What’s New in State Taxes for Pass-Through Entities—Tips for the 2014 Tax Filing Season

New legislation and evolving administrative practices result in ever-changing state tax filing requirements for pass-through entities. From the elimination of the requirement to withhold income taxes in Kansas to the introduction of new apportionment sourcing rules in Massachusetts, pass-through entities and their owners will see many changes again this tax filing season. This article summarizes some of the new requirements, procedures, and issues taxpayers and return preparers will need to consider for 2014 returns.

Apportionment

Apportionment changes continue to dominate the headlines of state tax changes in 2014. These changes have generally been in the nature of adopting single factor apportionment based on sales or gross receipts and moving towards a market or customer-based sourcing of sales or gross receipts instead of the traditional costs of performance approach. Taxpayers should pay close attention to this trend, as market-based sourcing of certain financial or service receipts may trigger nexus and filing requirements in certain economic nexus states.

Minnesota completed its transition to a single sales factor in 2014.¹ New York City continues to phase in single sales factor apportionment, increasing its weight to 73 percent of the apportionment fraction for 2014, with the payroll and property factors making up 13.5 percent each.

On January 2, 2015, the Massachusetts Department of Revenue issued a lengthy set of final regulations providing rules for market-based sales factor sourcing, effective for tax years beginning on or after January 1, 2014.² The detailed rules include numerous examples and specific provisions for various types of services—such as services delivered by physical medium

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¹ Minn. Stat. § 290.191, Subdiv. 2(b).
² 830 CMR 63.38.1.
and services delivered by electronic transmission—and transactions involving intangible property, as well as how to determine whether and how corporate owners of pass-through entities must include the activities of those entities in their apportionment computations.

In Connecticut, pass-through entities having at least one member that is also a pass-through entity (or a nonresident trust or individual) must source sales of tangible personal property based on destination rather than origin (regardless of the F.O.B. point or other conditions of sale). Receipts from services, however, must be sourced based on the location where the services are performed by an employee or to the office or branch of the service provider from where the services are performed.

Pass-through entity filers should also take note of a position being taken by the Pennsylvania Department of Revenue. Under its current policy, the Department deems a corporate partner to be the direct owner of its proportionate share of all assets owned by the partnership. This approach results in all income flowing through pass-through entities to be deemed business income in the hands of a corporate partner, even from underlying partnerships that are not unitary with the corporate partner. If the corporate partner has no other apportionable income in Pennsylvania, the Department will adjust a corporate partner’s apportionment factor to 100 percent unless the corporate partner provides the apportionment information for each partnership in which it invests. When the partner reports other apportionable business income, the Department may use a percentage of less than 100 percent. On appeal, the Board of Appeals ("Board") has generally denied relief unless a corporate partner has provided apportionment information for each pass-through entity in which the corporate partner owns an interest. In a few instances, the Board granted relief when a corporate partner was able to provide apportionment information for each partnership doing business in Pennsylvania, but has not been consistent in granting relief on this basis. However, the Board reportedly has plans to adopt a uniform position on this issue. Further, the Board of Finance and Revenue (the next level of appeal in Pennsylvania) generally has granted limited relief or denied relief entirely.

3 Conn. Gen. Stat. § 12-711(c)(2), repealing the position taken by the Department of Revenue Services in Conn. Agencies Regs. 12-711(c)-4(f), which sourced gross receipts for a partnership based on the location of the office or other location of the business.

State Tax Withholding

Many states require withholding of state income tax on pass-through income sourced to their states. However, these rules are subject to numerous exceptions and exemptions, and the withholding rates may vary for different types of partners. This is another area of frequent change and one to which partnerships must pay close attention, as the states generally aggressively pursue partnerships for failure to follow the rules.

Beginning in 2014, Illinois required tax withholding on nonbusiness income allocated to Illinois. In prior years, withholding was required only on trade or business income sourced to Illinois. Also, withholding should take into account credits that are passed through to partners, shareholders, or beneficiaries.

Kansas has eliminated the requirement for pass-through entities to withhold tax from distributions to partners, members, and shareholders—including to individuals and to corporations. Effective January 1, 2013, Kansas repealed the individual income tax on income from partnerships, but neglected to repeal the withholding requirement. Because of this inconsistency, partnerships may have continued to withhold until the July 1, 2014 effective date of the withholding repeal.

Taxpayers that have had amounts withheld by a pass-through entity prior to the repeal may file an income tax return to seek a refund of the withheld tax. The Kansas Department of Revenue’s Policy and Research division has informally instructed taxpayers to follow three steps to request a refund of withholding: (1) call the Department of Revenue directly to discuss the refund needed; (2) request a marked-up 2013 withholding form from the pass-through entity indicating amounts withheld (i.e., mark the 2013 form as 2014); and (3) attach a statement to the 2014 income tax return of the pass-through entity’s owner that explains the amounts withheld and requests the refund (e.g., “Withholding was remitted pursuant to KSA 79-32,100e prior to the statute’s repeal on 7/1/14; pursuant to Notice 14-09, taxpayer hereby requests a refund of the remitted amount.”).

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6 35 ILCS § 5/709.5(a).
7 Because of this repeal, the withholding Form KW-7 is no longer required, and the Kansas Department of Revenue has removed it from general availability.
Although not a new development, many partnerships doing business in Vermont may be surprised to find a difference in rates can mean the partnership will owe additional taxes when it files a composite return. Vermont requires pass-through entities to make estimated payments on behalf of certain non-resident owners at the marginal tax rate of 6.8 percent (the second lowest marginal rate applicable to individuals).\(^8\) Alternatively, pass-through entities may file a composite return for their non-resident owners. Vermont composite returns, however, must include all non-resident owners of the pass-through entity. For pass-through entities with 50 or more non-resident partners, Vermont requires the filing of a composite return. The tax computed on the composite form BI-473 (Partnership/Limited Liability Company Schedule) is at the tax rate of 7.8 percent.

It also should be noted that the Vermont Department of Taxes has indicated that it will continue to administer the safe harbor provisions for non-resident estimated payments, originally outlined in since-retracted Technical Bulletin TB-05. To qualify, pass-through entities must make quarterly payments at least equal to the amount required based on the prior year’s income, and then make a catch-up payment to pay the full current year liability by the non-extended return due date. Payments made after the original due date will not be considered in determining whether the entity meets the safe harbor provision. Also, if a business overpays estimated taxes for non-residents (Form WH-435), the Department now offers the option of refunding the overpayment to the entity or applying it as a credit forward, in addition to the previous practice of distributing the full amount to the owners’ income tax accounts.

Partners with South Carolina income may be eligible for a refund of overpaid taxes. South Carolina’s phase-in of lower rates was complete in 2014. The new law provides for a reduced rate of three percent on active trade or business income of a pass-through business for partners that are individuals, estates, trusts, and non-corporate entities.\(^9\) Nevertheless, the withholding rate remains unchanged at five percent.\(^10\)

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\(^8\) 32 V.S.A. § 5920(c) (partnerships and limited liability companies) and 32 V.S.A. § 5914(c) (S corporations).

\(^9\) S.C. Code Ann. §12-6-545(B)(2).

New and Changed Tax Forms

A number of states revised their forms for 2014 or changed the forms that pass-through entities and their owners must file.

As a result of legislation passed last year, Illinois made numerous form changes for the 2014 filing year. Of special importance, the composite return and pass-through entity payment income tax returns have been eliminated. The amounts previously reported on those forms must now be included on Form IL-1065. Prepayments of tax related to those returns should be made with Form IL-516-I (for withholding from individuals and estates) or IL-516-B (for withholding from corporations, partnerships, and trusts), and extensions filed with Form IL-505-B. The instructions to these new forms warn filers that using any other vouchers to make prepayments likely will result in misapplication of funds. Nonresident taxpayers who have had pass-through withholding payments made on their behalf satisfying their tax liability do not have to file a separate return unless they are required to make pass-through withholding payments on behalf of their own partners, shareholders, or beneficiaries. A taxpayer who elected to credit an overpayment on its 2013 Form IL-1023-C (Composite Income and Replacement Tax Return) to a tax year ending on or after December 31, 2014, must include the credit as an overpayment credit on its Form IL-1065 for that tax year.

Also, the Illinois Department of Revenue has developed Schedule K-1-P(3) (Withholding Calculation for Nonresident Members) and Schedule K-1-P(3)-FY (Pass-through Withholding Calculation for Nonresident Members—for Fiscal Filers) to assist in calculating the amount of pass-through withholding required to be reported and paid for nonresident members. Finally, Form IL-1023-CES (Composite Estimated Tax Payments for Partners and Shareholders) and Form IL-1000-P (Prepayment Voucher for Pass-through Entity Payments) have been replaced by voluntary prepayment voucher Forms IL-516-I (for withholding from individuals and estates) and IL-516-B (for withholding from corporations, partnerships and trusts).

Vermont has also made significant changes to its pass-through entity forms for 2014 filings. In previous years, the state required partnerships and S corporations to file different forms. Now, both partnerships and S corporations must complete Form BI-471 (Business Income Tax Return).
Also, entities filing a composite return must file a new schedule (Schedule BI-473) for reporting the amount of Vermont-sourced income distributed to pass-through entity owners. Entities that do not file a composite return must report the amount of Vermont source income distributed to their owners on Schedule BI-472 (Non-composite Schedule).

It is not always easy to locate all the necessary forms for pass-through entities. In Arkansas, for example, the Pass-through Entity Withholding Report, Form AR941PT, cannot be obtained from the Arkansas Department of Finance and Administration website because taxpayers must be registered with the state for withholding tax to file the AR941PT. Taxpayers can register to withhold on the state’s website Withholding Registration Form AR4ER; the process takes approximately three to four weeks. Once registered, the state will send the taxpayer a Form AR941PT to remit the withholding tax payment.

Especially relevant to pass-through entities in the real estate business, California has introduced a new form for reporting like-kind exchanges occurring on or after January 1, 2014, that involve an exchange of property located in California for non-California property. Taxpayers must file the new form (Form FTB-3840) each year gain is deferred—even if the taxpayer has no other filing responsibility in California. Failure to file the form could result in a Notice of Proposed Assessment from the California Franchise Tax Board for tax on the gain deferred as a result of the like-kind exchange, plus penalties and interest.

Moving in the opposite direction, Nebraska no longer requires partnerships to file a Nebraska tax return if the only connection the partnership has with Nebraska is that one or more limited partners reside in the state. The current regulations, which require filing if any partner resides in the state, conflict with the instructions for the 2014 Form 1065N. The Department of Revenue is reportedly in the process of revising the regulations to match the instructions. Accordingly, a limited partnership that has Nebraska resident partners, none of whom are general partners charged with the management responsibility of the partnership and that conducts business entirely outside Nebraska is NOT required to file Form 1065N.
Electronic Filing

Shoppers aren’t the only ones migrating their activities to the Internet. State revenue departments also have continued their move to mandated online filing. For example, California has instituted mandatory e-filing rules for tax years beginning January 1, 2014, that include pass-through entity filings. Failure to file electronically will trigger a penalty beginning with returns filed on or after January 1, 2017. Even in the absence of a penalty (until 2017), the Franchise Tax Board (“FTB”) has noted that electronic filing is required unless a waiver is granted. The FTB has indicated that it will grant waivers liberally during the first couple years of this e-file mandate and written requests for these waivers must be submitted annually. Waivers can be requested at:

www.ftb.ca.gov/professionals/busefile/Business_eFile_Waiver_Req Request.asp.

Other states also have moved to the electronic filing route. In Connecticut, for tax periods beginning on or after January 1, 2014, all Forms CT-1065/CT-1120SI (Composite Income Tax Return) and any associated payments must be filed and paid electronically. Also, Montana now requires e-filing for Form PR-1 (Partnership Information and Composite Tax Return) if the partnership has more than 100 partners. In Pennsylvania, beginning with the 2014 filing season, the Department of Revenue began accepting electronic payment of the quarterly estimated withholding tax for nonresident owners filed with the PA-65ESR through the MeF Fed/State program. Third-party preparers who prepare more than ten PA-65 Corp (Directory of Corporate Partners) returns must e-file those returns, and must continue e-filing in the future, regardless of the number of returns they prepare.

Beginning January 1, 2015, all pass-through entities are required to file their Virginia annual returns and make all payments electronically. This requirement applies to 2014 returns, return payments, and withholding payments filed after January 1, 2015. Pass-through entities unable to file and pay electronically may request a waiver from this requirement. Finally, for periods starting on or after January 1, 2014, West Virginia taxpayers remitting more than $25,000 for a single tax type must file returns and make payments electronically, unless specifically excluded.

12 Conn. Gen. Stat. § 12-690(b); Form CT-1065/CT-1120SI EXT Instructions.
14 72 P.S. § 10.
Some Good News…Rate Reductions

Because Massachusetts achieved revenue growth benchmarks set by state law, the withholding tax rates applicable to individuals, estates, and trusts decreased from 5.25 percent to 5.20 percent.\(^\text{15}\)

North Carolina reduced its tax rates on individuals to 5.8 percent\(^\text{16}\) and corporations to 6 percent in 2014.\(^\text{17}\) However, partnerships are required to withhold for all taxpayers, including corporations, at 5.8 percent.\(^\text{18}\) Partnerships with significant corporate partners may want to consider including a note to these partners that the withholding likely will not be sufficient to cover their entire tax liability and they should be prepared to pay additional tax.

Starting in tax year 2014, corporate taxpayers meeting the definition of a "Qualified New York Manufacturer" ("QNYM") will be subject to a zero percent income tax rate.\(^\text{19}\) Despite qualifying for this reduced rate, the instructions to Form CT-2658 (Report of Estimated Tax for Corporate Partners) require withholding to be uniformly calculated for all corporate taxpayers at 7.1 percent. While the withholding requirement statute\(^\text{20}\) references rates prescribed by Tax Law section 210.1(a)—which should permit a partnership to withhold on a QNYM partner at zero percent—it is unclear how to present such disparate rate treatment for corporate partners. To avoid this issue, a QNYM corporate partner may want to consider providing the partnership with a Form CT-2658-E exemption certificate to avoid being overpaid on estimated taxes.

West Virginia’s phase-out of its entity-level franchise tax will be complete in 2015. For 2014, the rate has been reduced from 0.20 percent to 0.10 percent.\(^\text{21}\)

\(^\text{16}\) N.C. Gen. Stat. § 105-153.7(a) (Effective for 2015, the rate for individuals is decreased to 5.75 percent).
\(^\text{17}\) N.C. Gen. Stat. § 105-130.3 (Effective for 2015, the rate for corporations is decreased to 5 percent).
\(^\text{18}\) N.C. Gen. Stat. § 105-154(d).
\(^\text{19}\) N.Y. Tax Law § 210(1)(a)(vi).
\(^\text{21}\) W.Va. Code § 11-23-6(b).
Other Changes to Keep in Mind

Connecticut passed legislation in 2014 requiring non-resident individual owners and certain pass-through entity owners of pass-through entities to pay Connecticut tax (or recognize a Connecticut loss) on the disposition of an interest in a pass-through entity if more than 50 percent of the entity’s assets consisted of real property located in Connecticut. The tax is based on an apportioned amount of the gain or loss computed by reference to a property factor made up of the entity’s real property located in Connecticut divided by its total assets everywhere. This rule also applies to tiered structures when any entity within the tiered structure owns Connecticut real estate exceeding 50 percent of its total assets based on fair market value on the day of the disposition of the partnership interest.

In Pennsylvania, legislation enacted in 2014 made significant changes affecting pass-through entities. Under the new rules, a pass-through entity that fails to file a PA-20S/PA-65 information return will be subject to a $250 failure to file penalty. The $250 penalty also applies to each missing Schedule RK-1 (state K-1 for residents) or NRK-1 (state K-1 for nonresidents), meaning penalties could add up quickly for a pass-through entity with many owners. Also, assessments of tax may be made at the entity level if there is an understatement of income in excess of $1 million and the entity has 11 or more owners, or when a partnership has at least one owner that is another entity or trust.

Montana recently announced it will begin sending out delinquency letters to partnerships (and S corporations) that have previously filed returns, but have since stopped filing. In many cases, entities historically may have filed a return in Montana, but in a later year, no longer have significant activity in the state and stop filing, perhaps without filing a final return. Filing in some years and not in later years is often an issue for entities in “fund of funds” structures. This change in policy may result in those entities receiving notices from the Montana Department of Revenue.

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23 72 P.S. §§ 7306.2 and 7352(f)(3).

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Looking Forward to 2015…

For tax years beginning in 2015, New York Metropolitan Commuter Transportation Mobility Tax (“MCTMT”) payments now must be combined with New York State estimated tax payments made on behalf of partners. To conform to the state’s personal income tax estimated tax due dates, estimated MCTMT payments for nonresident partners are now due on April 15, June 15, September 15, and January 15.\(^{24}\) Previously, MCTMT estimated payments were due on the last day of April, July, October, and the following January.

Also, new forms will be required in 2015 MCTMT. Partnerships will need to submit estimated payments with their required personal income tax payments for nonresident individual partners using Form IT-2658 (Report of Estimated Tax for Nonresident Individual Partners and Shareholders), rather than Form MTA-405 (Report of Estimated MCTMT for New York Nonresident Individual Partners).

For taxable years beginning on or after January 1, 2015, the District of Columbia will be moving to a single sales factor apportionment formula with market-based sourcing for sales other than sales of tangible personal property.\(^{25}\)

Illinois decreased its income tax rates for nonresident individuals, estates, and trusts beginning January 1, 2015, from 5 percent to 3.75 percent (trusts are subject to an additional 1.5 percent replacement tax resulting in a new trust tax rate of 5.25 percent).\(^{26}\) The income tax rate for nonresident corporate filers beginning in 2015 decreased from 7 percent to 5.25 percent (plus 2.5 percent replacement tax resulting in a new corporate tax rate of 7.75 percent).

Virginia is drafting updated pass-through entity withholding guidelines. This update may augment or supersede the current guidelines in Virginia Public Document Ruling 07-150 (P.D. 07-150). The state is preliminarily expecting to issue these updated guidelines in April 2015.

\(^{25}\) D.C. Code Ann. § 47-1810.02(d-2).
\(^{26}\) 35 ILCS § 5/201(b)(5.2) & (12).
Conclusion

Keeping up with the required compliance responsibilities of a pass-through entity can challenge even sophisticated taxpayers. Those complexities increase exponentially as a business expands operations across the country. In some industries, the use of multiple tiers of pass-through entities magnifies these challenges and the associated risks of making mistakes in tax filings. Because many tax news services focus their coverage mainly on corporate tax developments, it is critical for pass-through entities and their owners to use a broad approach to identify issues and changes that could affect their state tax filing responsibilities.