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Tax Management
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Tax Policy

Bloomberg BNA recently asked attorney Zachry T. Gladney of Alston & Bird his thoughts regarding nexus and other state tax challenges faced by pass-through entities today. His responses are below.

Pass-Through Entities Next in Line for Nexus Issues: Attorney Zach Gladney Talks About State Tax Impact

Interview by Lauren E. Colandreo

Given the increased popularity of pass-through entities and the increased attention to them at the federal level, it should come as no surprise that states' attempts to tax pass-through entities have become more aggressive in recent years.

In this interview, Zach Gladney, a partner with Alston & Bird LLP's state and local tax group, discusses nexus issues and other state tax challenges faced by pass-through entities today. Gladney also provides suggestions on how pass-through entities can avoid or prepare for these challenges and points to states which he believes provide the correct model for pass-through entity taxation in the current climate.

Zachry Gladney is a partner in the State and Local Tax Group in Alston & Bird LLP's New York office.

BLOOMBERG BNA: What are some of the biggest state tax issues pass-through entities are facing today?

GLADNEY: Nexus issues abound for partners and members of pass-through entities, and are increasingly a topic of focus for the states. States are asserting nexus over partners by imputing the partnership's in-state activities to the out-of-state partners, sometimes regardless of how passive the interest in the partnership may be. Whether nexus of the partnership should flow through to the partner is a complex issue that often implicates the commerce and due process clauses, and that often ends with a dispute in court. Generally speaking, general partners and managing members are considered to be actively engaged in the business of the pass-through entity and are typically subject to tax in the states where the pass-through entity is doing business. However, the issue of taxability becomes much less clear when limited partners and non-managing members hold a passive interest in the pass-through entity. Limited partner and non-managing member interests in pass-through entities are analogous to holding the stock of a corporation, which is understood not to create nexus for the owner of the stock.

Another important issue that we see with pass-through entities is the flow-through of tax attributes, especially with the apportionment of a partnership's income for corporations that are partners. Generally, corporate partners can either apportion partnership income by applying the apportionment of the partnership, or the corporation can combine the partnership's

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factors with its own factors when computing the corporation's apportionment for all of its income subject to taxation by the state. Like nexus, this issue is complex, especially when the state's rules on the methodology that the partner should employ may be less than plain. More often than not, the state's rules on how a corporation should apportion a partnership's income are not plain, and taxpayers are left with relying on any applicable IRC provisions, GAAP rules, and financial accounting guidelines to support their chosen position on the issue.

BLOOMBERG BNA: What differences exist, if any, between the concerns faced by individual partners/members and corporate partners/members?

GLADNEY: States sometimes adopt rules specifying that a corporate partner/member is taxable in the state on the pass-through income it receives from the partnership or LLC that is conducting business in the state. As a result, corporations may face additional concerns in these states that adopt a more onerous approach for the taxability of income passed through from the same partnership operating in-state compared with their individual partners. In these instances, the corporate partners/members are left to argue that the state rule is unconstitutionally applied to their circumstances under the commerce and due process clauses.

For example, in In re Shell Gas Gathering Corp., Nos. 821569 and 821570 (N.Y. Tax App. Trib. Sept. 23, 2010) the New York Tax Appeals Tribunal upheld an ALJ's determination that two nonresident corporate members of an LLC doing business in the state were subject to the state's corporate franchise tax due to their receipt of New York-sourced income. The issue arose based on the division's regulations that expressly provide that if a partnership is doing business in the state then all of the corporate general partners are subject to tax under Article 9-A of the Tax Law. The burden was then on the taxpayers to show that they have been unconstitutionally assessed. The taxpayers argued that their interest was passive and thus did not satisfy the constitutional nexus standards; however, the tribunal disagreed and held that the LLC members were like a general partner interest and taxable in the state not because of their presence in the state, but because of the presence of the LLC in which they owned a membership interest. The tribunal's reasoning is flawed, and the decision creates difficult-to-navigate precedent on the issue in New York.

BLOOMBERG BNA: What can taxpayers do to best prepare for, or avoid, these issues?

GLADNEY: When audits arise, taxpayers are best situated to address nexus and apportionment issues if the partner or member agreements properly reflect the partners' interest in the partnership, especially where the documentation can effectively demonstrate that the partnership interest is a purely passive investment vehicle that does not include an active role in the business or management of the partnership. If the partnership and operating agreements fully and accurately characterize the passive nature of the interest in a pass-through entity, taxpayers will be better equipped to defend against audit issues and can avoid unnecessary and expensive state tax controversies.

Taxpayers can also minimize the risk of unnecessary state tax controversies by applying an intentional and consistent strategy among the states for whether they have nexus by virtue of holding an interest in the pass-through entity. With an intentional strategy in place, taxpayers are best able to avoid the temptation to file state tax returns for informational or minimum tax purposes in states where the partner or member does not have constitutional nexus. For example, we have worked with taxpayers that have filed state returns reflecting minimal tax due out of an abundance caution, only to be audited and assessed tax on the basis of 100 percent apportionment to the state. In this instance, the taxpayer's interest in the partnership was such a passive investment that the partner did not have the necessary information to fully establish the partnership's apportionment to apply to the income. As a result, the state defaulted to an assessment on the basis of 100 percent apportionment. The state later settled under very favorable terms for the taxpayer after it was established that the partner did not have constitutional nexus with the state but not before considerable time and expense was invested by the partner.

BLOOMBERG BNA: Recently, states have begun trying to establish economic nexus over pass-through entities' partners and members. What tax implications and difficulties will the businesses and their members encounter as a result of this?

GLADNEY: Because the economics of the partnership pass through to the partners, states are becoming increasingly aggressive in asserting that the nexus of the partnership also flows through to the partner. As a result of this increased attention on establishing economic nexus based on the pass-through of nexus, partners and members will likely see an increase in audit activity, leading to an increase in assessments. This increase in activity will likely be consistent for general partners as well as for many limited partners and members that are entirely passive investors in the pass-through entity as the states test the constitutional limitations of "pass-through nexus." This will likely be true even where the circumstances indicate that the partner does not have sufficient contacts with the state to satisfy the constitutional nexus standards under the commerce and due process clauses.

Additional difficulties that limited partners and non-managing members may encounter through the increase in audits will also likely include challenges obtaining the information for those states [in which] the pass-through entity is "doing business" and obtaining the information necessary to establish an apportionment percentage from the pass-through entity. This is especially true where the interest in the pass-through entity is purely a passive investment vehicle that is focused solely on a rate of return rather than the business of a portfolio company that may be multiple levels removed from the investor. For example, imagine the difficulty involved for a fund of funds (i.e., a private equity fund that invests in other private equity funds) to obtain the necessary apportionment information for the portfolio company that is held by the lower-tier fund.

BLOOMBERG BNA: What brought on this recent attention to pass-through entity nexus?

GLADNEY: The states are largely playing catch-up to the not-so-recent trend away from doing business through a traditional corporate structure to the majority of businesses being conducted through the use of pass-through entity structures. There is also increasing attention at the federal level on the auditing and taxa-

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tion of pass-through entities, which has, to some degree, had a real trickle-down effect to the states. Congress recently enacted new rules (effective in 2018) that generally provide that audits of partnerships will be conducted at the partnership level and that deficiencies will also be paid by the partnership rather than by the partners. Combine the increased attention on partnerships at the federal level with the expanding economic nexus landscape at the state level, and you have a recipe for the increased attention to pass-through entity nexus.

BLOOMBERG BNA: What defenses to nexus assertions are available to partners and members?

GLADNEY: When partners and members are defending against nexus assertions, state statutes on what qualifies as ''doing business'' in the state are a good place to start. The case law out of California on this issue, such as the taxpayer wins in Swart Enterprises Inc. v. California Franch. Tax Bd., 7 Cal.App.5th 497, (Cal. Ct. App. 2017) and In re Appeals of Amman & Schmid Finanz AG, California SBOE Legal Opinion No. 96-SBE-008 (April 11, 1996), has been decided on the basis of the standard for doing business in the state as defined by state statute and prior case law interpreting the statute. However, in most instances, taxpayers must rely on the commerce and due process clauses when defending against flow-through nexus assertions. Under the commerce clause, taxpayers may argue that their interest in the partnership or LLC is of such a nature that they themselves do not have substantial nexus with the state even though the partnership is doing business in the state. Under the due process clause, taxpayers may argue that they have not ''purposefully availed'' themselves of the in-state market, typically because their interest may be so passive that they are only concerned with the return on investment and have not themselves directed their activities into the state merely by investing in a partnership doing business in the state.

It's also noteworthy that every state now has LLC statutes, which generally provide that a member does not have an ownership interest in the LLC property. These LLC statutes, much like their limited partnership counterparts, should be referenced when confronting assertions that a passive interest in these entities is alone sufficient to create nexus.

BLOOMBERG BNA: What states, if any, are most aggressive in asserting nexus over pass-through entities and their members? What should taxpayers in these states look out for?

GLADNEY: California has been aggressive with pursuing flow-through nexus assertions over members and limited partners but has had limited success with appeals that have reached a decision. Leading to the California appeals that have been litigated on the issue, the California Franchise Tax Board (FTB) officially announced its position on whether a business entity's interest in an LLC, treated as a partnership for tax purposes, is sufficient to require the entity to file California returns in California FTB Legal Ruling No. 2014-01 (July 22, 2014) (''Legal Ruling 2014-01''). In that ruling, the FTB said that ''wherever a partnership does business, the activities of the partnership are attributed to each partner, with the consequence that in geographic locations where the partnership is 'doing business,' the partners are also 'doing business.' ''

The FTB ruling also addressed an exception to this rule for out-of-state corporate limited partners whose only connection with California is their ownership interest in a limited partnership. The FTB said this exception doesn't extend to LLCs because all members of an LLC, unlike limited partners in a limited partnership, have the right to manage and conduct the business of the LLC, thus making them subject to tax as general partners. This position, however, is overly broad since the rights of the members of an LLC are often determined by agreement and should therefore be analyzed on a case-by-case basis.

In fact, Legal Ruling 2014-01 was released while a suit was pending on the issue before the Fresno County Superior Court. On Nov. 14, 2014, the court entered an order in Swart Enterprises Inc. v. California Franch. Tax Bd., holding that an Iowa-based farming company with a tangential investment in California did not meet the statutory requirements for doing business in California. Swart argued that it didn't meet the definition of doing business in California because it was not actively engaging in a transaction, and alleged violations of the due process, equal protection, and commerce clauses of the U.S. Constitution. The court rejected the FTB's narrow interpretation of the limited partnership exception, saying that ''there is no legal authority for this conclusion.'' The decision in Swart demonstrates that Legal Ruling 2014-01 is an example of when a department's wide-reaching position on nexus is improper. On Jan. 12, 2017, in Swart, the California Court of Appeal affirmed the Fresno County Superior Court's decision and held that an out-of-state corporation whose sole connection with the state was a passive ownership interest in a manager-managed California LLC did not constitute ''doing business'' under the California corporation franchise tax.

New York is another state that has been aggressive in asserting flow-through nexus over partners and members. As discussed previously, in In re Shell Gas Gathering Corp., the New York Tax Appeals Tribunal upheld an ALJ's determination that two nonresident corporate members of an LLC doing business in the state were subject to the state's corporate franchise tax due to their receipt of New York-sourced income. The tribunal equated LLC members with general partners and thus created problematic case law on the issue in New York.

The Pennsylvania Department of Revenue has also been aggressive in asserting flow-through nexus over partners and members, likely on the basis of case law favorable to the state. The Pennsylvania Supreme Court, in Wirth v. Commonwealth, 95 A.3d 822 (Pa. 2014), upheld the commonwealth court's decision that a nonresident who invested in a limited partnership that maintained an office building in Pittsburgh was liable for personal income tax on the gain the partnership earned from the cancellation of debt when the building was foreclosed on. In that case, the court determined that the taxpayer had waived his commerce clause nexus arguments because his brief had only addressed the minimum contacts, due process nexus standard. Under the due process standard, the taxpayer had the requisite minimum contacts because he had invested in a limited partnership whose primary purpose was to own and manage property in Pennsylvania and had therefore purposefully availed himself of the opportunity to invest in Pennsylvania real estate. However, the

court did not address the distinction between limited and general partnership interests.

BLOOMBERG BNA: Are there any states that apply what you believe are the appropriate rules regarding pass-through entity nexus rules? Similarly, are there any judicial rulings that serve as a model for the correct application of these rules?

GLADNEY: The judicial rulings in Alabama, California, and New Jersey have developed as models for the correct analysis of these issues of ''pass-through nexus.''

In Lanzi v. Alabama Dept. of Rev., 968 So.2d 18 (Ala. Civ. App. 2006), cert. denied (Ala. 2007), the Alabama Department of Revenue assessed tax against the distributions received by a Georgia resident, who was a limited partner in a family-operated partnership, created under the laws of Alabama, which existed to make a profit and to manage and preserve family assets through the buying and selling of bonds, stocks, and other securities. In that case, the court held that participation in the limited partnership did not establish that the taxpayer had purposefully availed himself of the benefits of an economic market in the forum state, and, therefore, the taxpayer had not established minimum contacts within the state for purposes of taxation.

In BIS LP Inc. v. Dir., Div. of Taxn., 26 N.J. Tax 489 (N.J. Super. Ct. App. Div. 2011), the New Jersey Superior Court, Appellate Division, held that a foreign corporation's interest in a limited partnership doing business in New Jersey did not create nexus for purposes of New Jersey's Corporate Business Tax. The Division of Taxation argued that the nonresident limited partner had nexus with the state because it derived taxable receipts from a partnership doing business in the state and the limited partner and the partnership were a unitary business. However, the court held that the two were not integrally related and that the limited partner was merely a passive investor with no control [of], or potential to control, the partnership. However, in Village Super Market of PA Inc. v. Dir., Div. of Taxn., 27 N.J. Tax 394 (N.J. Tax Ct. 2013), the New Jersey Tax Court held that a 99 percent limited partner was taxable because all of the limited partner's business was conducted in New Jersey and because it was not a mere holding company. The tax court distinguished BIS, and the decision suggested that the tax court had doubts about the economic substance of the limited partner structure.

BLOOMBERG BNA: Are there any new strategies for pass-through entities that hope to avoid nexus?

GLADNEY: Taxpayers are well advised to adopt intentional nexus positions based on the constitutional authority set forth in the commerce and due process clauses and the past case law that applies to pass-through entity nexus. Being prepared to defend against nexus assertions before they occur is the best strategy for addressing the issues that may arise during audit, and it prevents taxpayers from finding themselves in a tax controversy where an unnecessary return filing with the state triggered an audit.

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