
Business/Nonbusiness Income From Partnership Interests

by Jeffrey M. Vesely and Jeffrey N. Saviano

This presentation was presented at the COST 2009 Spring Audit Session/Income Tax Conference, May 18-21, 2009 in Cambridge, Massachusetts.

I. Nexus

A. Aggregate Theory

1. Aggregation of owners
2. Partners deemed to be direct owners of the partnership's assets.
3. If a partnership is doing business in the state, all partners are deemed to be doing business in the state.
 - a. General or limited partners

B. Entity Theory

1. Revised Uniform Partnership Act (RUPA)
2. Partnership redefined as an entity distinct from its partners.
3. Treatment similar to a corporation and its shareholders.
 - a. Investment in a corporation does not create nexus between the shareholder and the state in which the corporation is doing business.
4. Ownership of a partnership interest, by itself, does not give rise to nexus in those states which have adopted RUPA.

C. Special Rules for Limited Partners

1. Some states treat limited partners differently
 - a. New York
 - (i) Passive investment treated similarly to shares of stock.
 - b. Alabama
 - (i) Revenue Ruling 98-002 (May 4, 1998)
 - (A) Ownership of limited partnership interest does not subject a foreign corporation to franchise tax because it does not constitute doing business in the state.
 - c. California
 - (i) Appeal of Amman & Schmid Finanz AG, 96-SBE-008 (April 11, 1996)
 - (A) Foreign corporation not doing business in California simply because it is a limited partner in a limited partnership that is engaged in business in California.
 - (ii) Revenue and Taxation Code Sections 17955 and 23040.1
 - (A) Nonresident individual and foreign corporate partners of investment partnerships exempt from tax.

II. Partnership Income

- A. Business v. Nonbusiness
 1. Determine at the partnership level or at the partner level?
 - a. Some states make this determination at the partnership level and some at the partner level.
 - (i) California Regulation 25137-1
 - (A) Classification of income made at the partnership level.
 - (B) Compare, Appeal of Peel Construction, Inc., 87-SBE-007 (January 6, 1987)
 - (1) Partner's distributive share was not business income unless the partner was unitary with the partnership.

- (ii) Idaho State Tax Commission Ruling No. 17221 (October 7, 2003)
 - (A) Classification of income made at the partner level.
- b. If at the partnership level and the income is business income, the next question is whether the partner is conducting a unitary business with the partnership?
 - (i) If unitary, combine the partner's share of partnership income and factors with the rest of the partner's unitary business.
 - (ii) If not unitary, apportion the partner's share of the partnership income as a separate trade or business for the partner.
 - (A) Appeal of Bay Alarm Company, 82-SBE-094 (June 29, 1982)
 - (1) Corporation engaged in the business of installing burglar alarms was a partner in a general partnership which engaged in leasing dairy cows in New Mexico and California. The partnership was found not to be unitary with the corporation. The partnership's losses were apportioned between New Mexico and California.
- c. If at the partnership level and the income is nonbusiness income, do you look to the partnership's commercial domicile or the partner's?
 - (i) Vastly different results may occur.
 - (ii) Appeal of National Dollar Stores, Ltd., 86-SBE-163 (September 10, 1986)
 - (A) Losses from an oil drilling partnership in Colorado were nonbusiness losses to a California clothing retailer because oil drilling was unrelated to the taxpayer's business. The losses were allocated to Colorado.
 - (iii) Appeal of W.R. Thomason, Inc., 87-SBE-025 (March 3, 1987)
 - (A) A California corporation with out-of-state limited partnership interests was not permitted to deduct in California its distributive share of the partnerships' losses, because they were nonbusiness losses allocable entirely to the states in which the partnerships' property and activities were located. The California State Board of Equalization (SBE) rejected

the taxpayer's argument that the limited partnership interests were "securities" and thus the losses should be allocated to the taxpayer's commercial domicile (California).

(iv) Appeal of Angelus Hudson, Inc., 83-SBE-247 (December 13, 1983)

(A) Losses attributable to a nonunitary out-of-state drilling venture were sourced to where the partnership property was located and the partnership activity was conducted.

B. Unitary v. Nonunitary

1. Normal rules regarding the existence of unity apply.

a. No unity of ownership required.

(i) Appeal of Saga Corporation, 82-SBE-102 (June 29, 1982)

(A) Unity of ownership exists per se since if a unitary relationship otherwise exists, the income and apportionment factors of the partnership are included only to the extent of the corporate partner's ownership interest. This is to be contrasted with the situation when unity exists between two corporations and all of the income and factors are included.

b. Planning opportunity.

(i) Investment in a unitary partnership versus a unitary corporation can present an opportunity for combination or breaking a combination depending on which entity is used under the unity of ownership rules.

2. General versus limited partners

a. While there is no hard and fast rule applied by the states, generally limited partners are not considered to be unitary with the partnership due to the passive nature of the relationship. The converse is not necessarily true however, i.e., whether a general partner is unitary with the partnership is a factual determination.

b. Appeal of Gasco Gasoline, Inc., 88-SBE-017 (June 1, 1988)

(i) The SBE noted that limited partners will seldom be able to demonstrate a unitary relationship given the "inherent passive investment nature" of such interests even where the partnership

is engaged in a similar line of business and is expected to provide a source of supply to the limited partnership.

3. Sampling of unitary determinations
 - a. Appeal of Willamette Industries, Inc., 87-SBE-053 (June 17, 1987)
 - (i) A joint venture in which a paper products manufacturer had a 50% interest was part of the taxpayer's unitary business. There were substantial purchases of raw materials and waste products by the taxpayer from the joint venture. The SBE focused on unities of operation and use.
 - b. Appeal of A. Epstein and Sons, Inc., 84-SBE-141 (October 10, 1984)
 - (i) Closed corporation (Taxpayer) was engaged in rendering design services and to a lesser extent was also involved in the construction business. A partnership was formed by individual corporate shareholders to comply with New York architectural laws which did not allow a corporation to practice architecture. The partnership rendered services to the corporation at cost. Taxpayer argued the partnership was its nominee and thus the property, payroll and sales of the partnership should be included. The SBE concluded that the exclusion of the factors was appropriate and that the partnership was not unitary with Taxpayer. The SBE relied on the absence of proof and held that the fact Taxpayer was forced to establish the partnership in order to comply with New York laws served to emphasize its separateness.
 - c. Appeal Pittsburgh Des Moines Steel Co., 83-SBE-120 (June 21, 1983)
 - (i) A joint venture in which the taxpayer held a 50% interest was unitary due substantial contributions and dependencies. The joint venture was a real estate project leasing space to business clients. The taxpayer fabricated steel structures. Notwithstanding the diversity of the operations, unity was found due to the joint venture's dependency on the taxpayer for financial support and the providing of materials and know-how to the structure of the project.
 - d. Appeal of Powerine Oil Co., 85-SBE-080 (June 26, 1985)
 - (i) Despite the diverse nature of the businesses, a corporation engaged in oil refining and distribution was unitary with a joint venture which mined and processed copper, due to the corporation's supervision of the copper mining and processing business and its providing of financing.

C. Partnership Factors

1. If unity exists, the corporate partner generally is required to include a pro rata share of both the partnership's apportionment factors and income.
2. Homart Development Co. v. Norberg, 529 A. 2d 115 (R.I., 1987)
 - a. Failure to include a pro rata share of the partnership factors caused distortion.
3. 21 International Holdings, Inc. & 21 Foam Company, Inc. v. Clark, No. 97-11 (R.I. Dist. Ct., July 3, 2002)
 - a. Inclusion of the partnership factors caused distortion, contra to Homart.
4. In determining the pro rata share, what should be used?
 - a. If a partner has a fixed ownership interest in the partnership, the issue is relatively straightforward.
 - b. If the partner's interest changes or if the partner has different interests in various partnership items or if special allocations exist, the problem can become more complex.
 - (i) California is proposing to revise Regulation 25137-1 and this issue is being considered.
 - (ii) Query, should a UDITPA § 18 adjustment be made?

D. Sale of Partnership Interest

1. Appeal of Centennial Equities Corporation, 84-SBE-086 (June 27, 1984)
 - a. Gain on the sale of partnership interests was business income because the partnerships were an integral part of the taxpayer's unitary business.
2. Appeal of Holiday Inns, Inc., 86-SBE-074 (April 9, 1986)
 - a. Gain from the sale of an interest in a California real estate partnership by a nonresident corporation doing business in California was nonbusiness income and allocated to the taxpayer's commercial domicile. The SBE considered the partnership interest an intangible.
 - b. Subsequent to Holiday Inns, California amended Revenue and Taxation Code Section 25125 to provide a special rule for allocating nonbusiness gains and losses from the sale of a partnership interest based on the location of the partnership's assets.

E. Current Developments

1. Colorado

- a. Colo. Rev. Stat. §§ 24-60-1308, 39-22-303.5(2); Colo. Dept' Rev. Tax Update (Dec. 15, 2008)

For tax years beginning on or after January 1, 2009, business income is no longer apportioned using the two- or three-factor methods. Instead, Colorado requires single sales-factor apportionment. Nonbusiness income may be either apportioned in the same manner or directly allocated to the state of origin. Colo. Rev. Stat. §§ 24-60-1308, 39-22-303.5(2); Colo. Dept' Rev. Tax Update (Dec. 15, 2008).

2. Georgia

- a. Amended Reg. §560-7-8-.34

Amended Reg. §560-7-8-.34 updates withholding requirements for distributions to nonresident members of pass-through entities. The amended regulation broadly defines "distribution credited" as a "recognition or assignment of interest in proceeds or property" of a pass-through entity, including a "net distributive share of income which is passed through to members and which may be subject to Georgia income tax." A "nonresident" is defined as an individual or fiduciary member who resides outside Georgia and all other members whose headquarters or principal place of business is located outside Georgia.

As for distributions to nonresidents, certain items are subject to Georgia income tax, including the nonresident's share of Georgia separately stated (provided no deduction for items of loss exists) and non-separately stated income. An entity is required to withhold tax on the payment of guaranteed payments and distributions being credited, but not paid, to nonresident members. In lieu of withholding, the entity is allowed to make an election to file a composite return for one or all nonresident members. Nonresident members whose aggregate annual distributions are less than \$1,000 can now be included in the return.

The amendment gives further guidance on computing the tax due, and the options available to make the computation under the composite return. Also, nonresident withholding is not required for distributions paid or credited to a member which also is a pass-through entity, provided the entity makes certain elections and agreements. Finally, a withholding statement must be distributed to any nonresident member and filed with the Department on or before the earlier of the date the return is filed or the due date for filing the return of the pass-through entity. These amendments are retroactively effective for taxable years beginning on or after Jan. 1, 2008.

3. Illinois

a. 86 Ill. Adm. Code 100.3500, 100.9730

Pursuant to a 2008 regulatory change, Illinois now provides that for taxable years ending on or after July 30, 2004, taxable income distributable to a nonresident partner in an investment partnership is nonbusiness income allocable to the partner's state of residence (for individuals) or commercial domicile (for entities). In contrast, such income is considered business income and apportioned as if the income had been received directly by the partner if the partner made an election to treat all income as business income or if the income was derived from investment activity and meets any of the following criteria:

(1) the income is related to business activity conducted in Illinois by the nonresident partner or member of the partner's unitary business group;

(2) the income serves an operational function to any other business activity of the nonresident partner or any member of that partner's unitary business group; or

(3) the assets of the investment partnership were acquired with working capital from a trade or business activity conducted in Illinois in which the nonresident partner or member of that partner's unitary business group owns an interest.

For taxable years ending on or after Dec. 31, 2004, an "investment partnership" is exempt from Illinois income tax.

b. Shakkour and Thorne v. Bower, No. 1-04-1646, (Ill. App. Sept. 1, 2006), *petition for leave to appeal denied*, No. 103823 (Ill. Sup. Ct. Jan. 24, 2007).

An Illinois appellate court held that income received by a nonresident partner was nonbusiness income because the distributed income related to the partnership's sale of an intangible asset made in conjunction with the partnership's cessation of business operations. The taxpayer, Leila Shakkour, was a general partner in O'Connor Partners (the "Partnership"), an Illinois partnership engaging in the trading of securities, options, currency, commodity options, and derivatives. The Partnership owned trading software used in the trading of financial products that it licensed to users that it eventually sold. The Illinois Department of Revenue argued that the distributive share of the proceeds from the sale of the trading software should be classified as business income allocable to Illinois because the software was an integral part of the Partnership's business operations. The court, in ruling for the taxpayer, held that the sale was an extraordinary event that was a marked departure from its previous business of licensing the

software and fell within the business liquidation exception to the functional test.

4. Massachusetts

a. Mass. Laws 2008, H. 4904, enacted July 3, 2008; 830 CMR 63.30.3

Effective for tax years beginning on or after January 1, 2009, Massachusetts adopts the federal tax classification rules for unincorporated entities (i.e., adoption of federal check-the-box provisions). Prior law adopted the federal entity classification rules for LLCs, but not for other unincorporated entities. Under H. 4904, partnerships, business trusts, and LLCs will generally be classified for Massachusetts purposes in the same manner as the entity is classified for federal income tax purposes. Business trusts that are taxed as corporations for federal income tax purposes will be fully subject to the corporate excise, including the corporate income tax and a .26% net worth / property tax. Under prior law, business trust income was taxed at a 5.3% rate and there was no net worth or property tax imposed at the state level. Dividends from former business trusts now taxed as corporations will be eligible for the corporate excise dividends received deduction to the same extent as dividends paid by corporations. Transition rules with respect to pre-existing business trusts require resident shareholders to pay tax on distributions of previously untaxed business trust income earned before the business trust became subject to taxation as a corporation.

In addition, under H. 4904, partnerships will no longer be permitted to be taxed as corporations for federal purposes while retaining partnership treatment in Massachusetts (so called "99-13 partnerships" under prior law). Rather, partnerships will now be taxed according to their federal income tax classification. Consistent with the change to conform to the federal entity classification rules, the H. 4904 revises the entity level income tax with respect to S corporations with QSUBs. Under prior law, QSUBs and disregarded LLCs owned by S corporations were treated as taxable entities separate from the S corporation. Under H. 4904, QSUBs and LLCs owned by S corporations will be disregarded under the corporate excise. Effective for tax years beginning on or after January 1, 2009, the income, property and apportionment factors of a QSUB or disregarded LLC owned by an S corporation will be included in the income and non-income measures of its parent S corporation.

New rule (830 CMR 63.30.3) provides guidance on recently enacted entity classification rules that changed the manner in which unincorporated businesses are classified and treated for Massachusetts corporate excise and personal income tax purposes. The Commonwealth now adopts the federal check-the-box rules, which permit unincorporated businesses to elect how they will be classified. The final rule notes the effect of the changes upon entity classification

and the potential tax consequences of reclassification of entity choice. The transition rule, in effect for events occurring on or after July 3, 2008, is also detailed in the regulation. The rule is effective for taxable years beginning on or after Jan. 1, 2009. Mass. Dept. of Rev., 830 CMR 63.30.3, promulgated March 20, 2009.

b. Mass. Dept. of Rev., LR 09-3 (May 1, 2009).

The revenue commissioner used her discretionary authority to allow a company classified as a domestic manufacturing corporation to continue to qualify as such even though for its 2009 tax year the application of the new check-the-box rules will result in it no longer meeting certain thresholds. Under Massachusetts law, corporations engaged in substantial manufacturing activities and that receive manufacturing corporation status are eligible for certain tax benefits. In order for a corporation to qualify for manufacturing corporation status, a minimum percentage of a taxpayer's gross receipts, tangible property (35%) and payroll must be derived from manufacturing activities. Prior to the application of the new check-the-box rules, a wholly owned pass-through entity's manufacturing attributes flowed up to the company, causing it to meet the tangible property 35% threshold.

Under the new rules, however, the pass-through entity is treated as a separate entity and as such, its attributes do not flow-up to the corporation, causing it to not meet the threshold. Even though the corporation no longer meets the tangible property threshold, it may be treated as a manufacturing corporation if, in the discretion of the Commissioner, its manufacturing activities are otherwise substantial. In this case, the Commissioner exercised her discretionary authority and allowed the company to continue to retain its manufacturing classification because it has previously been classified as such and would otherwise qualify if the pass-through entity's activity was included.

c. NES Group, Inc. and Tomsich v. Mass. Comm'r of Rev., Nos. C271893 and C271894 (Mass. App. Tax Bd. Sept. 30, 2008).

The Department of Revenue did not exceed its authority by reclassifying a holding company as a manufacturing corporation after taking into account the activities of its pass-through entities members. The taxpayers were an S corporation operating as a holding company and its sole shareholder, a resident of Ohio. The holding company owned in part, or in full, various out-of-state partnerships and qualified subchapter S subsidiaries, some of which did business in Massachusetts and operated as manufacturing companies. After an audit, the Department of Revenue reclassified the holding company as a manufacturing corporation. As a result of the reclassification, the Department assessed additional taxes on the taxpayers. On appeal, the Appellate Tax Board found that the Commissioner "acted in accordance with well-settled principles of the taxation of partnerships and S corporations" in

attributing the manufacturing activities of the various operating partnerships and subsidiaries to the taxpayer and its sole shareholder. The Board also rejected the taxpayers' contention that inclusion of the entities that have no connection to Massachusetts in considering manufacturing classification is unconstitutional. Lastly, the Board upheld the assessment of penalties even though the taxpayers relied on the advice of an accounting firm.

5. Missouri

Mo. Dept. of Rev., Private Letter Ruling 4970 (Aug. 5, 2008)

a. Mo. Dept. of Rev., Private Letter Ruling 4970 (Aug. 5, 2008)

In a 2008 private letter ruling, the Missouri Department of Revenue held that a limited partnership operating exclusively in the state, investing in common stock and securities of publicly and non-publicly traded corporations, mutual funds, and federal and state municipal bonds, was involved in the “trade or business” of investing and, therefore, its partner—a nonresident individual holding a general and limited partnership interest—was required to source his share of partnership income to Missouri. The limited partnership did not provide services, did not own real property or an interest in another pass-through entity, and its portfolio was managed by a third-party financial institution also located in Missouri.

In support of its conclusion, the Department explained: [T]he Partnership’s trade or business is investing in securities such as stocks, mutual funds, bonds and other investments, even if it has a contractual relationship with a bank to do so. The Partnership incurs income from carrying on its trade or business of investing in Missouri. This income is thus Missouri source income. Because a partnership is a flow-through entity, partners are deemed to be carrying on the trade or business of the partnership. Therefore, income from the Partnership’s trade, investing, is Missouri source income for the partners, including Applicant.

Here, Applicant is a nonresident and general partner in the Partnership. As a general partner, Applicant is deemed to be in the Partnership’s trade or business. The income Applicant received as a partner is income derived from sources within this state, is attributable to a business carried on in this state, and is thus Missouri source income. Section 143.421.3, RSMo, provides that Missouri nonresident partners must report their share of Missouri income on their Missouri individual income tax return. As a nonresident, Applicant is subject to Missouri individual income tax on this income under Missouri law. There is no provision of Missouri law exempting this income from Missouri income tax.

6. New York

- a. In re: Petition of Gabriel S. and Frances B. Baum, Nos. 820837 and 820838 (N.Y. Tax App. Trib. Feb. 12, 2009).

Nonresident shareholders' gain from the sale of stock of the S corporation pursuant to an IRC §338(h)(10) deemed asset sale was not included in the nonresident's income for New York income tax return purposes. The nonresident shareholders of an S corporation sold their shares of stock in the S corporation to another corporation through an IRC §338(h)(10) deemed asset sale. The nonresident shareholders claimed the deemed asset sale on their New York nonresident income tax returns, which resulted in a loss due to basis offset. Following an audit, the Division of Taxation concluded that the nonresidents had improperly offset their gains from the deemed asset sale by their losses recognized upon the deemed liquidation of the S corporation. The Division subsequently issued notices of deficiency to each of the nonresident shareholders. On appeal, the New York Tax Appeals Tribunal found that the deemed asset sale is not valid at the state level and, as such, the gain from the deemed asset sale may not be included in the entire net income of the New York S corporation for purposes of determining its state franchise tax under Article 9-A. Because the deemed asset sale cannot be included in the entire net income of the S corporation, it may not be passed through, pro rata, as New York source income to the shareholders of the S corporation. Accordingly, the taxpayers' gain from the sale of stock in the S corporation is not included as New York source income to them, since they are nonresident individuals.

- b. N.Y. Dept. of Taxn. & Fin., TSB-A-08(7)C and TSB-A-08(4)I (Dec. 15, 2008).

An S Corporation that is exempt from the New York franchise tax pursuant to P.L. 86-272 because the corporation's activities are limited to the solicitation of orders in New York (or related ancillary activities) for the sale of tangible personal property is further ineligible to make the New York "S" election under Tax Law Art. 22 §660(a). Nonresident shareholders of an ineligible S Corporation are not subject to personal income tax on their pro-rata share of income, gain, loss, and deduction into their federal adjusted gross income, unless the stock of the corporation is employed in another trade or business carried on by the shareholder in New York. N.Y. Dept. of Taxn. & Fin., TSB-A-08(7)C and TSB-A-08(4)I (Dec. 15, 2008).

As to resident shareholders, they must include in their New York return all pass-through items of income, gain, loss, and deduction that are included in the federal return. The S Corporation itself must file a New

York tax return if the New York “S” election has been made. If this election has not been made because the corporation is ineligible, then no New York return is required. If the corporation is exempt from New York tax, it is not required to file a tax return as a C corporation in New York, however, foreign corporations that are authorized to do business in New York that are disclaiming tax liability are required to file form CT-245 and pay an annual maintenance fee.

As to LLCs treated as partnerships, resident individual partners are subject to personal income tax on income earned from all sources. Nonresident partners are exempt from tax if the partnership’s only business activities within New York are protected under P.L. 86-272. As to partners that are foreign corporations, if the corporation is not otherwise subject to tax and the corporation’s activities in New York are protected under P.L. 86-272, the corporation is not subject to tax. The partnership itself is not subject to New York tax, but is required to file a tax return if either: (1) at least one partner who is an individual, estate, or trust that is a resident of New York; or (2) any income, gain, loss, or deduction for New York sources. Finally, every foreign LLC that has income derived from New York sources determined under the rules of Tax Law §631 is required to file a LLC/LLP filing fee. An LLC treated as a partnership for tax purposes that meets the protections of P.L. 86-272 is not subject to the filing fee.

7. North Dakota

a. N.D. Laws 2009, H.B. 1086, enacted April 8, 2009

Effective August 1, 2009, ND Stat. §57-38.1-17.1 regarding the gain or loss from the sale of a partnership interest is amended to provide that this provision applies to the extent that if prior to the sale of the partnership interest, the partnership's income or loss constituted nonbusiness income.

8. Oregon

a. Crystal Communications, Inc. v. Oregon Dept. of Rev., No. TC 4769 (Or. Tax Ct. Dec. 10, 2008).

Income and gain connected with the ownership and sale of an intangible asset (FCC License) is Oregon-sourced income to nonresident shareholders of an Oregon S Corporation. Per state law, an item of income from an S Corporation becomes Oregon-source income to an individual nonresident shareholder only to the extent that such income is from property employed in a business, trade, profession or occupation carried on in Oregon. In this case, the S Corporation engaged in developing its exclusively held cellular telephone territory, negotiated lease agreements on property owned in Oregon, entered into contracts for the purchase of equipment needed to make use of the intangible

property, retained professional assistance in protecting these assets, and worked in furtherance marketing the goods and services the S Corporation offered. These activities constituted a trade or business because the activities amounted to more than the ownership and collection of income from an asset or the mere management of an investment.

9. Utah

a. Utah Laws 2009, ch. 312 (S. 23), enacted March 25, 2009

Effective for taxable years beginning on or after January 1, 2009, Utah requires certain pass-through entities to withhold and remit income tax on or before the due date of the entity's return, not including extensions, on behalf of owners that are nonresident individuals, nonresident or resident C corporations, and nonresident or resident pass-through entities. Provisions of the legislation ([S.23](#)) define "pass-through entity" to include an S corporation, general partnership, limited liability company, limited liability partnership, limited partnership, or similar business entity (but does not include a trust or estate). The legislation also provides rules for determining the character of the income, gain, loss, deduction, or credit, and reporting and filing requirements for pass-through entities for corporate and personal income tax purposes.

A pass-through entity is not required to withhold income tax on behalf of a resident *individual* owner. In contrast, withholding is required on behalf of a resident owner that is a C corporation or pass-through entity. An exemption is also provided for a *pass-through entity* that is exempt from corporate income tax or that is: (1) a publicly traded partnership as defined by IRC §7704(b); (2) classified as a partnership for federal income tax purposes; and (3) that files an annual information return identifying and reporting certain information on partners with Utah-source income exceeding \$500 in a taxable year. The Utah Tax Commission has discretionary authority to waive penalties and interest in the event a pass-through entity fails to withhold income tax, if the owner on whose behalf tax should have been withheld timely files and remits tax due.

An owner is not required to file an income tax return if: (1) the owner does not have unadjusted or adjusted gross Utah-source income, apart from the amount derived from the pass-through entity; (2) the owner does not seek to claim a tax credit; (3) the pass-through entity withholds tax on the owner's behalf (in an amount equal to or great than the minimum tax if the owner is a C corporation); and (4) the owner is not a member of a unitary group. An owner on whose behalf income tax is withheld may claim a credit against their income tax liability for the amount withheld.

The pass-through entity is required to provide a statement to the owner on whose behalf tax is withheld, showing the amount of tax withheld on their behalf. Unlike other types of pass-through entities, S corporations are required to make estimated tax payments, pursuant to corporate income tax provisions pursuant to Utah Code Ann. §59-7-504. S corporations are also subject to corporate income tax provisions for assessments, penalties, refunds, or records retention. However, S corporations are not subject to the corporation income minimum tax.

b. Utah Laws 2008, S.B. 136, enacted March 14, 2008

Effective for taxable years beginning on or after January 1, 2009, the apportionment provisions for sales other than sales of tangible personal property are amended. Specifically, S.B. 136 amends Utah Code §59-7-319 to provide that a receipt from the performance of a service is considered to be in Utah if the purchaser of the service receives a greater benefit of the service in Utah than in any other state. A receipt in connection with intangible property is considered to be in Utah if the intangible personal property is used in Utah. If the intangible property is used within and without Utah, receipts related to the intangible property are apportioned to Utah based on the percentage of the use of the intangible property that occurs in Utah during the taxable year. There are specific provisions that apply to sales other than a sale of tangible personal property that are derived, directly or indirectly, from the sale of: (1) management, distribution, or administration services to or on behalf of a RIC; or (2) a securities brokerage service by a taxpayer if the taxpayer is primarily engaged in providing a service in Utah to RICs (this provision also applies to affiliate of said taxpayer). S.B. 136 also amends individual income tax provisions (Utah Code §59-10-118) to provide that all business income is apportioned using the same methods, procedures and requirements of Utah Code §§ 59-7-311 through 59-7-320 (Utah's UDITPA provisions). These changes are effective for taxable years beginning on or after January 1, 2009.

10. Virginia

a. Va. Public Doc. Rul. No. 08-199 (Dec. 19, 2008).

A 2008 Virginia Public Document Ruling reveals the difficulty of allocating (versus apportioning) partnership income under the state's sourcing regime. The ruling involved a corporation headquartered in Virginia that held a 50% interest in a partnership that operated exclusively in a state other than Virginia ("State A"). The corporate partner allocated income generated by the partnership to State A. On audit, however, Virginia disallowed the allocation and included the corporation's distributive share of partnership property, payroll, and sales in the denominator of its Virginia apportionment formula. Upholding the auditor's recharacterization, the Virginia Department of Revenue reasoned that "Taxpayer must demonstrate that its

investments are not operational assets involved in a unitary business.” In reaching its conclusion, the Department indicated that the taxpayer failed to furnish information demonstrating it was not unitary with the partnership. The Department also noted that partnership income retains its character in the hands of the partner. Finally, the Department laid out the filing process the corporation should have followed: file the return using the statutory method, pay any tax due, then file an amended return proposing an alternative method within the time prescribed for filing amended returns claiming refunds.

11. Wisconsin

- a. Louis Dreyfus Petroleum Products Corp. v. Wisconsin Dept. of Rev., No. 03-I-132 (Wis. Tax App. Comm. Jan. 2, 2008).

A company's capital gain income from the sale of its interest in a partnership was apportionable to Wisconsin, but interest income it derived from a loan of the proceeds it received from the sale of its interest in the partnership was not apportionable to the state. During the time at issue, the company's sole activity was limited to holding an interest as a general partner in the partnership, which owned a service station in Wisconsin. The company sourced the entire capital gain to Connecticut, the state in which it was commercially domiciled.

On appeal, the Tax Appeal Commission applied both the unitary business test (i.e., functional integration, centralization of management, and economies of scale) and the operational function test (i.e., does the income from a capital transaction serve an operational rather than an investment function) to determine that a unitary relationship between the company and partnership existed and that the income served an operational, rather than an investment, function. The Commission also found that the interest income the company derived from its loan of the proceeds received from the sale of the interest was not apportionable to Wisconsin because after the company sold its interest it no longer had a unitary or operational connection with the partnership and it ceased to have any contacts with Wisconsin.

For further information, please contact:

Jeffrey M. Vesely, Esq. **(bio)**
Pillsbury Winthrop Shaw Pittman LLP
50 Fremont Street
San Francisco, CA 94105
+1.415.983.1075
jeffrey.vesely@pillsburylaw.com

Jeffrey N. Saviano
Ernst & Young LLP
200 Clarendon Street
Boston, MA 02116
+1.617.859.6902
jeffrey.saviano@ey.com

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2009 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.