Pass-through entities face new challenges as states aggressively use the concept of nexus to increase tax revenues from these entities or their owners. In this article, practice leaders at Baker Tilly Virchow Krause, LLP and Bradley Arant Boult Cummings LLP discuss recent state tax developments in which ownership interests in a pass-through entity were sufficient to give the state jurisdiction over the nonresident owners of the entity doing business in that state. They discuss also apportionment of pass-through income.

Recent State Tax Developments for Pass-Through Entities: Nexus Over Nonresident Owners and Apportionment of Income

By Patrick H. Smith, Bruce P. Ely, William T. Thistle, II and J. Sims Rhyne, III

It is critical for the owners of pass-through entities and their advisers to continually monitor changes in the complex and evolving world of state and local taxation. These changes can become a trap for the unwary and expose pass-through entities and their owners to unnecessary tax liability and penalties. The complexities in this area of the law are compounded when pass-through entities operate in multiple states and their owners reside in various other states. Compared with resident owners over which a state has jurisdiction because of their physical presence in the state, nonresident owners of pass-through entities are presented with more difficult issues. Thus, owners of multistate pass-through entities must continually keep themselves apprised of changes in the law of not just their state of residence, but also each state in which the pass-through entities operate.

This article contains selected recent developments related to the state taxation of pass-through entities (referred to, intermittently, as “PTEs”) and their owners. These updates, spanning the past 12 months, cover nonresident owner nexus (i.e., jurisdiction to enforce the collection of tax) and apportionment of a PTE’s multistate income.

NONRESIDENT OWNER NEXUS

Alabama

Nonresident Nexus Unnecessary for Composite Income Tax. Chief Administrative Law Judge Bill Thompson of the Alabama Department of Revenue upheld the imposition of the state’s mandatory composite income tax on an Alabama-based LLC owned in part by a nonresident residing abroad. In his ruling, Judge Thompson reasoned that it was irrelevant whether the state had jurisdiction over the nonresident member, who lived in...
Greece, because the statutory composite filing/payment requirement was imposed on the LLC, which clearly had a sufficient nexus with the state to permit Alabama to enforce collection of the tax through the composite filing. Citing International Harvester Co. v. Wisconsin Dept. of Taxn., 332 U.S. 435 (1944), Judge Thompson explained, “I agree with the Taxpayer’s representative that Alabama’s composite return and payment provisions were enacted . . . to avoid the jurisdictional problems involved in taxing a nonresident partner or member. But such provisions are clearly constitutional, and while the tax is measured by the nonresident’s distributive share of the entity’s income, it is levied on the in-state entity.” Tsitatia LLC v. Alabama Dept. of Rev., Administrative Law Judge Rulings Docket No. BPT. 12-492 (Feb. 1, 2013).

**Authors’ Commentary:** In International Harvester, the U.S. Supreme Court upheld a Wisconsin statute that required an in-state corporation (International Harvester) to withhold and remit Wisconsin income tax on dividends paid to out-of-state stockholders who themselves had no nexus with the state. The Court indicated that “[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporations’ Wisconsin earnings as is distributed to them.” This decision serves as the legal foundation for the ubiquitous state income tax withholding requirements today.

**Nonresident Member May Not Be Personally Assessed.** In another Alabama Administrative Law Division decision, however, Judge Thompson ruled that while the state had authority to collect income tax from an Alabama-based PTE, that authority did not extend to the PTE’s nonresident owners. Thus, Alabama could not personally assess income tax against an individual who resided and worked in Minnesota and received income from an Alabama-based LLC because the taxpayer had no contacts in, or connections with, Alabama other than being a member of and receiving income from the LLC. Applying the Alabama Court of Civil Appeals’ landmark decision in Lanzi v. Alabama State Dept. of Rev., 968 So. 2d 18 (Ala. Civ. App. 2006), cert. denied, Ala., No. 1051475 (April 13, 2007), Judge Thompson held that Alabama could have assessed the tax against the PTE but cannot assess the tax against the nonresident member personally. As such, the final assessment was voided. The Department did not appeal the decision. Vogt v. Alabama Dept. of Rev., Administrative Law Judge Rulings Docket No. INC. 11-660 (Jan. 3, 2013).

**Registration With Secretary of State Constitutes Nexus.** Alabama Chief Administrative Law Judge Thompson ruled that an LLC organized in the state but inactive since December 2007, though never dissolved, was subject to the minimum annual $100 business privilege tax, along with interest, for 2007-2012. Pointing to the state’s statute that imposes a business privilege tax filing requirement on any corporation or LLC “doing business in Alabama, or organized, incorporated, qualified, or registered under the laws of Alabama,” Judge Thompson explained that, “[b]ecause the Taxpayer was registered with the Alabama Secretary of State’s office from 2007 until 2012, it was qualified to do business in Alabama in those years, and thus liable for the minimum $100 business privilege tax in those years.” Interestsingly, Judge Thompson waived the associated penalties. Old Lodge Catering, LLC v. Alabama Dept. of Rev., Administrative Law Judge Rulings Docket No. BPT. 12-1402 (March 27, 2013).

**Authors’ Commentary:** A 50-state survey conducted by Bloomberg BNA earlier this year revealed that 13 states take the position that the mere act of registering to do business is sufficient to trigger an income tax filing/payment obligation in the state. However, not all states agree. In Rylander v. Bandag Licensing Corporation, 18 S.W.3d 296 (Tex. App. 2000), for example, the question arose as to whether qualification to do business in a state, without more, was a sufficient basis for a state to assert jurisdiction. The Texas appeals court held that the Commerce Clause and Due Process Clause prohibited a state from asserting franchise tax jurisdiction over a corporation that had merely qualified to do business in a state without engaging in any other activity there. Bloomberg BNA 2013 Survey of State Tax Departments: Key Findings and Analysis, Vol. 20, No. 4 (April 26, 2013).

**California**

**General Partner Deemed to Be Doing Business in State.** A California State Board of Equalization (SBE) decision held that the taxpayer, a Nevada corporation, was liable for the state’s minimum franchise tax. The taxpayer was a managing general partner of Horizon Partners, a Nevada limited partnership. One of Horizon’s other general partners was USA Properties, a corporation located in California and registered with the California Secretary of State. The SBE held that Horizon was doing business in California through its general partner, USA Properties, because Horizon’s activities were attributable to the California corporation. The SBE explained: “When a corporation (here, the managing general partner) is a general partner of a partnership doing business in California (here, Horizon), the corporation is considered to be doing business in California.” Thus, the SBE concluded that the Franchise Tax Board properly imposed late filing and demand penalties. Appeal of SUP Inc., Cal. State Bd. of Equal., No. 571262 (Nov. 14, 2012, released March 7, 2013) (not to be cited as precedent).

**Authors’ Commentary:** Based on Bloomberg BNA’s recent 50-state survey, most states now take the position that owning an interest in a PTE is in itself sufficient to create nexus. According to the survey, only two states—Vermont and West Virginia—responded that a general partnership interest would not trigger nexus. In Appeal of SUP, however, California took its position one significant step further by attributing the in-state activities of one general partner to the other. Incredibly, the BNA survey further indicated that all but six states take the position that nexus could arise from owning a non-management interest in an LLC. It is difficult to square these positions with the Due Process Clause of the U.S. Constitution, which ensures that a nonresident have advance notice before being subjected to judicial jurisdiction, unlike the Commerce Clause (which was devised to preempt burdens on interstate commerce).

In 2011, the Supreme Court renewed its focus on the Due Process Clause in ruling that J. McIntyre Machinery, Ltd., a U.K. machinery manufacturer, was not subject to personal jurisdiction in the state courts of New Jersey (i.e., did not have nexus), even though an indi-
vidual was injured in New Jersey while using a machine manufactured by the company. *J. McIntyre Machin., Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011). The McIntyre decision affirmed earlier Supreme Court due process jurisprudence holding that an out-of-state actor must purposefully target a particular forum (i.e., state) in order for the state to properly assert jurisdiction. Phrased tax terms, in order for a state to assert jurisdiction over an out-of-state taxpayer and enforce the collection of its tax, the nonresident must have purposefully directed its activities toward that particular state.

In a recent ruling, a Kentucky federal court held that an ownership interest in an LLC that was conducting business within the state alone was not sufficient to establish personal jurisdiction for the individual owners under the Due Process Clause. *United States v. Bacara Partners, LLC*, 109 A.F.T.R.2d (RIA) 2357 (E.D. Ky. 2012). Although this was not a case involving taxpayer nexus under the Due Process Clause, the holding should signal to taxpayers that a mere ownership interest in a PTE should not create a due process tax nexus.

Thirty Thousand LLCs Expected to Receive Non-filing Notices. Each year, the California FTB contacts over 150,000 corporations through a Delinquency Control (DLC) program. Under the program, corporate taxpayers that are incorporated or qualified to do business in California but have not filed a return receive a notice. Annually, the program generates over $50 million in revenue for the state. The DLC Program has been expanded to include LLCs as of Jan. 1, 2013. Without this expansion, the FTB estimates an additional 59,000 taxpayers will be contacted per year. According to an FTB budgetary report made available to the public, “the additional contacts will result in approximately $21 million in total revenue during the first 5 fiscal years and increasing to more than $7 million in annual revenue in later fiscal years.” Non-filers will receive a “Request for Past Due Return” notice 60 days after the extended due date of the tax return and, if the business still fails to file, an official “Demand for Past Due Return” notice, after which the business entity’s account enters the collection cycle. The FTB may also suspend a domestic entity or forfeit a foreign organization’s rights and privileges for failure to return payments and pay taxes due. Cal. Franch. Tax Bd., Tax News December 2012.

Authors’ Commentary: California is stepping up its enforcement of LLC tax compliance. Under the state’s general filing requirement, an LLC—whether taxable as a partnership or disregarded federally—is required to file California Form 568 and pay the $800 annual tax if it is either (1) organized in California, (2) registered with the California Secretary of State to transact business in the state, or (3) doing business in the state. A taxpayer is “doing business” in the state if it actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California, or meets any of the state’s apportionment factor presence tests based on property, payroll, or sales in the state. Additionally, a foreign (i.e., non-California), nonregistered LLC that is a member of an LLC doing business in California, or a general partner in a limited partnership doing business in California, is considered to be doing business in the state. Even if an LLC is a limited partner, if it exceeds the apportionment factor presence tests, it is considered to be doing business in the state.

Separately, the LLC may also be required to pay the LLC graduated fee, ranging from $900 to $11,790, based on its gross receipts. LLCs must pay the fee if any of the following conditions apply: (1) the LLC is organized in California; (2) the LLC is registered with the California Secretary of State to transact business in the state; or (3) the LLC is doing business in the state. The fee is only required, however, if total California annual income is at least $250,000. The fee is based on total California-source income rather than on worldwide total income. Unlike the $800 LLC tax, an LLC owner is required to remit the LLC gross receipts fee only if it has its own independent California operations, and only to the extent of its own activities.

Note also that California requires that quarterly estimated payments generally be paid on behalf of nonresident owners who exceed a de minimis distribution of California-source income, as well as a nonconsenting nonresident (NCNR) tax on the distributive share of California-source income received by nonresident LLC members.

**Illinois**

**Guaranteed Payments From Illinois Partnership Create Nexus for Nonresident Partner.** The Illinois Department of Revenue ruled that an out-of-state individual taxpayer, whose only connection to the state was his receipt of guaranteed payments from a partnership operating in Illinois, had sufficient nexus with the state to be subject to Illinois income tax. The taxpayer had requested confirmation from the state that he did not have an Illinois filing obligation based on the fact that, in his words, he did not own property in state, had never visited the state, and did not possess an ownership interest in the PTE operating in the state. The Department rejected the taxpayer’s request, pointing out that he received an Illinois K-1-P, Partner’s Share of Income, Deductions, Credits, and Recapture, from the Illinois partnership indicating his receipt of guaranteed payments related to Illinois-source business income. The Department added that “guaranteed payments received by a nonresident partner from a partnership doing business in the state are subject to the state’s income tax, even when the partner has no other connection with the state.” The Department further explained the partnership’s duty to withhold income tax on those payments. Ill. Dept. of Rev., General Information Letter No. IT 12-0028-GIL (Sept. 27, 2012).

**Indiana**

**General Partner’s Distributive Income Is Operational, Not Investment, Income.** The Indiana Tax Court rejected an out-of-state corporation’s argument that partnership income received by a general partner was investment income that should be sourced to the corporation’s state of domicile and held that the income was Indiana-source operational income. *Vodafone Americas Inc. v. Indiana Dept. of State Rev.*, Ind. Tax Ct., No. 49T10-1002-TA-7 (June 18, 2013). The taxpayer Vodafone Americas Inc.’s only connection with Indiana was a 45 percent general partnership interest in a partnership that was doing business in Indiana. Vodafone argued that its partnership interest was “intangible” personal.
property and, therefore, the associated income was sourced under Indiana Code Ann. §6-3-2-2.2(g), which provides that “receipts in the form of dividends from investments are attributable to this state if the taxpayer’s commercial domicile is in Indiana.” Stating that substance, not form, should control the characterization of its income, Vodafone argued that its status as a general partner should be disregarded because it lacked managerial control over the Indiana partnership. As evidence of its lack of control, Vodafone stated that it could only appoint four of nine board members, and decisions by the partnership required a majority vote.

Disagreeing with Vodafone’s argument, the tax court found that merely being a general partner in a partnership causes the income received by that general partner to be characterized as operational income. The tax court stated that a limited partner is considered a passive investor because it has given up its right to participate in management in exchange for limited liability. The tax court found that the absence of control is not determinative regarding whether a partner is an active or passive investor. Thus, the tax court concluded that Vodafone’s income from the partnership was operational income sourced to Indiana because Vodafone was a general partner in the Indiana partnership.

**Authors’ Commentary: Vodafone** concerned taxable years ending March 31, 2005 through March 31, 2008. Effective retroactively to Jan. 1, 2009, Indiana amended its sourcing provision. Previously, income derived from a PTE was considered income from an intangible. Now, it is “considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income producing activity.” Ind. Code Ann. §6-3-2-2(a).

**New Jersey**

**Due Process Clause Prohibits Taxing Resident Shareholders on Out-of-State Income.** This New Jersey Tax Court decision involved a New Jersey resident trust. Beginning in 2006, a New York resident served as the sole trustee of the trust, which he administered exclusively outside New Jersey. During 2006, the trust owned cash, bonds, and stock in four S corporations, each of which conducted business in New Jersey. The S corporations issued the trust a Schedule NJ-K-1 reporting the S corporations’ share of income/loss allocated to New Jersey—around $3 million of the approximately $5 million the trust received. The trust also reported approximately $100,000 in interest income, none of which was allocated to New Jersey. Thus, the trust paid tax on its pro rata share of S corporation income allocated to New Jersey but did not pay tax on the interest income or on the net pro rata share of S corporation income allocated outside the state. The trust was then audited, following which New Jersey issued an assessment of approximately $200,000, including interest and penalties. The state maintained that the trust was taxable on 100 percent of its undistributed income, including its pro rata share of S corporation income allocation outside New Jersey. In contrast, the trustee argued that the trust entirely lacked sufficient contacts with New Jersey for the state to subject the trust to tax on its income allocated outside the state. The court agreed with the taxpayer, explaining:

Trust A was not administered in New Jersey and the Trustee was a resident of New York. Therefore, Trust A could only be taxed on the undistributed income if it owned assets in New Jersey, thus running afoul of the precedent set by the Tax Court in Pennoyer and Potter and the guidance adopted by the Director. . . . [T]he owner of stock in an S corporation does not own or hold title to the underlying assets of the corporation. . . . [T]his court may not apply N.J.A.C. 18:35-1.5 as written [which subjects a resident shareholder to tax on its income from all sources] and subject Trust A to taxation on its out of state income because Trust A does not have sufficient contacts with New Jersey to satisfy constitutional due process requirements.

Thus, despite the language of the taxing statute, the Tax Court held that the trust was not subject to tax on its out-of-state income because it did not have sufficient contacts with the state to satisfy constitutional due process requirements. Accordingly, the trust did not owe tax on the interest income earned in the year in question. *Residuary Trust A v. New Jersey Dir., Div. of Taxn.*, N.J. Tax Ct., No. 000364-2010 (Jan. 3, 2013).

**Pennsylvania**

**Nonresident Limited Partner Had Income Tax Nexus.** In *Marshall, Jr. v. Commonwealth*, 41 A.3d 67 (Pa. Commw. 2012) (on appeal), the Commonwealth Court of Pennsylvania, an intermediate appellate court, affirmed an earlier decision in which a Texas individual who owned a limited partnership interest in a Connecticut-based limited partnership was held to have nexus with Pennsylvania. For financial accounting, federal income tax, and Pennsylvania income tax purposes, the partnership incurred losses from operations for each year of its existence. However, in 2005 the lender foreclosed, resulting in cancellation of indebtedness income to the partnership related to discharged nonrecourse liabilities. The court acknowledged that the Texas individual was a passive investor who never participated in the management of the partnership or its underlying property, but nevertheless concluded that the individual had nexus with Pennsylvania (which could therefore assert jurisdiction over him), explaining:

[I]mposition of the Pennsylvania personal income tax on Marshall, as a limited partner of the Partnership, as a result of the disposition of the Property at foreclosure does not violate Marshall’s Due Process rights. Marshall would have us focus solely on his status as a limited partner in the Partnership and, consequently, his limited, if not nonexistent, right to control the Partnership’s business affairs. That, however, is a superficial analysis. Marshall did not simply passively invest in a Connecticut limited partnership, as one would trade stocks on a stock exchange. To the contrary, he invested in a specific and limited purpose Connecticut limited partnership, whose “primary purpose was ownership and management” of a substantial commercial property in the City of Pittsburgh—“a sixty-four story office tower and related site improvements, known as the United States Steel Building . . . and the underlying parcel of land of approximately 2.676 acres.” The investment objectives and policies of the Partnership were directed to maximizing the partners’ return on
their investment through the Partnership’s ownership of the Property. Marshall knew all of this when he chose to invest in the Partnership as a limited partner. He purposefully availed himself of the opportunity to invest in Pennsylvania real estate through a partnership. These are sufficient minimum contacts for the imposition of a tax on Marshall and his fellow partners upon disposition by the Partnership of the Property.

As a result, the court affirmed a Board of Finance and Revenue decision that the Texas individual owed personal income tax to Pennsylvania on his distributive share of discharge of indebtedness income resulting from the foreclosure of the Pittsburgh commercial property owned by the partnership. The taxpayer filed exceptions to the court’s Jan. 3, 2012, decision, essentially advancing the arguments previously presented to the court. Not surprisingly, the court overruled the exceptions, holding that the prior decision “fully and properly addresses the issues set forth in Marshall’s exceptions.”


**Authors’ Commentary:** Many tax nexus judicial decisions to date have provided only a cursory analysis of due process considerations, focusing more on Commerce Clause nexus. In contrast, Marshall focuses on the due process requirement that a nonresident (here, Texan Robert Marshall), “purposefully availed” himself of the benefits and protections of a forum (here, Pennsylvania) in order for the forum to assert jurisdiction over the nonresident. In other words, the Texas individual must consciously direct his activities toward Pennsylvania; otherwise, it would violate his due process rights for Pennsylvania to assert jurisdiction over him. One would expect that in many, perhaps most, cases, a passive limited partner would have no specific knowledge of where the partnership in which the limited partner invests intends to operate. For that reason, the Commonwealth Court was careful to analyze the partner’s knowledge of Pennsylvania activities in which the limited partnership would be involved at the time the nonresident invested in the partnership.

Oddly, no mention is made in the decision of nonresident withholding. Pennsylvania began requiring pass-through entities to withhold and pay quarterly personal income tax for nonresident owners that are individuals, estates, or trusts for tax years beginning on or after Jan. 1, 1992.

Finally, it is also worth noting the apparent disparity in treatment of the partnership’s nonresident investors compared to its Pennsylvania owners. While the Pennsylvania resident partners were permitted to offset their share of the gain on foreclosure with the loss on liquidation, the nonresident partners were not permitted to recognize the loss on liquidation for Pennsylvania tax purposes. The court’s explanation was that intangible assets, such as a limited partnership interest, typically reside where the holder is domiciled, with the result that any gain or loss resulting from the disposition of a limited partnership interest owned by a nonresident would not be sourced to Pennsylvania.

**Tennessee**

**Trial Court Holds That General Partner Had Nexus.** A Tennessee Chancery Court held that Vodafone Group, PLC, a British company that owned a 45 percent (non-managing) general partner interest in Cellco Partnership d/b/a Verizon Wireless, a general partnership, was doing business in Tennessee (i.e., had nexus) and therefore was subject to the state’s franchise/excise tax. During the relevant period, Verizon Wireless continuously and systematically engaged in the wireless voice and data business in Tennessee. According to the trial court, “a general partner of a general partnership doing business in Tennessee is present in Tennessee, does business in Tennessee, and meets all constitutional requirements for taxable nexus with Tennessee through the activities of the general partnership in Tennessee.”


**Authors’ Commentary:** Vodafone illustrates a common view among the states that the activities of a general or limited partnership or LLC may be attributed to the general partner/managing member in all events. (See, e.g., Conn. Gen. Stat. §12-214(a)(3)(A); Mass. Regs. Code tit. 830, §62.5A.1(3)(b)(1).) Expressed in due process terms, if a partnership is directing its activities toward a particular state, then the general partner or managing member must be consciously directing its activities toward that forum by virtue of its management role. While this may often be the case, it is not invariably true. As the Marshall decision illustrates, a limited partner, though passive by nature, could nevertheless purposefully direct its activities (e.g., the deployment of capital) toward a particular jurisdiction. It is similarly possible that a general partner, though possessing limited managerial rights, does not necessarily participate in a decision to operate within a state and indeed may be unaware of the partnership’s activities within that forum. Consequently, depending on the facts, the Due Process Clause may prohibit a state’s assertion of jurisdiction over the general partner. Vodafone filed a similar refund suit in Florida but that case has been settled by the parties.

**APPORTIONMENT OF MULTISTATE INCOME OF A PTE**

**California**

**Single Sales Factor Required for PTEs, Too.** California recently issued an administrative release clarifying that PTEs must, like corporations, apportion income using the single sales factor. Proposition 39, which added Cal. Rev. & Tax. Code §25128.7 for taxable years beginning on or after Jan. 1, 2013, requires that the business income of an apportioning trade or business (other than one described in Cal. Rev. & Tax. Code §25128(b), deriving more than 50 percent of gross business receipts from agricultural, extractive, savings and loan, and/or banking or financial activity) is apportioned to the state by multiplying the business income by the sales factor. Cal. Code Reg. tit. 18, §§17951 through 17953 requires such businesses to source such business income in accordance with the provisions of the corporate apportionment rules. Thus, an apportioning trade or business, regardless of its form of ownership (e.g., partnership, LLC, sole proprietorship, or corporation), that carries on business within and without California is required to apportion the nonresident’s business income using the single sales factor. Cal. Franch. Tax Bd., Tax News April 2013.
Idaho

Allocation and Apportionment of Guaranteed Payments. Effective retroactively to Jan. 1, 2013, Idaho limits to $250,000 in a calendar year the amount of guaranteed payments paid by a partnership doing business in Idaho that may be attributed to the state in which the partner performed the services. Amounts paid in excess of $250,000 per year are sourced to Idaho based upon the partnership’s Idaho apportionment factor. The $250,000 limit will be adjusted annually for inflation. This legislation also clarified that all guaranteed payments made to retired partners are sourced to the recipient partner's state of domicile. L. 2013, H.B. 139 (c. 83), amending Idaho Code §63-3026A.

Illinois

‘Read Our Statute.’ The Illinois Department of Revenue (IDOR) summarily rejected a taxpayer’s request for alternative apportionment because the alternative method requested appeared to be the default method provided by statute. The taxpayer was a limited partnership based in Texas whose sole source of income was derived from its investment in other partnerships, including partnerships operating in Illinois. In its ruling, the Texas LP explained that it did not receive apportionment information from its underlying partnership investments that operated in Illinois and therefore was unable to calculate an Illinois sales factor. The IDOR referred the taxpayer to its statutory provision for the allocation of income derived from non-unitary partnerships, 35 ILCS 5/305, which provides that the partner allocate its share of Illinois-source income as determined by an apportionment calculation at the underlying partnership level. Ill. Dept. of Rev., General Information Letter IT 13-0001-GIL (March 21, 2013).

Authors’ Commentary: The compliance issue indicated by the taxpayer—lack of timely apportionment data from an underlying PTE investment—is not uncommon. Nevertheless, in the IDOR’s recitation of facts, the taxpayer appeared to describe a context where apportionment data was irrelevant; i.e., it appeared that the Texas LP was non-unitary with the underlying partnerships, in which case the Illinois statute required that the nonresident LP allocate its share of the Illinois-source income as apportioned at the underlying entity level. The Department’s brusque response dodged the thornier question of how a nonresident partner should apportion its distributive share of income in the context in which the partner and partnership are unitary but the underlying partnership fails to timely provide apportionment information to the partner.

Michigan

S Corp Shareholder Aggregates Apportionment Factors. In a unanimous decision, the Michigan Supreme Court upheld the taxpayers’ position in Wheeler Estate v. Michigan Dept. of Treas., 825 N.W.2d 588 (Mich. Ct. App. 2012) and Malpass v. Michigan Dept. of Treas., 815 N.W.2d 804 (Mich. Ct. App. 2011), ruling that multistate business income may be reported by individuals through either the unitary or separate-entity method. The Court further held that unitary reporting was proper even when the unitary business includes an entity located in a foreign country. Malpass et al. v. Michigan Dept. of Treas., Mich., Nos. 144430, 144431, 144432, 145367, 145368, 145369, 145370 (June 24, 2013).

Authors’ Commentary: Although the Court held that combined reporting of income and apportionment factors was permitted, it did not indicate that this method was required. The Court had held in abeyance an appeal of a Michigan Court of Appeals case, Winget v. Department of Treasury, Mich. Ct. App., No. 302190 (Oct. 16, 2012) (unpublished), that had ruled the sole shareholder of several S corporations could not combine apportionment factors of the various S corporations whose stock he owned. Noting that the S corporations were legally separate and distinct business entities with no common ownership at the entity level, the intermediate appellate court had ruled that the S corporations did not form a single business entity and, therefore, the taxpayer was required to apply a separate apportionment percentage to each S corporation. In its abeyance order, the Court referred to two cases pending on appeal before it, Malpass and Wheeler Estate, which could resolve the issue raised in the present application for leave to appeal. Winget v. Michigan Dept. of Treas., Mich. Ct. App., No. 302190 (Oct. 16, 2012 - unpublished); leave to appeal ordered to be held in abeyance, Mich., No. 146218 (April 1, 2013).

Minnesota

LLC Not Unitary With Corporate Member. The Minnesota Tax Court held that there was insufficient flow of value between the taxpayer and an LLC, of which it was a member, and inadequate control by one over the other to establish the existence of a unitary business between the taxpayer and the LLC during the period at issue. Express Scripts Inc. v. Minnesota Comr. of Rev., Minn. Tax Ct., No. 8272 R (Aug. 20, 2012). The taxpayer, a Delaware corporation, provided pharmacy benefit management (“PBM”) services and operated a mail-order pharmacy. The taxpayer and two other PBM services formed an LLC to create an electronic prescription and information routing service to facilitate prescription benefit communications. The tax court ruled that there was insufficient flow of value between the taxpayer and the LLC to establish a unitary business relationship between the two entities. The evidence showed that the taxpayer and the LLC conducted arm’s-length transactions. Moreover, the LLC had its own departments responsible for making its own operational and strategic decisions. During the period at issue, the taxpayer employed no LLC employees; none of the taxpayer’s employees was employed by the LLC; and the two businesses maintained separate human resources personnel, separate legal and accounting departments, separate books and records, separate data processing systems, separate intellectual property ownership, separate purchasing offices, separate office facilities, and separate bank accounts.

On Jan. 18, 2013, the Minnesota Supreme Court dismissed the Commissioner of Revenue’s petition for certiorari as untimely filed. Thus, the ruling of the tax court is now final. Express Scripts Inc. v. Minnesota Comr. of Rev., Minn., No. A12-1966 (Jan. 18, 2013).
**Virginia**

**Pass-Through Income Taxable.** The primary shareholder of a Virginia-based S corporation that provided financial and retirement services, also owned a membership interest in an out-of-state LLC that provided investment and asset management services to the S corporation. The primary shareholder resided outside Virginia. The Virginia S corporation was the out-of-state LLC’s only client. On his Virginia income tax return, the primary shareholder and his wife attributed a loss received from the Virginia S corporation to Virginia while attributing income from the out-of-state LLC as entirely out-of-state. Based on the number of days the taxpayer spent in Virginia and the nature of the business, the Virginia Department of Taxation (VDOT) ruled that the LLC and taxpayer conducted operations in Virginia and therefore had income subject to Virginia income tax. The Department noted that in future years the taxpayer should document the time worked in Virginia and elsewhere. Va. Dept. of Taxn., Ruling of the Commissioner PD 12-219 (Dec. 21, 2012).

**No Alternative Apportionment for Limited Partnership.** In a recent ruling, the Virginia Tax Commissioner denied a limited partnership’s request to allocate an item of extraordinary income to another state, based on separate accounting. Va. Dept. of Taxn., Ruling of the Commissioner PD 13-86 (June 10, 2013). The applicant was an out-of-state limited partnership that had Virginia source income for the 2012 taxable year, but it also sold some real estate located in another state. The limited partnership argued that using Virginia’s statutory apportionment method substantially increased its income subject to tax in Virginia and that it should be allowed to use separate accounting for the income attributable to other states. In rejecting the limited partnership’s request, the Commissioner stated that the taxpayer failed to provide any evidence that demonstrated that the statutory apportionment method was inequitable. Further, the taxpayer apparently did not follow the established procedure for requesting an alternative apportionment method.

The ruling points out that for a Virginia taxpayer to request an alternative method of allocation or apportionment, it must first file a tax return using the statutory method and pay the income tax due. The taxpayer must then file an amended return proposing an alternative allocation or apportionment method. To this amended return, the taxpayer must attach a statement as to why the statutory method is inapplicable or inequitable and explain the proposed method of allocation or apportionment. The ruling affirmed that the VDOT will not grant a taxpayer’s request unless it determines that: (1) the statutory method produces an “unconstitutional result”, or (2) the statutory method is inequitable because it results in “double taxation” and the inequity is attributable to Virginia’s rules.

**Authors’ Commentary:** It is interesting to note that the Commissioner did not address the issue of whether the taxpayer’s ownership and use of the out-of-state land was part of the taxpayer’s unitary business in Virginia. Possibly the taxpayer did not raise the issue when submitting its ruling request; it’s not clear. This ruling also highlights the problems with Virginia’s policy for requesting an alternative apportionment or allocation method. Requiring the taxpayer to file an incorrect return and then forcing it to seek a refund and admit that its original return was incorrect raises due process concerns and places an onerous burden on taxpayers.

**CONCLUSION**

As the above discussion illustrates, there have been numerous recent developments addressing issues that affect the state taxation of pass-through entities and their owners. Because this is an ever-evolving area of the law, with regard to both case law and statutory and regulatory changes, it’s very important for the owners of pass-through entities and their advisers to closely monitor these developments. This is especially true when making choice-of-entity decisions or determining the state and local tax reporting requirements based on the operations of pass-through entities.