3.2(a)(5) (In general, "If a partnership is doing business, employing capital, owning or leasing property or maintaining an office in New York State, then all of its corporate general partners are subject to the [Business Corporation Franchise Tax]").

b. New York City. N.Y.C. Gen. Corp. Tax Rule section 11-03(a)(5) ("If a partnership is doing business, employing capital, owning or leasing property or maintaining an office in New York City, then all of its corporate general partners are subject to the general corporation tax").

c. New Jersey. N.J. Reg. section 18:7-7.6(a) ("A foreign corporation that is a general partner of a general or limited partnership doing business in New Jersey is subject to filing a corporation business tax return in New Jersey and paying the applicable tax under the terms of the corporation business tax to New Jersey. Such a corporation is also deemed to be employing or owning capital or property in New Jersey, or maintaining an office in New Jersey, if the partnership does so").

The tax consequences may be greater for partners deriving other income (i.e., non-partnership income) from the state but otherwise lacking a tax presence in the state — such as a partner with in-state activities (exclusive of the partnership's activities) limited to those permitted under federal Public Law 86-272. By virtue of their partnership interest, such partners may be treated as having a presence exceeding the protection of that law, with the result that all of the partners' in-state income may be subject to taxation. In general, such partners

will use their entire in-state and out of state apportionment factors to compute their income apportioned to the state. As an alternative, such partners may seek to separately account for their partnership and non-partnership income.

2. Apportionable/Allocable Character of Income Passed-Through.

a. General. Identification of a "general" rule is difficult, due to the variation in the states' treatments of corporate partners' shares of partnership income and factors. Instead, six states' treatments are discussed below. As is indicated below, the states differ in both the substance of their required treatments and the formality of their methods for prescribing those treatments.

b. California. California franchise tax treatment differs based on whether the partner and partnership are engaged in a unitary business. If the partner and partnership are engaged in a unitary business (disregarding ownership requirements), the partner includes its distributive share of the partnership's income and proportionate share of the partnership's factors with its own income and factors. Cal. Franchise Tax Reg. section 25137-1(f).

If the activities of the partner and partnership do not constitute a unitary business, the partner's share of the partnership's trade or business income is treated as a separate trade or business. Apportionment occurs at the partnership level (i.e., according to the partnership's factors), with the partner treating its distributive share of the partnership's business income as California business income. That income, when added to the partner's other California income, is the taxpayer's measure of tax. Cal. Franchise Tax Reg. section 25137-1(g)(1).

c. Illinois. In general, where a corporate partner and its partnership are unitary (disregarding ownership requirements), the partner determines its net income by including its share of the partnership's income and factors with its own business income and apportionment factors. Ill. Reg. section 100.3380(d). (Such inclusion is prohibited where 80 percent or more of the partnership's business activity is conducted outside of the United States, where the partner and partnership use different apportionment methods or where the partnership is not in the same general line of business or a step in a vertically structured enterprise with the corporate partner. Id.)

Where the partner and partnership are not engaged in a unitary business, the pass-through of income and factors is not permitted. Instead, the partner's distributive share of the partnership's business income is apportioned by the partnership's factors, and the partner's distributive share of the partnership's nonbusiness income is allocated as if such items had been paid, incurred or accrued directly to the partner in its separate capacity. Ill. Law section 35 ILCS 5/305.

d. Kentucky. Through tax years ending December 31, 2004, the Kentucky Revenue Cabinet directed corporate partners to include their

distributive share of partnership income in their apportionable income. The Revenue Cabinet classified income from a partnership as being from intangible property and does not include the partner's proportionate share of the partnership's factors with the partner's own factors. Instead, partners included in their receipts factor denominator the net income (not gross receipts) allocated to them by the partnership and include their Kentucky distributive share of the net income from the partnership in their receipts factor numerator. Ken. Rev. Policy 41P200 (June 1, 1983) & Schedule A to Form 720 (Apportionment and Allocation).

Under a law change effective January 1, 2005, partnership factors now generally flow through to the partners.

e. Mississippi. Mississippi income tax law does not contain any special rules regarding allocation and apportionment of income to corporate partners. However, Miss. Tax Regulation section 806.II.B. ("Exceptions") provides that, at least for partnership's earning income in a single state, "Partnership income is allocated directly to the state where the partnership gross income or loss occurred." Moreover, the Mississippi Tax Commission informally advises corporate partners of partnerships earning income in more than one state to take into account their share of the partnership's Mississippi income — that is, with apportionment occurring at the partnership level. The partners do not include their share of the partnership's factors with their factors.

f. New Jersey. Under N.J. Reg. section 18:7-7.6(g), if a corporate partner and a partnership are engaged in a unitary business, the corporate partner includes its distributive share of the partnership's operational income and proportionate share of the partnership's apportionment factors with its entire net income and factors. If the corporate partner and the partnership are not engaged in a unitary business, the partner's distributive share of the partnership's income is apportioned to New Jersey using the partnership's apportionment factors.

g. Tennessee. Under Tennessee law, a corporate partner generally includes its share of the partnership's income and factors with its income and factors. Tenn. Code Ann. section 67-4-2012(k).

h. Arizona. In Central Newspapers, Inc. & Subsidiaries v. Arizona Department of Revenue (Docket No. 1936-05-I November 22, 2005) the Arizona Board of Tax Appeals held that where a partner with Arizona tax presence is not unitary with its partnership, there is "no theory under which Arizona can tax [] -- a Washington partnership with no nexus to Arizona – on its sales into Arizona." The Board of Tax Appeals therefore held that the partnership's Arizona sales were not includable in the sales factor numerator of Arizona consolidated report filed by the partnership's Arizona corporate partners.

3. Other Issues.

a. Allied Signal. In Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992), the United States Supreme Court held that for income to be treated as apportionable, the income must arise either from a unitary business activity or from a use of capital that serves an operational purpose as opposed to an investment purpose. The rule of Allied Signal does not present an issue in the typical situation where a partnership earns income in the course of its business activities and either the partner's use of capital by participating in the partnership is in furtherance of an operational purpose or the partner and the partnership are engaged in a unitary business. Moreover, in determining whether a unitary relationship exists, states disregard the percentage of ownership threshold required when determining whether two corporations are unitary. See, e.g., Cal. Franchise Tax Reg. section 25137-1(f) & Ill. Reg. section 100.3380(d).

If a partner is not unitary with the partnership and if the partner's interest in the partnership serves an investment (i.e., non-operational) purpose, the treatment of income passed-through from the partnership is less clear. As a matter of federal Constitutional law, the better treatment seems to be for that income to be classified as nonapportionable and instead allocated under the states' rules for investments in intangibles.

However, as is indicated above, not all states follow this approach for nonunitary partnership interests. For example, California treats income as apportionable by reference to the character of the income in the hands of the partnership. See Cal. Franchise Tax Reg. section 25137-1. Under that regulation, where the partner and the partnership are not engaged in a unitary relationship, the partner's interest is deemed to be a separate trade or business, with apportionment of the partnership's income occurring at the partnership level.

b. Withholding of Tax. Certain jurisdictions require partnerships to withhold state income taxes from amounts paid or distributable to nonresident partners, including business entities not having a tax presence in the state. For example:

(i) Indiana. Ind. Code section 6-3-4-12 generally requires partnerships to withhold income tax on distributions made to nonresident partners. Withholding is not required on amounts paid to partners qualified to do business in Indiana. 45 IAC section 3.1-1-107.

(ii) Georgia. Ga. Code Ann. section 48-7-129(a) generally requires a 4 percent withholding from distributions to nonresident partners, to the extent those distributions are attributable to property owned or business done in Georgia. Ga. Reg. section 560-7-8-.34. (But see the exception discussed below for certain corporate limited partners.)

(iii) New Mexico. New Mexico requires pass-through entities to deduct and withhold tax on a nonresident owner's share of net income. NMSA 7-3-2 and 7-3-5, and adding a new section to the Withholding Tax Act). For purposes of this law, "pass-through entity" is defined to include partnerships and limited liability companies, unless they are taxed as corporations for federal income tax purposes. The provision is intended to apply to corporate partners as well as natural persons. Withholding is not required if the nonresident owner executes an agreement with the Department of Revenue to report and pay the tax on its own return. See also 3 NMAC 3.2.10 (effective December 31, 1999).

c. Sales and Use Tax Presence. Under the aggregation theory, the states may treat a partnership's presence in the state as creating a presence for the partners for purposes of other taxes, most notably sales and use taxes. Under that approach, a partner not otherwise required to collect and remit states sales and use taxes (because it otherwise lacks substantial nexus) may be required to do so because its partnership has such a presence in the jurisdiction.

B. Limited Partners.

1. General. Taxing jurisdictions do not follow a uniform rule for determining the income tax presence of limited partners. Three approaches indicative of the range of possible treatments are described below. The discussion below applies to limited partners that are not also general partners in the same partnership and that do not participate in the limited partnership's business; limited partners that are also such general partners or that participate in the partnership's business may be treated as doing business where the partnership is doing business.

2. Jurisdictions Not Distinguishing Between General and Limited Partners. Certain jurisdictions treat limited partners as having tax presence to the same extent as general partners. For example:

a. New York City. N.Y.C. Gen. Corp. Tax Rule section 11-06(a) ("Corporations as Limited Partners") provides that "...a corporation shall be deemed doing business in the City if it owns a limited partnership interest in a partnership that is doing business, employing capital, owning or leasing property, or maintaining an office in the City." (New York City provides limited exceptions for partners in publicly-traded partnerships and partners in portfolio investment partnerships. Rule section 11-06(b) and (c).) A New York City Administrative Law judge determined that the same result occurs even if the corporation does not hold the limited partnership directly, but instead holds an interest in a general partnership which holds the interest in the limited partnership. Matter of Ellsworth Co., Inc., (NYC ALJ) (July 21, 2000) (stating that "The fact that an intermediate general partnership interest exists between Petitioner and the City limited partnership is of no legal consequence.").

b. New York Sate. In general, for Business Corporation Franchise Tax purposes, New York State does not distinguish between general and limited partners. (Regulation section 1-3.2(a)(6) provides certain narrow circumstances in which a foreign corporate limited partner will not be treated as having a tax presence despite the contacts and activities of the limited partnership. Limited partners not meeting those conditions are treated as having a presence for purposes of the tax.)

c. North Carolina. In Final Decision 97-548 (April 24, 1998), the North Carolina Secretary of Revenue ruled that the "doing business" rule (N.C. Admin. Code Rule Sec. 17:05c.0102(b) for determining liability for the State's corporate franchise and income tax does not distinguish between general and limited partners. Thus, the Department held that all partners (general and limited) in a partnership that is doing business in North Carolina are likewise doing business in North Carolina. That interpretation was confirmed in an administrative decision. Perkins Restaurants, Inc., Tax Review Board Administrative Decision 351, January 28, 1999. In Perkins, the taxpayer was a limited partner in a partnership that owned and operated restaurants in North Carolina. The Board rejected the taxpayer's argument that it was not doing business in North Carolina and was not subject to the State's corporate franchise and excise tax was rejected. The Tax Review Board held that "the 'doing business' rule is applicable for all tiers of the partnership structure and does not distinguish between general and limited partners of a partnership. Therefore, a limited or general partner in a partnership, which is a partner in a partnership that is 'doing business' in North Carolina, is likewise 'doing business' North Carolina."

d. Illinois. In Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E. 2d 73 (App. Ct. 1st Dist. 2000), leave to appeal denied (May 31, 2000), the Illinois Appellate Court held that a corporate limited partner should be treated in the same manner as a corporate general partner for purposes of determining income tax presence, and that all such partners are treated as doing business in Illinois and being taxable on their distributive share of partnership income. ("Certainly, the physical presence in the taxing state of the partnership that generates the income suffices as a physical presence of the nonresident partner in the state....Plaintiff's characterizations of itself as a separate entity to whom the 'substantial nexus' between the partnership's activities and Illinois did not apply, for taxation purposes, meritless. Plaintiff has failed to cite any case that has applied the Complete Auto test to bar a state from taxing the distributable income of a nonresident limited partner of a partnership that is physically present in Illinois, operates in Illinois, and whose activities undisputedly have a substantial nexus to the taxing state. We decline to extend Quill to the state tax imposed on partnership income. We hold that the tax here is valid under the commerce clause.") Id. at 81-82.

e. Alabama. While no Alabama law or court decision expressly states that a limited partner has an Alabama tax presence merely because of its interest in a limited partnership doing business in Alabama, Regulation

810-3-24.01 ("Taxation of Partnership Income") defines "partnership" as including limited partnerships as well as general partnerships. Consistent with that definition, the regulation describes the Alabama gross incomes of partners without distinguishing between general and limited partners. In addition, in Alabama v. Lanzi, No. CV-2003-2705 (Ala. Cir. Ct. November 11, 2004) an Alabama Circuit Court overruled an Alabama administrative law judge and held that a nonresident individual limited partner had tax presence in Alabama by virtue of its ownership interest in a limited partnership formed under Alabama law. See also Danov Corporation v. State of Alabama, Alabama Department of Revenue, Administrative Law Division, No. 97-283 (December 22, 2000), an administrative law judge treated a limited partner as having a tax presence in the state merely by virtue of its partnership interest, stating, "The taxpayer clearly had nexus with Alabama through its investment in (the partnership) in Alabama."

f. Florida. Florida Rule 12C-1.002 does not distinguish between general and limited corporate partners in providing that, "The partnership's conduct of business, derivation of income or existence within Florida shall be deemed attributable to the partners, rather than to the partnership itself."

g. Georgia (individual partners). Georgia law provides that individual partners are taxable on their share of the partnership's net profits, without distinguishing between general and limited partners. Georgia Stat. section 48-7-24(a). Georgia's Court of Appeals held that nonresident individual limited partners are subject to Georgia income tax on their share of the partnership's net profits. Department of Revenue v. Sledge, 528 S.E.2d 260 (Ct. App. 3d Div. 2000), pet. for cert. denied (May 26, 2000).

h. Wisconsin. Effective for periods beginning on or after January 1, 2001, limited partners and members of LLCs, treated as partnerships for federal income tax purposes, are treated as doing business in Wisconsin and as having a Wisconsin presence for corporate income tax purposes if their partnership/LLC is doing business in Wisconsin. 2001 Wisconsin Act 16, amending Wisconsin Stat. Section 71.22(lr).

i. New Jersey. Effective for periods beginning on or after January 1, 2001, New Jersey law generally provides for corporate limited partners to consent to New Jersey Corporation Business Tax jurisdiction on their distributive income from the partnership. The consent is to be provided to and retained by the partnership. In the absence of such a consent, the partnership is required to remit a payment of tax to the state equal to the tax (at the maximum rate) on the non-consenting partner's share of the partnership's income apportioned to New Jersey. New Jersey Stat. sections 54:10A-5 and -7.

j. Massachusetts. In Utelcom, Inc. v. Massachusetts Commissioner of Revenue, Mass. App. Tax Board No. C262339 (January 31, 2005) the Massachusetts Appellate Tax Board held that a corporate partner has tax presence for Utility Corporation Tax purposes by virtue of its ownership of a limited

partnership interest in a partnership conducting business in the state. In reaching that conclusion, the Board adopted in principle a personal income tax decision finding tax presence consequences for personal income tax purposes from the holding a limited partnership interests.

3. Jurisdictions Recognizing Some Differences Between General and Limited Partners.

Some jurisdictions/taxes may treat limited partners as having a tax presence only to the extent of the partner's distributive share of the partnership's income apportioned to the state, or only for income (but not franchise) tax purposes. For example, in Appeal of Amman & Schmid Finanz AG, No. 96-SBE-008 (April 11, 1996) the California State Board of Equalization ("SBE") held that a limited partner does not have a franchise tax presence (i.e., is not doing business in California) merely by reason of its status as a limited partner in a partnership doing business and holding real property in California. The SBE observed that under California's Revised Limited Partnership Act, limited partners are not bound by the obligations of the partnership, have no interest in specific limited partnership property, and are not in an agency relationship with the partnership's general partners. However, California imposes a corporation income tax on corporations not subject to the corporation franchise tax, i.e., corporations not doing business in California, Cal. Franchise Tax Reg. section 23501. The tax is imposed on net income derived from sources within California. Cal. Rev. & Tax. Code section 23501, et. seq. Foreign limited partners have been treated as being subject to the corporation income tax on the California source income of their distributive share of their partnership's California source income. See Appeal of Amman & Schmid Finanz AG, supra.

4. Jurisdictions Not Treating Corporate Limited Partners as Having a Tax Presence. Certain jurisdictions, including Texas, New Jersey and Georgia do not treat corporations as having an income tax presence despite their status as limited partners in partnerships having a presence in the jurisdiction.

a. Texas. The Texas Comptroller's Office has ruled that a foreign corporation limited partner does not have a franchise tax presence merely by reason of its status as a limited partner in a partnership doing business in Texas). See, e.g., Ruling, April 5, 1995. As of the May 17, 2006 date of submission of this outline, the Texas legislature has approved legislation taxing most partnerships. H.B. No. 3 (79th Legislature, 2006). The Governor's approval of the legislation is expected.

b. Georgia (non-individual partners). Georgia law provides for tax presence of all nonresident "individual" partners, and defines "individual" as "a natural person." Georgia Stat. section 48-7-24(a) and 48-1-2(12). No comparable provision exists for non-individual partners. The difference in the treatments of individual and non-individual partners under Georgia law was acknowledged by a Georgia Assistant Attorney General in a 1982 memorandum to the Director of the

Georgia Department of Revenue's Income Tax Division. The memorandum further stated that "Because income or loss from a corporation's limited partnership interest is treated as income or loss from intangible personal property rather than as from the activities of the partnership itself, a corporation whose only contact with Georgia is by virtue of its limited partnership interest in a partnership operating in Georgia should not be considered to be owning property or doing business within the State." Memorandum from Warren R. Calvert to John G. Carter (October 13, 1982).

Note, however, that effective for tax years beginning on or after January 1, 2002 the Georgia Department of Revenue amended its regulations to provide that "A corporation will be considered to be owning property or doing business in Georgia whenever the corporation is a partner, whether limited or general, in a partnership which owns property or does business in Georgia." Ga. Reg. section 560-7-7-03e

c. Kentucky. Under a law effective January 1, 2005, Kentucky treats the "maintaining of an interest in a general partnership" as subjecting a partner to the state's income tax. The provision does not apply to interests in limited partnerships.

5. Pass-through of Income and Factors. The states do not have a uniform treatment of partnership income received by a limited partner. Illinois has ruled that, in general, a limited partner and its limited partnership may not be treated as being in a unitary relationship. See, e.g., Ill. Ltr. Rul. Nos. IT-88-0258 (September 21, 1988), IT-88-0323 (December 12, 1988). In that case, characterization of income as being business or nonbusiness first occurs at the partnership level, with apportionment of partnership business income also occurring at the partnership level. The partners report as Illinois income their distributive share of the partnership's Illinois income. Ill. Law section 35 ILCS 5/305(a). The partnership's nonbusiness income is taken into account by the partners as if the items were paid directly to the partners. Ill. Law section 35 ILCS 5/305(b).

6. Withholding of Tax and Composite Reporting.

The states increasingly are becoming concerned that limited partnerships and LLCs are being used both to avoid entity level tax and to help nonresident limited partners and nonresident LLC members avoid state taxation. In response, many states are requiring withholding of tax from distributions to nonresident partners that do not agree to be subject to the state's tax.

In their desire to collect tax on amounts distributable to such nonresident partners, the states sometimes attempt to make the partnership liable if a nonresident partner does not pay state income tax. However, the mechanisms used to collect the partner's tax from the partnership may be flawed. For example, on December 28, 2001, Alabama enacted law sections 40-18-22.1 which holds the

entity liable for a partner's nonpayment of tax, even if the partner has provided the entity with a consent to Alabama tax jurisdiction (which consent the entity has filed with the state). The attempt to impose liability on the partnership in such circumstances appears to be unfair, as once the partnership receives the partner's consent it cannot control the payment of the partner's tax. Moreover, the Department of Revenue's demand that the partnership pay the partner's liability may be issued after the partner has ceased to be affiliated with the partnership, in which case the partnership will be unable to obtain reimbursement by withholding from future distributions to the partner.

The states may permit or require the filing of a single, "composite", report by partnerships on behalf of certain of their partners. Typically, composite reporting is used where a partnership has noncorporate members having no income from the state except for income earned through the partnership. See e.g., Connecticut Information Publication 2005(13) describing Connecticut's composite return requirements.

C. Multi-Tiered Partnerships.

1. General. When partnerships are themselves partners in other partnerships, complex issues may arise regarding the character and sourcing of income received by the ultimate partners. As the states do not follow a uniform approach to the pass-through of income and factors from partnerships to first-tier partners, neither do they follow a uniform approach to the treatment of multi-tiered partnerships. New Jersey and Illinois practices reflect the range of possible approaches.

2. Specific Jurisdictions.

a. New Jersey. New Jersey looks through the tiers of partnerships to the ultimate corporate partner. As described in N.J. Reg. section 18:7-7.6(i), "A 'tiered partnership,' for the purposes of this section, is a partnership whose partners are partnerships. A corporation that is a partner in a partnership that in turn is a partner in yet another partnership is not immune from New Jersey taxation simply because of the tiered partnership. The ultimate tax burden and loss benefit falls on the corporate partner. The corporation shall file a New Jersey corporation business tax return taking account of its ultimate distributive share of the tiered partnership's income or loss from New Jersey activities."

b. Illinois. The Illinois Department of Revenue generally has interpreted the pass-through provision of regulation Section 100.3380(d) as applying to first-tier corporate partners only. Therefore, where the partner is another partnership, pass-through of income and factors to a corporate partner in an upper-tier partnership generally has not been permitted even where the corporate partner is engaged in a unitary business with the lower-tier partnership. (The Illinois Department of Revenue may require such pass-through.)

Notwithstanding the Illinois Department of Revenue's general interpretation, it occasionally permits a corporate partner in an upper-tier partnership to include its share of the factors of a lower-tier partnership in the computation of its apportionment percentage. For example, the Department of Revenue agreed with a taxpayer that a failure to include such factors would be inherently distortive of Illinois taxable income. Priv. Ltr. Rul. IT-97-0015 (June 26, 1997). See also Priv. Ltr. Rul. IT-96-0159 (December 17, 1996).

IV. Planning With Partnerships.

A. General. In appropriate circumstances, use of a partnership structure can provide significant state tax advantages. Those advantages may include favorable methods for determining amounts subject to tax and protection from nexus for purposes of income and other taxes. However, use of partnership structures may have the effect of spreading the partnership's tax presence to its partners or may result in a flow-through of apportionment factors, both of which can produce unexpected results. Planning with partnerships — particularly where the partners have multi-state business activities — therefore requires caution and frequently requires analyses of tax consequences in jurisdictions and under taxes other than those for which a partnership structure is being considered.

B. Example.

a. Texas Franchise Tax. As is discussed above, the Texas Comptroller has ruled that foreign limited partners, otherwise lacking a Texas tax presence, generally will not become subject to the state's franchise tax by reason of their holding of the limited partnership interest. See, e.g., Rulings 9911323L (November 2, 1999) and 9606338L (June, 1996, "Methods of Tax Avoidance; Prepared at the Request of the Ways and Means Committee"). Therefore, foreign corporations conducting business in Texas should be able to reduce their liability for that tax by operating in a limited partnership form instead of as a general partnership or C corporation. (Of course, the limited partner must be a passive investor in the partnership, as participation in the partnership's management or activities could cause that partner to be subject to the tax.) Note, however, that as of the May 17, 2006 date of submission of this outline, the Texas legislature has approved legislation taxing most partnerships. H.B. No. 3 (79th Legislature, 2006). The Governor’s approval of the legislation is expected.

LIMITED LIABILITY COMPANIES

I. Multiple-Member LLCs - Classification as Corporations or Partnerships.

A. General Income Tax Classification.

For income tax purposes, almost every state classifies and taxes multiple-member LLCs in accordance with the LLC's federal classification. See, e.g., Ill. Law sections 35 ILCS 5/1501(a)(4) ("Any entity ...shall be treated as a corporation if it is so classified for federal income tax purposes"), 1501(a)(16) ("Any entity ...shall be treated as a partnership if it is so classified for federal income tax purposes"); N.Y. State (see, e.g., TSB-A-97(7)I (August 6, 1997) ("It has been established that the classification of an LLC for New York State tax purposes will follow the classification accorded the LLC for federal income tax purposes."); N.Y. City Admin. Code section 11-126; Tenn. Code Ann. section 48-211-101; Cal. Tax Law section 23038.

B. State Income Taxation of LLCs Taxed as Corporations for Federal Income Tax Purposes.

For state income tax purposes, LLCs classified as corporations for federal income tax purposes are taxed as corporations for state income tax purposes. In general, the state income tax treatment of such LLCs is the same as the LLCs would have received if incorporated.

C. State Income Taxation of LLCs Classified as Partnerships for Federal Income Tax Purposes.

With limited exceptions, LLCs taxed as partnerships for federal income tax purposes are taxed as partnerships for state income tax purposes. As a result, LLCs treated as partnerships are subject to the partnership income and other business earnings taxes discussed above with regard to partnerships.

For corporate income/franchise tax purposes, Texas and Kentucky (and formerly Florida) treat all LLCs as corporations without regard to the LLCs' federal classification.

1. Texas. Under Tex. Tax Code Ann. sections 171.001(a)(2) and (b)(3)(A), LLCs are classified as corporations for Texas franchise tax purposes. Texas franchise tax is composed of a tax on the entity's taxable capital and, to the extent it produces a greater tax than the tax on taxable capital, a tax on net taxable earned surplus. Tex. Tax Code Ann. section 171.002. Apportionment is by a single factor (receipts) apportionment formula. The tax on net taxable earned surplus is imposed at a 4.5 percent rate.

2. Kentucky. Under a law effective January 1, 2005, Kentucky treats limited liability companies as corporations for income tax purposes. KRS 141.010(24)(C)(D) and (E).

3. Florida. Florida no longer imposes its corporate income tax on LLCs treated as partnerships for federal income tax purposes. See Fla. Stat. Ann. section 220.02.

Through the effective date of the amendments to Florida law (discussed below), LLCs were classified as corporations for Florida corporate income tax purposes. See Fla. Stat. Ann. sections 220.02(1) and 220.03(1)(e). For the relevant periods, the computation of Florida income tax began with the entity's federal taxable income which, for LLCs, was defined to be equal to the amount of taxable income determined as if the LLC was a corporation under the Internal Revenue Code. Fla. Stat. Ann. section 220.13(2)(j) & Reg. section 12C-1.013(e). After specified additions and subtractions, the corporate income tax was imposed at 5.5 percent of the LLC's net income allocated and apportioned to Florida. (Apportionment was by a three factor formula (property, payroll and receipts), with receipts being double-weighted.)

The Florida Department of Revenue interprets the change in the state's treatment of LLCs as being effective July 1, 1998. See, e.g., Fla. Dept. of Revenue, TIP #98(C)1-05 (July 1, 1998). However, taxpayers should be aware that the amendments to Section 220.02 are subject to a special effective date provision which makes them effective retroactive to January 1, 1997. While the Florida Department of Revenue interprets that special effective date as applying only to a different subsection of the amendments to Section 220.02, the effective date provision actually states — twice — that it applies to all of the amendments to Section 220.02.

D. Other State Fees And Taxes On LLCs. Many states impose modest annual taxes/fees on domestic LLCs and foreign LLCs registered to do business in the state. See, e.g., Delaware ($200). Del. Limited Liability Act. section 18-1107(b).

Other states impose annual fees on LLCs with those fees being determined by the number of members of the LLC. For example:

- New York State imposes an annual fee on LLCs classified as partnerships for federal tax purposes and having income derived from New York sources. That annual fee is $50 per member (determined on the last day of the taxable year), to a maximum of $10,000 per year, and is payable to the Department of Taxation and Finance. N.Y.S. Tax Law section 658(c)(3). For 2003 and 2004, the fee amounts were $100 and $25,000, respectively, but were scheduled to decrease to the prior rates beginning January 1, 2005. However, the scheduled decrease has been postponed until at least 2007. Ch. 61 (S.B. 3671) Laws 2005.

- Tennessee imposes an annual fee on LLCs doing business in Tennessee. The fee is $50 per member to a maximum of $3,000, and is payable to the Secretary of State. Unlike New York State, Tennessee imposes its fee on all LLCs, without excluding those LLCs classified as corporations for state Franchise and Excise Tax purposes. Tenn. Code Ann. section 48-247-103(d).

California imposes an $800 annual tax on LLCs doing business in the state. Cal. Rev. & Tax. Code sections 17941 and 23153. In addition, California imposes on LLCs an annual gross receipts fee. For periods ending prior to January 1, 2001, California annually adjusted the

amount of this fee. However, effective for taxable years beginning on or after January 1, 2001, the fee structure no longer will be revised annually. Instead, the fee amounts are now fixed, with the maximum fee set at $11,790 annually. Cal. Rev. & Tax Code Sections 17942 and 17943. The characterization of the gross receipts fee as being a fee and not a tax permits the deduction of that amount in determining the LLC's California income. Cal. Rev. & Tax Code Section 17220(b). However, the "fee" was held to be an unconstitutional unapportioned tax in Northwest Energetic Services LLC v. California Franchise Tax Board (CGC-05-4377211 (SF Sup. Ct. March 3, 2006). The Franchise Tax Board has indicated that it will appeal the case.

II. State Income Tax Treatment of Members of LLCs Treated as Partnerships for State Income Tax Purposes.

A. Pass-Through of Income and Factors.

1. General. In general, state income taxation of members of an LLC classified as a partnership for state income tax purposes is the same as the states' treatment of similarly situated partners of partnerships. Therefore, while many states have not expressly addressed this issue, the income and factors should pass-through to the member for state tax purposes in the same manner that those items pass-through to partners.

2. Specific States.

a. California. An LLC that elects to be treated as a partnership for federal purposes will be treated as a partnership for California income and franchise tax purposes, Cal. Rev. and Tax. Code section 23038, and the LLC's members will be taxed under the California income tax provisions applicable to partnerships. Cal. Rev. & Tax. Code section 17087.6. As a result, corporate members of LLCs should be taxed on their distributive shares of the LLC's income (and include the LLC's apportionment factors with their own factors) in the manner described above with reference to partnerships.

b. New York State. The New York State Department of Taxation and Finance has advised that where a corporation is a member of an LLC treated as a partnership for federal income tax purposes (and therefore treated as a partnership for New York State tax purposes), the corporation is required to include its proportionate part of the LLC's income and apportionment factors with its own income and factors. TSB-A-97(13)(C) (June 26, 1997). The inclusion of those items is made in the same manner as for corporate partners under N.Y. St. Business Corp. Franchise Tax Reg. section 4-6.5.

B. Classification of LLC Members.

1. General. Many states have not expressly addressed the issue of how LLC members are to be classified. As noted above with regard to partnerships, classification as a general or limited partner may affect significantly the partner's liability for state taxes, with general partners being treated as having tax presence where the partnership has tax presence, but with limited partners potentially being

treated as not having such tax presence. However, because LLC statutes generally do not provide formal distinctions comparable to the general partner/limited partner distinction contained in the states' limited partnership laws, tax planning based upon a passive member's lack of a taxable presence in a particular state is difficult.

Theoretical arguments for why members of LLCs treated as partnerships for income tax purposes should not be presumed to have tax presence in a jurisdiction merely by virtue of the LLC's tax presence in the jurisdiction include the following:

- An LLC is a distinct entity formed under state law. Therefore,

(i) there is no basis for applying the aggregate or agency theories, under which a partnership is treated as a mere aggregation of its partners rather than as a distinct entity and which, by that treatment, provides a substantial justification for treating all partners of a general partnership as having tax presence in jurisdictions where the partnership has a tax presence.

(ii) while LLCs may be treated as partnerships for purposes of computing their and their members' state tax liabilities, they are not, in fact, partnerships. Moreover, the distinction between computational issues and entity lines is not new to state taxes, and in fact has received substantial attention in the Joyce/Finnigan debate. Arguments against presumptive nexus for members may draw support in Joyce jurisdictions from the reasoning applied by the jurisdiction in adopting the Joyce approach, or, if such reasoning is not available, from the very fact that the jurisdiction has adopted the Joyce approach.

- In general, LLCs are similar to limited partnerships in certain fundamental respects, including: (i) members generally have limited liability for the LLC's indebtedness and other liabilities, (ii) members do not have an interest in specific LLC property, and (iii) membership interests in LLCs generally are treated as intangible personal property. See generally Ill. Law sections 805 ILCS 180/10-10, 180/25-15, 180/30-1. See also the SBE's statement in Appeal of Amman & Schmid Finanz AG ("A general partner simply does not have agency rights over the obligations or the property of the limited partners"), which was made in concluding that limited partners are not doing business in California merely because their partnership is doing business in the state. That statement should have equal application to the relationship between members of LLCs.

Theoretical arguments for why members of LLCs treated as partnerships for income tax purposes should be treated as having a tax presence in those jurisdictions in which the LLC has a tax presence include the following:

- The arguments against finding such presence assume an ability to distinguish between active and inactive partners. Such a distinction is fact intensive, with results that are more likely shades of gray than black and white. The states cannot

efficiently administer their taxes if they must routinely contend with such fundamental factual questions.

- The arguments against finding such presence prove too much, as they apply equally to active and passive members of LLCs. Those arguments, if followed, could be interpreted to mean that an LLC's tax presence could not be attributed to even its most active member. Such a result provides greater protection than that received by limited partners — whose protection from tax presence is more clearly derived from the entity's enabling statute.

2. Specific Jurisdictions. In certain circumstances, specific jurisdictions may treat LLC members as being equivalent to limited partners. For example,

a. Ala. Rev. Rul. 96-005. (September 11, 1996) classifying LLC members not directly participating in the management of the LLC as equivalent to limited partners; and

b. N.Y.C. Finance Dr. Rul. 95-4567. (October 31, 1995), stating that "Because of the similarity in the structure and tax treatment of a limited partnership and a limited liability company, in our opinion, the criteria set forth in Rule section 11-06 for whether limited partners are deemed to be doing business in New York under the GCT should be applicable to members of a limited liability company." (Note, however, that except in the limited circumstances discussed above (relating to publicly-traded partnerships and portfolio investment partnerships), limited partners (and therefore members of LLCs) are treated as having a General Corporation Tax presence in the City if the partnership (or LLC) has a tax presence in the City. See Rule section 11-06.)

C. Withholding Requirements. Several states, including California, Georgia, Maryland, Minnesota and South Carolina, require LLCs to withhold tax on distributions made to their nonresident members. (California does not require such withholding for members consenting to California's tax jurisdiction. Cal. Rev. & Tax. Code section 18633.5(e).) In addition, the Ohio tax on pass-through entities (including LLCs not classified as corporations for federal income tax purposes) seems fairly characterized as a withholding-type tax. New Jersey generally imposes its Corporation Business Tax on LLCs classified as partnerships for federal income tax purposes to the extent that the LLC's corporate members do not consent to be subject to the tax. New Jersey Stat. sections 54:10A-15.7.

(See the discussion of limited partner withholding for analysis of possible state overreaching in attempting to hold limited liability entities liable for their members' nonpayment of income taxes.)

III. State Income Taxation of Single-Member LLCs.

A. General. The federal income tax treatment of single-member LLCs is provided for in the "check-the-box" regulations. For federal income tax purposes, such entities are treated as either corporations or divisions of their single-member, at the election of the single-member

LLC. Internal Revenue Regulation Sections 301.7701-1(a)(4), 301.7701-3(b)(1). If no election is made, the LLC is disregarded as an entity separate from its member. Internal Revenue Regulation Section 301.7701-3(b)(1).

B. Explicit Check-The-Box Conformity. For income tax purposes, many states have indicated an intention to follow the federal treatment of single-member LLCs as provided for in the check-the-box regulations. Such conformity may occur

- by statute (see e.g., Ariz. Rev. Stat. section 29-857; Georgia Code section 14-11-1104; Ind. Code section 6-3-1-11; Mo. Rev. Stat. section 347.187; Wis. Stat. section 71.22(1));

- by regulation (see, e.g., Del. Reg. section 1.1900.2);

- or, frequently, by administrative pronouncement or letter ruling (see, e.g., Ala. Rev. Procedure 98-001 (March 16, 1998); Ariz. Corp. Tax Rul. 97-2 (August 8, 1997) (interpreting Ariz. Law section 29-857); Haw. Tax Information Release 97-4 (August 4, 1997); Illinois General Information Letters IT-98-0038 (April 13, 1998) and IT-00-0094 (December 6, 2000); Iowa Ltr. Rul. (March 20, 1997); Mass. Technical Information Release 97-8 (June 16, 1997) and Letter Ruling 99-17 (November 30, 1999); Mich. Revenue Administrative Bulletin 1999-9 (January 21, 2000); Minn. Rev. Notice 98-08 (May 26, 1998) (see also 97-03 (March 17, 1997)); N.Y.C. Finance Memorandum 99-1 (October 21, 1999). N.Y.S. Advisory Opinion TSB-A-96(19)C (July 24, 1996); N.C. Technical Advice Memorandum 97-3 (January 27, 1997)); S.C. Information Letter 96-25 (December 19, 1996) and Ruling 98-11 (May, 1998); Va. Public Document 97-343 (August 28, 1997).

Prior to the adoption of the check-the-box regulations, the California Franchise Tax Board strenuously objected to the "tax nothing" treatment of single-member LLCs. California has since conformed to the federal treatment. See Cal. Rev. & Tax. Code section 23038(b)(2)(B)(iii). However, California imposes its LLC tax and LLC fee without providing an exception for LLCs that have had their income included in their members' determination of its California income. Id. and Cal. Rev. & Tax. Code sections 17941, 17942.

C. Implicit Check-The Box Conformity. Other states, while not expressly conforming to the federal classification of single-member LLCs, nevertheless will follow that classification for income tax purposes. This issue may arise because state tax definitions conform to the definitions provided by the Internal Revenue Code (as opposed to the definitions provided by the Internal Revenue Code and associated regulations), and may be resolved by reference to the state's tax definitions of "corporation", "partnership", and "taxable income".

For example, even before the Illinois Department of Revenue issued General Information Letter IT-98-0038 (April 13, 1998) (stating that Illinois income tax classification of single-member LLCs conforms to the federal income tax classification) taxpayers were aware that the state implicitly conformed to the federal income tax treatment of single-member LLCs under applications of the following Illinois law sections:

- 35 ILCS 5/102 (generally conforming the definitions of terms used in the Illinois Income Tax Act to the meaning of those terms in the IRC but without reference to the regulations (therefore presenting the implicit conformity issue));

- 35 ILCS 5/1501(4) (treating LLCs as corporations when they are so classified for federal income tax purposes). Under this section, a single-member LLC that is disregarded for federal income tax purposes is not a corporation for Illinois income tax purposes.

- 35 ILCS 5/1501(16) (treating LLCs as partnerships when they are so classified for federal income tax purposes). Under this section, a single-member LLC that is disregarded for federal income tax purposes is not a partnership for Illinois income tax purposes.

- 35 ILCS 5/203(b) and (e) (beginning the computation of taxable income with the entity's federal taxable income). Under this section, disregarded single-member LLCs do not have a taxable income for purposes of beginning the computation of their Illinois income. Also under this section, because the member's federal taxable income includes the disregarded single-member LLC's income, the member's Illinois income also includes the single-member LLC's income.

D. Nexus Issues. The Illinois Department of Revenue has expressed a concern that taxpayers will structure their operations so that the only contact with the state is through a disregarded single-member LLC, with the LLC's member taking care to avoid any state contact that might exceed the protection of Public Law 86-272. The Department of Revenue is concerned that the member might argue that it is protected from the state's income tax by that federal law, and therefore that it is not required to file an income tax return with the state. The issue is particularly significant in states using federal taxable income as the starting point for determining state taxable income. In such states (e.g., Illinois), a disregarded single-member LLC may argue that it lacks a federal taxable income, so that its only income in the state is from any required additional modifications to its (nonexistent) federal taxable income.

Various states have attempted to anticipate the issue by providing in their laws, regulations, or rulings that a member of a disregarded LLC is deemed to have a tax presence in the state by virtue of the LLC's tax presence in the state and is required to file an income (or comparable) tax return with the state. See, e.g., Wis. Stat. section 71.22(1r); Del. Reg. section 1.502.1(d)(2)(B); Haw. Tax Information Release 97-4 (August 4, 1997); N.Y.C. Finance Memorandum 99-1 (October 21, 1999); Mich. Revenue Administrative Bulletin 1999-9 (January 21, 2000).

California requires the member to consent to California tax jurisdiction. Cal. Rev. & Tax. Code section 18633.5(i)(1). If the member does not provide that consent, the LLC is required to make a withholding payment on behalf of the member. Cal. Rev. & Tax. Code section 18633.5(i)(2).

E. Other check-the box issues. Taxpayers should be aware that a state's conformity with federal check-the-box treatments may be limited to identified types of entities. See e.g.

Alabama Revenue Ruling 00-005 (June 28, 2001) (stating that the Department's pronouncement concerning the federal check-the-box regulations addresses the tax treatment of LLCs only and does not extend to business trusts) and Massachusetts Department of Revenue Directive 01-8 (November 13, 2001) (explaining that Massachusetts follows the federal tax classification of a non-U.S. business entity if the entity is a foreign LLC and listing particular types of non-U.S. entities which will be classified as foreign LLCs. In the Directive, the Department of Revenue advises taxpayers concerned about the Massachusetts classification of other types of non-U.S. business entities to request a letter ruling.)

IV. State Treatment of Single-Member LLCs For Non-Income Tax Purposes.

The states do not necessarily disregard single-member LLCs for taxes other than income taxes. For example, under a 2002 amendment, Florida treats single-member LLCs as separate entities for non-income tax purposes. Fl. Stat. Title 36, Section 608.471(3). Also, under New Jersey law, single-member LLCs are disregarded for purposes of taxation on income only. New Jersey Stat. section 42:2B-69. The Minnesota Department of Revenue took the same position in a 2002 administrative pronouncement. Revenue Notice 02-10 (July 8, 2002). In addition, the Hawaii and Michigan Departments of Revenue have stated that all single-member LLCs, including those that are disregarded for federal and state income tax purposes, are taxable business entities for General Excise (sales) Tax and sales and use tax purposes, respectively, and must be separately licensed and registered with the states for those taxes. Haw. Tax Information Release 97-4 (August 4, 1997); Michigan Revenue Administrative Bulletin 1999-9 (January 21, 2000). And the Illinois Department of Revenue has advised that single-member LLCs making taxable sales must be registered for and pay the state's Retailer's Occupation (sales) Tax. Ill. PLR No. ST-97-0483-GIL (September 29, 1997). While not discussed in any of the rulings, one consequence of the rulings seems to be that the sales tax presence of a single-member LLC in those states should not create a sales tax presence in those states for its members. <u>See also</u> New York State Advisory Opinion, TSB-A-99(7)S (January 28, 1999) ruling that a single-member LLC is an entity distinct from its members. Interestingly, New York sales and use tax law has not been amended for the use of single-member LLCs. As a result, the Department of Taxation and Finance has ruled that a single-member LLC is a <u>partnership</u> for sales and use tax purposes (TSB-A-98(2)S (January 30, 1998)) (applying the definitions contained in Tax Law Section 2(6) (" 'Partnership' and 'partner,' unless the context requires otherwise, shall include, but shall not be limited to, a limited liability company and a member thereof, respectively") to permit an exemption for transfers of property on formation of a partnership to apply to the formation of a single-member LLC).

As further examples, since Texas does not disregard SMLLCs even for franchise tax purposes, it is no surprise that The Texas Comptroller of Public Accounts ruled that SMLLCs are distinct taxpayers for sales tax purposes. Position Letter 200001993L (January 21, 2000). Of greater interest is the Comptroller's position that a federally disregarded entity that is recognized as an integral part of an exempt activity of its sole member does not qualify for an exemption from Texas sales or franchise taxes. To so qualify, the disregard entity itself must be exempt from federal income tax Position Letter 200106899L (June 21, 2001). Also, the Louisiana Department of Revenue ruled that a non-corporate entity that elects to be treated as a corporation for federal income tax purposes is not necessarily treated as a corporation for Louisiana franchise tax purposes. Check-the-box elections have no significance for Louisiana franchise tax

purposes. Louisiana Department of Revenue, Revenue Ruling 01-013 (October 1, 2001). And, the Utah Tax Commission has ruled that a SMLLC is a distinct person "required to collect and remit sales and use tax on taxable transactions, including transactions with affiliated entities." Utah Tax Commission Advisory Opinion 01-009 (May 18, 2001).

In contrast, Missouri requires conformity with federal income tax classifications for sales and use tax purposes. Missouri Law section 347.187(2). Also, Wisconsin has amended its laws so that the member of a disregarded single-member LLC is liable for withholding, sales/use, and recycling surcharge, and is responsible for obtaining a business tax registration certificate. Wis. Stat. sections 71.63(3)(c), 77.51(10), 77.935, 73.03(50)(d), respectively. (But see Wisconsin Private Letter Ruling W9812004 (December 22, 1997) narrowly interpreting those amendments in certain circumstances applicable to qualified subchapter S subsidiaries — and apparently indicating an intention to apply that same interpretation to single-member LLCs.) The Alabama, South Carolina, and Tennessee Departments of Revenue also have ruled that where a single-member limited liability company is treated as a division of its corporate member for federal and state income tax purposes, the LLC will be treated as a division of the corporate member for purposes of the states' sales and use taxes. Alabama Revenue Ruling 98-005 (June 18, 1998), South Carolina Private Revenue Opinion 00-4 (July 10, 2000), Tennessee Letter Ruling 00-47 (November 29, 2000).

V. Property Transfers Involving LLCs.

Even where a property transfer between an LLC and another entity or a person does not result in a federal or state income tax liability, the transfer may be subject to other state taxes. For example, the states may treat a transfer of property to or from an LLC as being subject to various transfer taxes even though there is no change in the ultimate ownership of the property. In this regard, the Wisconsin Tax Appeals Commission recently held that a transfer of real property from a partnership to an LLC was subject to Wisconsin's real estate transfer fee. See e.g. Sunset Meadows v. Wisconsin Dept. of Rev., Dkt. No. 98-T-129 (WTAC Mar. 5, 1999). In Sunset Meadows, the Tax Appeals Commission held that a transfer of real property from a partnership to an LLC, where a husband and wife held the same interests in each entity, was subject to the state's real estate transfer fee. The partnership argued that the transfer should not be subject to the fee because that transfer would have been exempt if it had been effected in two steps. (Wisconsin law exempts transfers between partnerships and their partners (and LLCs and their members) from this fee if all of the partners (members) are related to one another. Thus, if the partnership in Sunset Meadows had transferred the property to its partners, who in turn transferred the property to their LLC, both transfers would have been exempt from the fee). The Commission rejected this argument, noting that none of the exemptions from the fee apply to transfers between entities. See also, J&R Hotel Partnership v. Wisconsin Dept. of Rev., Dkt. No. 96-T-633 (WTAC Mar. 14, 1997). Compare Selle v. Wisconsin Dept. of Rev. Dkt. No. 98-T175 (WTAC Mar. 15, 1999) and Blado v. Wisconsin Dept. of Rev., Dkt. No. 98-T-166 (WTAC Mar. 19, 1999) (holding that transfers of real property from a trust by husband and wife trustees to the trustees' LLC were exempt from real estate transfer fee by the provision exempting transfers between LLCs and their members).

VI. Planning With LLCs.

A. General. Planning with LLCs typically involves either the use of LLCs treated as partnerships or, very recently, the use of disregarded single-member LLCs. The cautions provided above regarding planning with partnerships apply here as well, with the additional caution that few states have ruled that inactive members may be treated as equivalent to limited partners.

In many cases, tax planning with disregarded single-member LLCs will be driven by federal tax consequences or tax consequences in a particular state. However, even when use of a single-member LLC generates tax benefits that are predictable federally or for a tax in a particular state, the consequences for other taxes in that state, and the income and other tax consequences in other states, may be significantly less certain.

B. Examples. Use of an LLC instead of a partnership in each of the structures discussed above in the partnership planning section should have the income tax consequences described below. Also discussed below is a possible state tax planning use for single-member LLCs.

1. Texas Franchise Tax. LLCs are subject to Texas franchise tax. Therefore, use of an LLC instead of a limited partnership in the structure discussed above generally will result in a greater Texas franchise tax liability than would occur by use of a limited partnership.

2. Single-Member LLCs. Businesses may find that a need to separately incorporate their lines of business (for example, to isolate the risks of a particular activity) affects their state income tax liability in non-combination states. If such separate incorporation would create a greater income tax liability to that state than would occur with a single corporation, the use of a disregarded single-member LLC may permit the accomplishment of the business objectives without increasing the amount of income apportioned to the state.