Originally published in:
10th Annual Effective Hedge Fund Tax Practices Conference **November 1, 2008**

Effective Hedge Fund Tax Practices
State and Local Tax Considerations

By: Joe Lipari and Carolyn Joy Lee

State and local taxation (or "SALT") is a complex area that, at times, resembles the federal income tax and, at others, departs sharply from any resemblance to federal tax principles. In the context of "hedge funds," loosely defined, several fundamental and unique characteristics of SALT introduce elements of tax – both tax planning and tax pitfalls – that differ markedly from traditional federal income tax planning. Given fifty states (plus the District of Columbia), and myriad local taxing jurisdictions, generalizations are impossible, indeed dangerous. Nevertheless, there are a number of basic features of state and local taxation that, in various permutations, frequently surface as relevant, and significant, in tax planning for hedge funds.

I. Pass-Through Status; Generally

Hedge funds may, for state law purposes, be organized as general partnerships, limited partnerships or limited liability companies ("LLCs"), including Series LLCs. For federal income tax purposes, these different state law entities are invariably classified as partnerships.[1] As such, the entity itself pays no income tax; instead its partners are allocated distributive shares of the income, expense, gain, loss and credit of the partnership.[2] The partners then report that income on their individual or corporate income tax returns; or in the case of a partner that is itself a pass-through entity, pass the income up to their partners, and so on up the chain.

A threshold question in SALT is whether a state or locality conforms to the federal classification of the entity as a non-taxpayer pass-through entity. Generally speaking, state income tax statutes largely conform to the federal classification of entities. Thus, for example, an LLC classified federally as a partnership will likewise be classified, for SALT income tax purposes, as a partnership,[3] rather than as a corporation or some other form of entity.

That said, and as more fully discussed below, states add various bells and whistles to their basic conformity to federal classification. These include:

- Entity-level income taxes
- Entity-level fees
- Non-income type entity-level taxes

- Withholding and estimated tax payment obligation
- Partner consent conditions on pass-through classification
- Composite filing rules

As a result, while one may fairly begin the SALT analysis with the assumption that a vehicle classified federally as a partnership will be similarly classified for SALT purposes, that generality is a long way from the end of the analysis.

II. **Partners' Tax Status**.

At the federal level, partners too have federal classifications, which determine the federal income tax treatment of the ultimate taxpayers. Federally, partners break down into a variety of categories, including:

- U.S. individuals
- Foreign individuals
- Trusts
- Domestic corporations
- Foreign corporations

At the SALT level, the basic federal classifications of taxpayers are further subdivided, and include:

- Resident individuals
- Nonresident individuals
- Resident trusts
- Nonresident trusts
- Corporations doing business in-state
- Corporations doing business in multiple states
- Corporations whose activities are limited to investment
- Corporations taxed under various divergent state or local tax regimes
  - Banks
  - General corporations

- Utilities
- S corporations (recognized or not at the state level)

The state tax categorization of taxpayers is driven by two basic realities — geography and history. Borders, together with federal constitutional principles, limit the states' abilities to impose income taxes.

A. **State Taxation of Individuals**

States can impose tax on the worldwide income of individuals who are resident[4] or domiciled[5] in the state, but tax nonresidents only on income derived from in-state sources.[6] This, logically enough, leads to controversies (i) in determining resident status, and (ii) in determining the source of income. Since income from intangibles is sourced by reference to the domicile of the individual earning such income,[7] the stakes can be particularly high where investment income is concerned.

A taxpayer resident in Florida pays no state income tax on investment income.[8] A taxpayer resident in New York City pays state tax at 6.85% plus City tax at 3.648%. A taxpayer domiciled in Connecticut but meeting New York's definition of a statutory resident pays Connecticut income tax of 5% plus New York State income tax of 6.85% plus New York City income tax of 3.648% all on the same investment income, with no offsetting credits allowed. This result follows from dual resident status, which allows each of New York and Connecticut to tax the individual's worldwide income, and further allows each state to treat investment income from intangibles as sourced to that state, by virtue of the individual's status as a resident in that state. By way of contrast, if that same dual resident earned income working in New York City, New York would tax the earned income, but Connecticut would allow a credit for the New York tax paid, given that such tax was imposed on income sourced to New York resulting in the resident paying tax at the higher New York rate.

The source of income can vary depending upon the nature of a transaction as well. An individual partner in a partnership earning income from operations in various states generally is required to file income tax returns in those states, reporting to each his share of the income derived in such state. That same investor who sells his interest in the partnership generally is treated, however, as earning income from the sale of an intangible. That income is sourced to, and taxable by, the individual's state(s) of residence.[9] By contrast, if the partnership instead were to sell the underlying business, the individual partner generally will again be subject to tax in the jurisdictions in which the business was conducted, with the gain being divided among those jurisdictions (see below). His home state then will (usually) allow a credit for taxes paid to the source states. Although the federal income tax treatment of an asset disposition may not differ markedly from the federal treatment of a sale of partnership interests,[10] because of these differences between federal tax principles and SALT, and because of differences among state tax regimes, the SALT treatment of individual partners could vary considerably, depending upon the jurisdictions in which the assets or business are located, the residence(s) of the individual, and the structure of the relevant state tax regimes. (There often are other SALT considerations to weigh in evaluating an asset sale vs. an entity sale, including sales taxes, real estate transfer taxes, partnership-level taxes and fees, and partnerships' withholding/estimated tax obligations.

As with most of SALT, these analyses are highly fact-specific, and devils often lurk in the details.)

B. State Taxation of Trusts.

Trusts making investments through pass-through entities such as partnerships present some particularly sensitive SALT issues. Generally, states divide trusts into "resident" and "nonresident" categories.[11] Resident trusts, like resident individuals, are taxed on worldwide income; nonresident trusts are taxed only on income sourced to the taxing state.[12] And as with individuals, income from intangibles is sourced based on residency or domicile. In New York, for example, a trust classified as a resident trust would be fully taxable on all income earned, whereas a nonresident trust would not be taxed on its income from intangibles.

The residence of a trust is generally driven by the residence of the settlor at the time the trust is established or becomes irrevocable.[13] Thus, if an individual establishes an irrevocable trust at a time when the individual is (or is later proven on audit to be) a New York resident, that trust is a New York resident as well and, at least in theory, will remain so, forever taxable by New York on its worldwide income

As it turns out, however, the "forever" part was more than the constitution would allow. In Safe Deposit & Trust Co. v. Virginia,[14] the United States Supreme Court held that a trust established by a Virginia resident under the laws of Maryland, with a Maryland trustee and all of its assets physically located outside Virginia, could not be taxed by Virginia. This case, and one like it decided by New York's Court of Appeals,[15] led New York to adopt first regulations and then a statute[16] under which a trust otherwise classified as resident would nonetheless be exempt from New York income tax, provided certain conditions were satisfied.

These conditions for classification as an "Exempt Resident Trust" are:

- The trust cannot have any New York domiciliaries as trustees.[17]
- The trust cannot have any assets located in New York.[18]
- The trust cannot have any New York source income.[19]

In the context of hedge funds and other investments in pass-through entities, a classification rule like New York's for Exempt Resident Trusts can prove highly problematic. Under the statute, a single dollar of income derived from New York sources causes the trust to lose its "exempt" status, and revert to full taxability on all of its income. Whether the cliff effect as prescribed in the statute is in fact constitutional at its extreme is a good question, but serving as trustee in such a test case no doubt is not entirely appealing.[20]

Moreover, trustees may have no idea that a pass-through entity has made an investment, perhaps several tiers down, that produces New York source income until too late — when a K-1 arrives reporting the trust's distributive share of income from New York sources. Where the SALT taxation of a trust hinges upon a rule like New York's exemption, therefore, investments in pass-through entities can be dangerous, at best.

C. State Corporate Taxation

Blocker corporations are useful vehicles for tax exempts, and sometimes foreigners, investing in pass-through entities. By capturing income from U.S. business activities in a taxable C corporation, the ultimate investors bear one level of corporate tax, but also insulate themselves from any taint (unrelated business taxable income, FIRPTA) that might otherwise flow to them by reason of the investments or activities of the lower-tier pass-through entities.

Obviously the state and local taxation of corporations is a huge subject. In the hedge-fund context, certain aspects of SALT are particularly relevant. What follows is a 30,000-foot view of SALT as applied to corporations, to provide background for some of the more fund-specific issues discussed below.

As with all would-be taxpayers, in order for a state to impose tax on a corporation the state must establish the requisite "nexus" with the corporation. Nexus, Latin for connection, means a connection between the state and the taxpayer that is sufficient to subject the taxpayer to the jurisdiction of the state. For this purpose, federal constitutional principles established under the Due Process[21] and Commerce Clauses[22] are relevant, as are state constitutional and statutory standards.[23]

Exactly what constitutes nexus is, however, one of the most vexing problems in SALT. Clearly the state of incorporation has the power to tax; as does a state where a corporation is physically present by means of property or employees. Whether "economic nexus" — that condition of earning profits from in-state markets while having no physical presence in the state — suffices is a matter of ongoing controversy. Several states' courts [24] have upheld states' assertions of nexus to tax credit card companies and intangible holding companies based on those entities' economic ties to the jurisdiction, but the Supreme Court has thus far declined to get involved.[25]

Nexus based on the ownership of a partnership interest is a particularly interesting area of SALT. Historically, partnerships were thought of in terms of general partnerships, in which an agency relationship existed between the partnership and its partners, and partnership assets were, under some state laws, considered "owned" by the partners, as tenants in partnership, for example. As the economy matured limited partnerships took hold, but the basic concept that partners have a taxable nexus in the jurisdiction in which the partnership has nexus was not really challenged. Particularly given the pass-through tax treatment of partnerships, and the historic "agency" thinking around partnerships generally, the working assumption generally was that partners were subject to state tax in states in which the partnership has nexus.

Thus, for example, New York's regulations provide that a corporation will always be considered to be doing business in New York if it is a general partner in a partnership that does business in New York.[26] Corporate limited partners may, however, be excluded from taxable status if their New York contact is limited to investment in a "portfolio investment partnership." That, in turn, is defined as a partnership that meets the income tests applied to RICs under IRC § 851(b)(2), with carve-outs excluding dealers, and some special rules for commodities.[27]

New York also excludes from its tax base corporate limited partners that can demonstrate that they are not engaged, directly or indirectly, in the "domination or control" of the partnership. A raft of presumptions apply, under which corporate limited partners might be considered so engaged, notwithstanding that actual facts.[28]

As illustrated by Alabama's Lanzi case, discussed below, the assumption that limited partners cannot be taxed on investment income has not gone universally unchallenged.

Moreover, as limited liability companies came to the fore it became even less clear that the "old" general partnership concepts had any relevance. LLC statutes provide, for instance, that members have no ownership interest in LLC assets, and own only an interest in the entity.[29] And LLC members frequently have no rights or status even approaching agency. The question of whether, under Due Process or Commerce Clause principles, a state can assert jurisdiction over a member of an LLC based solely on the activities of the LLC has not, to date, been fully tested.[30]

Of course, if a pass-through entity is not itself subject to tax under the classification scheme of state income taxes, but the members of such entity also cannot be subjected to the state's taxing jurisdiction because, under Due Process or Commerce Clause principles, the members' contacts are not sufficient to create nexus, a large hole suddenly appears in state income taxation. This potential hole, as well as issues of collection and compliance, are pushing states around the country to adopt various forms of partnership-level taxes and/or withholding or estimated tax payment requirements. See section, below.

In addition to requiring nexus, the Constitution further require that a state tax

- Is fairly apportioned
- Does not discriminate against interstate commerce
- Is fairly related to the services provided by the state.[31]

The requirement of fair apportionment means that states must adopt some methodology for determining what portion of a multi-state taxpayer's income can fairly be said to be related to the taxpayers' activities in the state.

The apportionment regimes adopted by many states distinguish between "business" income and "non-business" income.[32] Business income is divided among the states in which a corporation conducts business activities, often under a formula that compares the locations of payroll, property and receipts, with the latest vogue being to emphasize, or use only, business receipts.[33] "Non-business" income may be allocated entirely to the domicile of the taxpayer,[34] or in the case of the New York investment capital regime,[35] based on the locations of the entities from which investment income is derived. Since income earned through a partnership generally retains its character as it passes up to the ultimate taxpayer,[36] the character of income as "business income" is generally determined by reference to the activities of the operating partnership, and is not a function of the "investment intent" of the partners.[37]

Where corporations are partners in partnerships numerous complex questions can arise. For example, as noted above, the apportionment of business income commonly relies on comparisons of, say, New York receipts to total receipts. Where partners engage in transactions with their partnerships, for example a corporate partner sells to a partnership in which it holds an interest, and then the partnership on-sells to customers, it is not always clear how to count the receipts. New York provides for an elimination of the receipts derived by the corporation on its sale to the partnership, to the extent of the corporation's percentage interest,[38] but this is not always clear. Variations on the confusion abound.

As another example, some states apply differing tax regimes to different types of corporations, depending upon the preponderant nature of the corporation's activities. Where a corporation is in one line of business and owns an interest in a partnership that conducts a different line of business, questions may arise as to which corporate tax regime the corporation belongs in.[39]

Finally, SALT employs a concept of "unitary business," in which the entity boxes into which tax lawyers so enjoy dividing businesses are blown away and state taxes are instead computed by reference to the entire "unitary" business, and not the separate companies conducting pieces of it.[40] Where corporations hold investments in partnerships it can be relevant, both in clarifying income and in apportioning it, to determine whether the business of the partnership is unitary with that of the corporation.

D. <u>State Taxation of S Corporations</u>

This is a subject on which all of the foregoing concepts of individual vs. corporate vs. pass-through taxation converge. Under the federal tax law, a qualifying corporation can elect pass-through status under Subchapter S.[41]

The effect of this election, which requires that all of the shareholders be individuals, estates or qualified trusts, is that tax generally is not imposed at the corporate level, but instead the income of the S corporation is passed through to its shareholders and taxed once, at the shareholder level.

In the world of SALT, there are different approaches to S corporations. In some cases, the federal S election translates automatically to a state S election, meaning the S corporation is not taxed but the shareholders are.[42] In some states S treatment is elective, and will not obtain unless a separate state election is made.[43] In other cases, such as New York City, S corporations are not recognized at all.[44]

And there are further variations on the theme. New York State, for example, has a corporate tax regime that generally can be very favorable to income derived from investments in corporate stocks and securities.[45] Individual investors could form federal S corporations, but not make a New York S election, and thereby enjoy only one level of federal tax, and essentially no current State income tax; and potentially no state income tax ever if a successful move to Florida was effected before the "hybrid" S was liquidated.

In 2007, however, the State clamped down on this type of planning. Specifically, effective April 9, 2007, New York State will deem a federal S corporation to have made a New York S election if its investment income is more than fifty percent of gross income for the year.[46]

And while S corporations can continue to have some attractiveness in SALT planning, they can create pitfalls as well. There is, for example, no mechanism to step up inside asset basis, even if an event occurs (a sale, or death) that steps up the outside basis of the S corporation shares. In a jurisdiction such as Pennsylvania, which divides income and losses into different, non-offsetting baskets,[47] income from the S corporation's disposition of its assets may not be offset by losses on the liquidation or other disposition of the S corporation, compounding the potential for mismatch that already exists at the federal level.

III. SALT Diversions from Classic Pass-Through Treatment

As overviewed above, the usual tax treatment of partnerships is as pass-through vehicles, which themselves pay no tax, but instead allocate their income among their partners, to be taxed at the partner level. In SALT, however, there are numerous variations on, and departures from, this basic theme.

A. Partnership-Level Taxes.

While many states and localities do treat partnerships as pass-throughs, there are some important exceptions where tax is imposed directly on the partnership, as a full-blown taxpayer. These partnership-level taxes may be imposed on net income, or on some other base. By way of illustration, two of the most significant partnership-level taxes are described below.

1. New York City Unincorporated Business Tax

New York City is not authorized to impose an income tax on nonresidents who earn their living working in the City but live outside it. To fill that perceived gap in its income tax scheme New York City taxes S corporations (as noted above), and also imposes a 4% tax on the net income derived from an unincorporated business.[48] The classic type of entity to be subject to the UBT is a partnership whose partners and employees provide services out of offices maintained in New York City.

The UBT is generally imposed on net income, as determined under federal income tax principles, but with certain modifications.[49] The UBT modifications will, for example, add back to federal income any tax-exempt interest earned on non-New York bonds.[50]

Importantly, the UBT does not, beyond a minimal amount (currently $10,000) allow the entity to deduct payments made to partners. Specifically, the UBT provides that "no deduction shall be allowed . . . for amounts paid or incurred to a proprietor or partner for services or for the use of capital."[51] This provision disallows deductions for guaranteed payments, as well as amounts paid under stand-alone contracts, for example, a management services agreement. One important exception to this disallowance is, that to the extent a payment to a partner reasonably represents the value of services provided to the payor partnership by employees (but not by officers or partners) of the payee partner,[52] the payment is deductible.

Given this limitation on the deductibility of what can be, in many cases, substantial payments, there has been considerable controversy over the definition of "partner."[53] The details of the relationship a "contract" partner has to a partnership can be very important in determining whether amounts paid to that individual are or are not deductible in calculating the payor's 4% UBT. Along similar lines, because the federal income tax law holds that an individual cannot be both a partner and an employee, amounts paid to such an individual are treated by the City as paid to a partner, and thus not deductible.

Several other features of the City UBT merit note. In addition to excluding from the UBT the activity of trading for one's own account (see Section V.B, below), the UBT maintains a bifurcated allocation system for business vs. investment income, much like the New York corporate taxes. Under this system, an unincorporated business that earns income from investments in corporate and governmental stocks and securities apportions such income based upon the activities of the investees, and not its own business activities.[54]

For business income, the UBT generally applies three-factor formulary apportionment.[55] In applying formula apportionment, gross income from the performance of services is generally allocated to New York City if the services were performed by an employee (or partner) "chiefly situated at, connected by contract or otherwise with, or sent out from, offices of the unincorporated business . . . situated within New York City."[56] There are, however, special rules for securities and commodities brokers, which may elect to source their receipts by reference (in part) to the location at which the order originated.[57]

There also is a special receipts allocation rule for receipts derived for management services provided to regulated investment companies. Under these provisions receipts are allocated based on the location(s) of the RIC's shareholders, assuming the relevant information can be obtained from the RIC by the manager.[58]

Tiered partnerships present some particularly interesting problems under the UBT. For example, the City's regulations generally provide that a UBT-taxable upper-tier entity should calculate its own investment allocation percentage for the investment income derived from the investment capital it holds directly, and then separately report the investment income allocated to the City by lower-tier entities in which it owns interests. There also is, however, provision for requesting a blended allocation, if the usual method is shown to produce results that are not "fair and equitable."[59]

In addition, the overall concept of the UBT is to impose tax at the lowest-level entity, and then allow a credit to partners up the chain that are themselves unincorporated entities subject to the UBT, or corporations subject to the City's general corporation or bank tax.[60] While this mechanism should, in theory, limit the City to one tax, at the UBT or corporate tax rate, on the net income generated in the City, there can be timing issues, or instances in which income taxed at a lower-tier level is offset by losses at a higher level.[61] Any situation involving tiers of entities engaging in New York City activities should, therefore, be carefully monitored.

2. The Texas "Margin" Tax

Texas imposes a margin tax on all entities that enjoy the privilege of liability protection.[62] In addition to applying to corporations, this tax is also directly imposed on LLCs, limited partnerships, limited liability partnerships, professional associations and business trusts.

General partnerships that are owned solely by individuals (i.e., human beings, not P.C.'s) are not subject to the new tax, nor are sole proprietorships.

Under Texas' "old" Franchise Tax, taxable entities paid the tax based on the higher of 0.25% of the entity's capital (net worth) or 4.5% of the entity's earned surplus (net income plus officer compensation). These tax bases have now been replaced with a "margin" tax base, and the tax rate is set at 1%, except for entities that qualify as retailers or wholesalers subject to a 0.5% tax rate.

A business' tax liability under the margin tax is calculated as the lesser of (i) 70% of total revenue, or (ii) total revenue minus either (x) cost of goods sold or (y) compensation. The election to deduct either COGS or compensation may be changed annually, but the election may not be changed retroactively by filing an amended return.[63] This tax base is then multiplied by an apportionment factor based solely on receipts: Texas sales or receipts divided by sales or receipts from everywhere. The apportioned taxable margin is then multiplied by the appropriate tax rate.

Alternatively, a business with $10 million or less in total revenue may choose to calculate its tax liability using the E-Z computation and a 0.575% tax rate.

The margin tax employs a "privilege period" concept, under which the entity pays for the privilege of doing business in the state during the calendar year when the tax is paid. However, the tax due is based on the business activity that occurred in the entity's accounting period that ended in the preceding calendar year. For example, an entity whose accounting period (i.e. fiscal year) ended on December 31st would pay for the privilege of doing business in the state during calendar year 2012 on May 15, 2012, but the tax due would be based on its business activity during calendar year 2011. This new and improved Texas margin tax was first due May 15, 2008, calculated based on business activity during 2007.

The margin tax does not apply to "passive entities." To qualify as a passive entity, an entity must meet the following criteria:

- The entity must be a general or limited partnership or a non-business trust;
- At least 90% of the entity's gross federal income during the period on which its margin is based must be "passive income," as described below; and
- The entity cannot receive more than 10% of its gross federal income from conducting an active trade or business.

In proposed regulations concerning passive entities, Texas has identified the following categories of income as the only income that qualifies as "passive income"[64]:

- Dividends, interest, foreign currency exchange gain, notional contract payments, option premiums, cash settlement or termination payments for a financial instrument, and income from a limited liability company;
- Distributive shares of partnership income, if the share is greater than zero;
- Net capital gains from the sale of real property, net gains from the sales of commodities traded on a commodities exchange, and net gains from the sale of securities; and
- Royalties from mineral properties, bonuses from mineral properties, delay rental income from mineral properties and income from other nonoperating mineral interests.

Security is defined to include[65]:

- An instrument defined by IRC §475(c)(2), where the holder of the instrument has a non-controlling interest in the issuer/investee;
- An instrument described by IRC §475(e)(2)(B), (C) or (D);
- An interest in a partnership where the investor has a non-controlling interest in the investee;
- An interest in a limited liability company, where the investor has a non-controlling interest in the investee; and
- A beneficial interest in a trust, where the investor has a non-controlling interest in the investee.

Non-controlling interest, for purposes of passive entity determination only, is defined as an interest of less than 50% held by the investor, either directly or indirectly, in the investee.[66]

Rental income is not considered "passive income" for purposes of the margin tax.

The proposed regulations also define an active trade or business, for purposes of the 10% passive entity exemption rule, as follows[67]:

- An entity conducts an active trade or business if the activities include active operations that form a part of the process of earning income or profit, and the entity performs active management and operational functions;
- Activities performed by the entity include activities performed by persons outside the entity, including independent contractors, to the extent that the

persons perform services on behalf of the entity and those services constitute all or part of the entity's trade or business; or

- An entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the active trade or business of one or more related entities.

Following the trend of other states, Texas has adopted a combined reporting structure under the margin tax, requiring entities that are engaged in a unitary business to report on a combined basis.[68] Specifically, the definition of "taxable entity" includes a combined group, and "combined group" is defined for this purpose as a group of taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a group report. Consequently, when the term "taxable entity" is used in the Texas margin tax, it refers to the unitary group, rather than to a specific entity.

Because the Texas margin tax requires combined reporting for all taxable entities that are (1) part of an affiliated group; (2) engaged in a unitary business; and (3) not excluded under the "Water's Edge" provision, Texas has the rather unique feature of requiring partnerships to file combined reports, with other partnerships and even with corporations. A combined group is required to include all taxable entities, without regard to whether the particular entity has nexus with Texas. The combined group files reports on a combined basis as a single economic unit.[69]

Under proposed regulations, however, the following may not be included in a combined group[70]:

- Exempt entities;
- Insurance companies that pay gross premiums tax;
- Passive entities (but the pro rata share of net income from a passive entity is included in total revenue to the extent not generated by the margin of another taxable entity); and
- Entities excluded under "Water's Edge."

Under the same regulations, the following must be included in a combined group[71]:

- Eligible entities, even if they lack nexus with Texas (income of these entities is included in combined group's total margin, but not in the gross receipts numerator).
- Pass-through entities (partnerships, LLCs taxed as partnerships or disregarded under federal law, and S corporations).

For purposes of defining the members of the combined group, the "affiliated group" includes one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member entities. A "controlling interest" is defined as follows[72]:

- for a corporation: more than 50 percent of the direct or indirect ownership of the total combined voting power of all classes of stock of the corporation, or of the beneficial ownership interest in the voting stock of the corporation; and
- for a partnership, association, trust, or other entity: more than 50 percent of the direct or indirect ownership of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.

B. Withholding and Estimated Tax Obligations

As noted above, the pass-through nature of partnerships separates the in-state business from potentially out-of-state taxpayers. This historically led to compliance and collection problems, as partners with relatively little contact with a remote state failed to understand their filing obligations, or to pay tax on their distributive shares of income allocated to such states.

Many states have now responded to this situation by enacting provisions that effectively require partnerships to pay their partners' taxes. Depending upon the state, and the situation, these rules can be fairly easy to live with, or can cause significant cash flow disruptions for partnerships, and for the co-partners of those whose income tax is being funded by their partnership. This section illustrates the two basic type of payment regimes, then addressed some of the business and practical issues these regimes create.

1. Withholding.

A pure withholding regime requires a partnership to withhold state or local income tax out of distributions made to targeted partners. In a classic[73] and simple scenario, a partnership would calculate the California source income allocable to a nonresident partner, multiply that income by a specified tax rate, and withhold, out of the cash distributions actually made to the nonresident partner, the requisite amount of tax due to California.[74] The partnership would then remit to California the aggregate tax due in respect of all of the partners to whom the withholding requirement applied. Those partners, in turn, would claim credit for the California tax withheld on their behalf when filing their nonresident income tax returns.

A variation on withholding from actual distributions is to "withhold" on income allocated to the targeted partner, without regard to whether there is an actual tax distribution to the partner. That looks more like an estimated tax payment.

2. Estimated Tax Payments

An estimated tax payment regime requires a partnership to make, for example, quarterly payments of estimated tax in respect of target partners.[75] This system differs from the pure withholding regime in that the timing of the payment requirement is fixed by the state's rules, and the partnership is required to fund the targeted partners' taxes without regard to whether the partnership would otherwise be distributing cash to the targeted partners on the appointed date.

3. Issues for Partnerships and Co-Partners.

The most obvious issue raised by these regimes is the obligation of a partnership to fund the partner's individual taxes. Where the payment obligations are coordinated with, and collectively no greater than, the partnership's intended distributions of cash, then neither the business nor the other partners is particularly burdened by the obligation to pay some partners' taxes directly to the state. In other circumstances, however, these payment obligations can create real dislocations.

In New York, for example, the introduction of requirements to pay quarterly estimated taxes of nonresident and C corporation partners threatened to put affected partnerships in default under debt obligations, such as HUD loans, that restricted or prohibited distributions to partners. The state found a way to waive the estimated tax payment obligation of such partnerships, but the episode stands as evidence of one kind of unintended consequence.

Partnerships required to make estimated tax payments, or to "withhold" in respect of allocated, rather than distributed, income also can face cash flow issues in circumstances where a transaction generates income but no cash or where a partnership has investments in multiple states some of which have income and others have losses. Cancellation of indebtedness income, for example, or gain on a foreclosure, can create significant income but no cash. If the targeted partners' taxes are paid by the partnership in these circumstances, those partners effectively enjoy a cash-flow benefit that their co-partners (usually in-state residents) do not. Similar problems can arise if the "distribution" triggering a withholding obligation is a "deemed distribution" resulting from a reduction of partnership liabilities.[76]

The obligation to make payments in respect of partners therefore creates business issues that, ideally, should be addressed in partnership agreements. If tax payments exceed distributions that otherwise would be made, those payments should be treated as loans to the targeted partners, to be repaid to the partnership, with interest. If partners contemplate receiving periodic "tax distributions" in any event, those distributions obviously should be calculated taking into account the taxes that might be required to be paid on behalf of targeted partners. Reference also should be made to any available "escape hatches" offered by states in which a partnership is, or anticipates it may be, doing business (see below), to require partners to make the necessary consents, etc. that would relieve the partnership of its payment obligations. In admitting new partners, or consenting to transfers, partnerships again should review their compliance obligations and plan insofar as possible to get out of the business of paying their partners' taxes.

One particularly sticky element of these requirements is identifying the partners in respect of whom they apply. Classically, these obligations apply with regard to "non-resident" individuals. This requires a partnership to know the residency status of all of its individual partners. A state may provide some guidance on this – California, for example, allows partnerships to assume that having a California street address for a partner absolves the partnership of responsibility in respect of that partner,[77] as long as it does not say "in care of."

Some regimes target entities as well, for example C corporations[78] or upper-tier partnerships.[79] Again, this requires a level of knowledge the partnership may not have. An entity denominated an LLC might be a disregarded entity wholly-owned by a nonresident, in which case as a tax matter the partner really is a nonresident; it might itself be a partnership; or it might have checked the box and been classified as a C corporation.

Withholding or estimated tax obligations in respect of entities also creates the potential for confusion where there are tiers of pass-through entities. If a California partnership is required to withhold out of distributions to an upper-tier partnership, for example, the withholding will be calculated with respect to the entire distribution to the upper-tier entity, even though that entity might be partially, or even entirely, owned by California residents who would not, in their individual capacities, be considered targeted partners.

There also may be discriminatory features of these tax regimes that potentially rise to the level of a constitutional problem. Requiring partnerships to pay the taxes of nonresidents may, or some fact patterns, make a nonresident individual a less attractive business partner. Requiring partnerships to calculate the targeted partners' taxes at a specified rate – usually the highest – and without taking into account other losses, deductions or credits that might actually be available to the partner, can effectively force nonresidents to pay estimated taxes on a less favorable basis than a similarly situated resident would pay. In a particularly egregious case, an offended targeted partner might have a legitimate constitutional complaint.

These and other potential problems with partnership withholding and estimated tax regimes make the available "escape hatches" important. There are differing mechanisms through which states may "turn off" a partnership's obligations to make payments in respect of a particular partner. California's system for nonresident members of LLC's, for example, is triggered only in respect of members who have failed to provide, for filing with the LLC's tax return, a consent form indicating they will file in California.[80] New York has a somewhat similar system for nonresident individuals and C corporations, except that they simply provide the requisite forms, on a periodic basis, to their partnerships.[81] California's more broadly applicable withholding regime permits partnerships to request waivers from the Franchise Tax Board – a somewhat more cumbersome process but potentially useful, especially where tiered entities are concerned.[82] California does not, however, provide any waiver of its IRC § 1446-like obligation to "withhold" California tax out of income allocated to foreign persons.[83]

Whatever the mechanism, there obviously can be considerable advantage to securing the necessary paperwork to liberate a partnership from the financial and practical obligations to pay partners' taxes for them.

C. <u>Composite Filings</u>

At the other end of the spectrum lie SALT provisions that enable partnerships to elect to make their partners' lives easier by filing tax returns <u>and</u> paying taxes for them. Numerous states have provisions under which eligible partners can satisfy their state tax filing obligations in respect of partnership income by being included in a composite return. Under these mechanisms, the partnership files a tax return on behalf of the eligible partners and pays their income tax. This tax is usually calculated at the highest rate, taking into account only the partnership's income, and without regard to any other items a partner might, on his own, take into account in calculating his state tax liability.

Composite returns offer an efficient and effective way to deal with one of the biggest drags on the SALT treatment of investment partnerships – the obligations of every partner, all the way up the chain, to file tax returns in every state in which their partnerships, directly or through lower-tier entities, earn state or local taxable income. Particularly in circumstances in which the tax to be paid can easily be funded by the distributions that would otherwise be made to the partners, composite filing solves the problems of both taxpayers and tax collectors in a manner that achieves rough justice, without driving everyone crazy.

The problem is that existing composite return rules are neither uniform nor particularly easy to work with. Frequently they are limited to nonresidents whose sole source of in-state income is the filing partnership.[84] An individual who invests in two partnerships, therefore, is ineligible. Sometimes a spouse's investment in another partnership likewise renders the nonresident ineligible. Some regimes restrict composite filings to human beings,[85] leaving trusts, corporations, and upper-tier pass-throughs in the lurch. And in some cases the paperwork required to file composite returns can be daunting.

Given that composite returns are generally elective, and serve mainly to enable compliance with a minimum of friction, it would seem logical to make these regimes as user-friendly as possible. Particularly in the context of hedge funds, where it can be complex to follow state or local income up the chain to the ultimate taxpayer, and where the affected taxpayers might rationally (if not legally) conclude that the ratio of the tax owed to the filing burdens involved does not merit compliance, a simple mechanism for making composite filings broadly available makes a great deal of sense. Unfortunately, that is not where we currently are.

D. Entity-Level Fees

States have experimented, with varying results, with a variety of fees imposed on pass-through entities. Often LLC's incur much higher fees than limited partnerships. Fees have been structured based on a dollar amount per member; a percentage of income or assets; or a simple annual fee for the privilege of being. At the extreme, fees have been successfully challenged as not sufficiently coordinated with state activity to withstand constitutional muster. In others, the fees have come to be understood as not operating particularly rationally. While potentially only a nuisance, on some facts these fees can represent a real and significant cost, and one to be planned for, particularly where tiers of entities with multi-state sources of income are involved.

E. Non-Income Taxes

Obviously, while entities classified as pass-throughs for federal income tax purposes should at least start from the same premise in analyzing their state and local income tax situation, the SALT world is full of taxes in which income tax classification is completely irrelevant. Sales taxes, real property transfer taxes, stock transfer taxes, property taxes (real, personal and intangible), and myriad other approaches to state and local revenue raising appear frequently at the state and local level, and can loom large. These taxes frequently treat income-tax pass-through entities as taxpayers, basically having no reference to their tax-free classification under income tax principles.

One of the more interesting aspects of these non-income taxes, in the context of pass-through entities, is the treatment of series LLCs.[86] These are state law vehicles in which different series of investments can be identified, with the LLC members having varying shares (or perhaps no share) in different series, and the assets of each series being walled off and protected from the liabilities of the other series.

Federal income tax experts have debated at length the proper characterization of these kinds of vehicles.[87] Apart from the questions of how many income tax partnerships, there are SALT questions that are not purely income tax issues. Is a transfer from Series A to Series B potentially subject to transfer tax? Sales tax? Do the in-state activities in Series A create nexus for the (different?) participants in Series B? Can we use a series LLC to wall off income from certain jurisdictions, and insulate partners who prefer not to incur state filing obligations? Are states really bound by the firewall concept, or can they collect unpaid taxes, for example a Texas margin tax, in respect of Series A activities out of Series B assets?

Not knowing the answers to some of the very basic federal questions, there should be no reason to assume we can divine the answer to these (and other) SALT questions. This is, however, another area in which the assumption that federal treatment will inform SALT is unwise.

IV. Special Allocations of State-Specific Income

As described above, an investment in a lower-tier pass-through entity can generate in-state-sourced income that is taxable to nonresidents. Similarly, the in-state presence of a lower-tier pass-through entity can generate nexus, and factors, that render an upper-tier entity subject to state tax. Depending upon the circumstances, these results could prove to be more trouble than they are worth, whether by engendering state tax filings by myriad partners, each of whom has only a small share of the in-state income; or by creating a taxable status that taints other income or activities.

This problem leads to the question whether income derived from certain state tax-sensitive investments or operations could be specially allocated to certain partners, and away from others, so as to achieve the result of capturing the state income and related tax filing obligations in some partners, while absolving others.

There are at least two different angles to this questions. On the one hand, an allocation might seek to channel state income to Partner A, and away from Partner B, simply to locate all of the in-state income and filing responsibilities in A, who will fully pay all the tax imposed by all affected jurisdictions on that particular income stream. This effort is not directed by a desire to reduce state taxes, only by a desire to contain them within a limited population.

Alternatively, one might seek a special allocation of state or local taxable income for more proactive planning reasons, such as the desire to direct income from state or local bonds to those individuals whose home states will grant exemptions for such income. This kind of special allocation does not seek to simplify compliance; it would use the allocations to reduce the partners' overall SALT burden.

The question whether such allocations "work" is an interesting one. As a general matter, assuming states' income taxes start with federal income, one needs at a minimum to design an allocation regime that passes muster under federal income tax principles.[88]

The question then arises whether the states might layer on their own rules to constrain special allocations of state-specific income. New York, for example has recently promulgated regulations, under both the corporate tax and the personal income tax, describing situations in which allocations may not be respected by the State. The corporate regulation states that an allocation will not be respected if it has the principal purpose of the evasion or avoidance of any tax imposed by the state or any of its political subdivisions on the corporation or the combined group of which it is a member.[89] Under the personal income tax an allocation likewise will not be respected if its principal purpose is the avoidance or evasion of the personal income tax.[90]

V. SALT and Investment Activities

While states with income taxes generally seek to impose tax on persons earning income from in-state activities, there are certain respects in which in-state investment activities can be kept below the threshold for the imposition of tax.

A. Individuals

As noted, investment income from intangibles generally is sourced to an individual's domicile, and taxed there, or not taxed at all if the home state has no income tax.

Moreover, while as a federal matter the activity of trading for one's own account can depart from pure investment and rise to the level of a trade or business, states may not go so far as to tax nonresidents engaging in such in-state activities. New York, for example, provides that a nonresident (other than a dealer) will not be considered engaged in business in New York solely by reason of the purchase or sale of property, or the purchase, sale or writing of stock option contracts, or both, for his own account.[91]

In Lanzi,[92] however, Alabama sought to tax a nonresident on his distributive share of income earned as a limited partner in a partnership managed by his parents in Alabama. The courts eventually agreed with the taxpayer that the ownership of a limited partnership interest was not sufficient, in itself, to subject the taxpayer to the taxing jurisdiction of the state in which the partnership conducted its activities.

Lanzi was decided on jurisdictional grounds, and raises questions far beyond pure investment activities. Not insignificantly, it no doubt led to the rather stringent rules Alabama applies to enable partnerships to qualify for pass-through status. In other jurisdictions, however, there are favorable statutes that exempt nonresident partners from tax on income derived from investment partnerships. These rules tend to impose both asset and income tests on the partnerships, necessary to qualify their nonresident partners for exemption from state tax.[93]

B. Partnerships

Jurisdictions that impose tax on the business activities may carve investment activities out of the scope of the tax. The New York City unincorporated business tax, for example, provides that an individual or unincorporated entity is not subject to UBT solely by reason of the purchasing, holding or sale of property, or the entry into a position in property, for his or its own account, or as a result of acquiring or owning, other than in the ordinary course of a trade or business, interests in other entities that qualify for the self-trading exemption.[94]

Texas' margin tax has a somewhat similar rule, for "passive" entities. As detailed above, that exemption requires that 90% of income be "passive income," as defined.[95]

C. Corporations

The bias in the taxation of corporation is an assumption that their activities are a business, and thus are taxable. In New York, for instance, there is authority holding that a corporation whose activities are limited to monitoring and administering various investments is nonetheless "doing business," and thus subject to tax.

There may, however, be special rules applicable to investment income. As noted, UDITPA divides income between business and nonbusiness, and removes nonbusiness income from the tax base of all but the corporation's state of domicile (i.e., commercial domicile).[96] Whether it is possible in a UDITPA state, for a corporation to have only nonbusiness income is an interesting question, with no clear answer.

To encourage its attractiveness as a headquarters state, New York apportions investment income by reference to the factors of the investees, not the investor. While this approach has been questioned of late,[97] it has withstood challenge.[98]

Most states conform to the federal income tax treatment of regulated investment companies. However, as "captive" REITs and RICs have come to be used by corporate groups to eliminate state taxation altogether, states are attempting different means to change their treatment of such investment vehicles.[99]

As noted above, New York provides a special rule for corporations investing in "portfolio investment partnerships."

Finally, foreign corporations may find relief under state parallels to IRC § 864. New York, for example, provides by statute that a non-U.S. corporation will not be treated as taxable based solely on its activities of investing or trading in securities or commodities for its own account.[100] Note in this regard that it was necessary for the New York provision to cover not only trading, as specified in IRC § 864, but also investing, because investing by itself could otherwise be sufficient to invoke state tax.

VI. Managers' Income

The people who run hedge funds and other investment vehicles derive various different types of income. At the federal level the most significant aspect of this subject revolves around tax rates, and specifically whether profits will be taxed as ordinary income or eligible for more favorable rates, currently 15% federally, applicable to certain investment income. Another significant question is timing, meaning the degree to which a manger-type may accrue compensation or other income but defer having to pay tax on it.

At the state and local level there are two additional questions of significance – whether the income is taxable at all, and if so where. Because taxpayers may reside, and derive income, is different jurisdictions at different times, the character, allocation, and timing of income can significantly affect the total SALT burden. For that reason, correctly identifying the type of income being earned can be significant.

A. Employment Income

Individuals earning income as employees are generally subject to tax in the jurisdictions in which their employment-related services are performed. Thus, the Connecticut resident who commutes to New York pays New York State (but not City) nonresident income tax, and Connecticut allows a credit against his resident income taxes for the source-state income tax paid to New York.

When individuals work in multiple locations, the location-of-performance rule can get complicated. While many individuals simply report all income as sourced to the location of their main office, the theoretically correct treatment (in most cases) is to identity the individual's physical location when performing services, and allocate the wages among those jurisdictions. That usually is done on a days:days basis, but if it can be shown that a particular portion of compensation, for example a bonus, was earned for particular work, it may be possible to further subdivide the allocation.

Obviously this location-based apportionment of wages requires considerable record keeping. And when deferred compensation is involved, that record-keeping can span several years. Where highly compensated individuals are involved, however, or in circumstances where allocation can reduce one's overall tax bill, proper documentation of the place in which services were performed can be very important.

One important caveat to the place-of-performance rule is New York's so-called "convenience of the employer" test.[101] Under this rule, individuals are required to allocate out-of-state work back to the in-state location of the employer when the services were performed out of state for the employee's convenience, and not as a requirement of the employer. Thus, the Connecticut resident who works from home must treat those workdays as New York workdays, unless he can establish he was working in Connecticut to fulfill his employer's needs.

There is legislation pending in Congress[102] that would curtail states' ability to tax nonresidents on in-state earnings, by providing that nonresidents are not subject to tax unless they spend at least 60 days working in the jurisdiction. What will come of that legislation remains to be seen.

B. Partners/Business Owners

As described above, businesses generally apportion their income among the jurisdictions based on factor apportionment. An individual partner in a service business does not, therefore, source his income to the state or office where he works. Instead the business applies the apportionment rules of each relevant jurisdiction, dividing its income among its places of business, and the partners then use that apportionment to report their respective distributive shares of income to each state. Whether that apportionment reflects payroll, property and receipts, or just receipts, or some variation on that theme, or perhaps a method of separate accounting, will depend on each jurisdiction's rules for apportioning business income.

What this means is that there can be a significant SALT difference between being an employee and being a partner. Some people have sought to bridge this gap by being employed by personal service corporations, with the corporation being the partner in the partnership. New York legislation enacted in 2007 has curtailed that opportunity.[103] And while some think it is possible to characterize one's self as both as employee and a partner, the IRS, and most states, believe such an individual is properly characterized solely as a partner.

Thus, a partner in a firm earning income from management services will look to the apportionment rules applicable to businesses, and not the wage sourcing rules, for dividing his earnings among the states. Similarly, an investor deriving profits from a business enterprise conducted through a pass-through entity will divide his income among the states in which the enterprise conducts business.

C. Investment Income From Intangibles

Income derived from investments in stocks, securities, and gain on the sale of partnership interests, is generally considered income from intangibles, and sourced to the state of domicile. As described above, this can be of particular significance in circumstances where an individual is a dual resident. It also can put a premium on planning for the form of an investment, and the form of transaction from which profits will be realized.

VII. Current Events

A number of recent federal income tax developments in the hedge fund area raise collateral questions in the SALT world. At the end of the day, the key federal issues are, as usual, timing (defer if possible) and character (LTKG if possible). From a SALT perspective, timing almost always follows federal; whereas character often does not. It is therefore important to consider which of the current actual or proposed events will, at the SALT level, change, or not change, the bottom line.

A. IRC § 457A/Deferral

The federal bailout legislation included a new provision designed to accelerate service income that hedge fund managers had heretofore been able to defer.[104] As articulated in legislative history,[105] where the payors of compensation are not U.S. taxpayers, and thus indifferent to the deferral of their deductions for compensation, their U.S. payees should not be able to use to advantage the deferral of their compensation income.

Translating to SALT, the state and local timing of the recognition of compensation income almost always coincides with the federal. Individual income taxes key off federal principles, and it is virtually unheard of for a state or locality to move the timing of income recognition into a year different from that used federally.[106]

Where compensation income is successfully deferred, however, SALT issues of real significance can arise in the year of recognition. New York's Stuckless[107] debacle illustrates this confusion well. The basic questions are, if income from services performed in years 1 and 2 is includible in income in year 3, and the taxpayer has lived or worked in more than one jurisdiction during years 1, 2 and 3, which state lays claim to tax the income, and in what amounts? In theory the income should be sourced, and taxed, in the jurisdictions where the services were performed; and the state of the taxpayer's residence during the year of recognition should allow a credit for income taxes paid to the source state.

In practice, however, the record-keeping necessary to prove where compensation was earned often is not carefully maintained, especially in the case of individuals who perceive themselves as simply living and working in the same state. New York residents, for example, often do not keep track of non-New York working days, as they view themselves as fully taxable in New York in any event. If their residence thereafter changes, however, that lack of record-keeping can create problems. It also can be difficult to determine how much compensation relates to which time period. A simple approach of pro-rating the entire compensation over the relevant time period based on days in vs. days out is a common tool for allocating deferred compensation, but it may not be the most accurate.

B. Carried Interest Proposals

As described above, the SALT distinctions between service income and investment income lie not so much in the rate structure – states tend to have only one tax rate applicable to all income and gain. The bigger questions for state and local tax planning is whether the nature of the income is taxable or not. For a person resident in Florida when income is earned, for example, the difference between having compensation for services and investment income is whether the state in which services were once performed, say Connecticut, can lay claim to tax some part of that income as compensation earned for services performed in Connecticut. If income derived as a distributive share of partnership investment income is instead recharacterized as ordinary income for the provision of services, the state tax consequences are not so much a question of rates but a question of taxation of nonresidents, and concomitantly a question of allocation, which means record-keeping.

Along similar lines, where investment income earned by an entity might be exempt from entity-level tax or withholding/estimated tax requirements, a change in character could create new SALT obligations for the entity.

The federal proposals to change the tax treatment of "carried interests" are of course replete with issues on their own terms.[108] They also need to be considered in SALT terms as well, to identify the often different considerations that are implicated by a change in timing, character, or both.

C. Deductibility of Expenses

There has been a flurry of activity of late regarding the federal treatment of expenses incurred by investors in partnerships.[109] At its core, the debate revolves around whether certain expenses fall under IRC § 162 as ordinary and necessary expenses incurred in the trade or business of a partnership, or instead expenses incurred in an investment activity, and limited by rules relating to portfolio income, itemized deductions, and the AMT.

Again, because state and local income taxes usually derive from the federal the computation of federal adjusted gross income and taxable income will usually flow into individuals' state income tax analyses as well. Because states may exempt investment income altogether, however, the details of the § 162 vs. § 212 debate may have less SALT significance, for some classes of taxpayers.

For taxpayers fully subject to state income tax, the federal outcome can affect their state tax burden, perhaps in somewhat unpredictable ways. New York State, for example, has regulations translating the federal itemized deduction cutback under IRC § 68 to the related New York State modifications,[110] and also imposes its own limitation on itemized deductions.[111]

D. New York City UBT

As noted above, New York City's unincorporated business tax excludes from the tax partnerships whose activities are limited to investing or trading for their own account. By contrast, a partnership that earns fees for management services would pay a 4% UBT on its compensation income. This dichotomy between taxable and nontaxable income frequently drives hedge fund "managers" to separate their activities into two different vehicles, one a UBT-taxable entity that earns service income, and the second a UBT-exempt investment vehicle deriving a share of the fund's investment income.

A few months ago a study was released by a fairly left-minded think tank that essentially leapt ahead of the federal carried interest debate to posit that investment income derived by manager-types be subjected to the UBT. How exactly such a proposal might work is not clear. Nor is it clear that the City, already geographically unique in imposing a tax on pass-through entities, would be advantaged overall by erecting any further disincentives to the conduct of financial activities within its borders.[112] In stressed financial times such as these, however, no tax increase should be considered beyond the realm of possibility.

---

1 See Treas. Reg. §§ 301.7701-2, -3.

2 Internal Revenue Code ("IRC") § 701.

3 See, e.g., N.Y. Tax Law §§ 2(5), 2(6), 658(c).

4 See, e.g., N.Y. Tax Law §§ 611 et. seq. Under New York law an individual is considered a statutory resident of New York State if he or she is domiciled in New York (with certain carve-outs), or if he or she maintains a permanent place of abode in New York and spends more than 183 days in the state. N.Y. Tax Law § 605(b). The City applies the same tests.

5 "Domicile" is generally defined as the place to which a person intends to return.

[6] See, e.g., N.Y. Tax Law § 631.

[7] This assumes the intangibles have not acquired a "business situs" in the state. An example of that would be securities held for sale to customers by a broker-dealer, or investments held as working capital for an in-state business. See N.Y. Tax Law § 631(b)(2).

[8] See, FL. Const. Art. VII § 5(a), prohibiting the imposition of a state personal income tax.

[9] Note that, in early 2008, New York's then Governor introduced legislation that would have characterized a non-resident's gain on the disposition of an interest in a partnership owning New York real estate as New York gain. S.6810/A.9810, Part T. That provision was not enacted.

[10] Compare, however, potential differences in holding periods and character. See, e.g., IRC §§ 1221, 1223, 1231, 741 and 751.

[11] See, e.g., N.Y. Tax Law § 605(b)(3) and (4). Trusts classified federally as grantor trusts will generally have the same SALT treatment, with the grantor taxed on the trust income. Note, however, that the disconnect between the trust as owner of the trust assets and the grantor as taxpayer can raise some interesting jurisdictional questions.

[12] See, e.g., N.Y. Tax Law § 618.

[13] See, e.g., N.Y. Tax Law § 605(b)(3).

[14] 280 U.S. 83 (1929).

[15] Mercantile-Safe Deposit & Trust Co. v. Murphy, 19 A.D. 765 (1963), aff'd 15 N.Y. 2d 579 (1964).

[16] N.Y. Tax Law § 605(b)(3)(D).

[17] The locus of trustees is based on an individual's domicile, or in the case of a corporate trustee, its commercial domicile. See J.P. Morgan Chase, TSB-A-04(7)I.

[18] In the case of intangible assets, location is determined by reference to the domicile(s) of the trustee(s). Id.

[19] For this purpose the rules applicable to nonresident individuals determine source. See, e.g., N.Y. Tax Law § 631.

[20] See In the Matter of Amauris Trust et al., DTA No. 821 369 et al., N.Y.S. A.L.J., (July 24, 2008) (addressing the time at which a settlor's residence is determined).

[21] U.S. Const. Fourteenth Amendment.

[22] U.S. Const. Art. I § 8 cl. 3.

[23] In New York, for example, corporations are subject to tax if they are "doing business," maintaining an office, or owning or leasing property in the state. N.Y. Tax Law § 209(1). State standards of nexus are limited by the federal Constitution, but can be narrower.

[24] Lanco Inc. v. Dir., Div. of Tax'n, 908 A.2d 176 (N.J. 2006).

[25] Lanco, supra, cert. denied, 127 S.Ct. 2974 (2007). Cf. Quill Corp. v. North Dakota, 504 U.S. 298 (1992), in which the Supreme Court held that an in-state physical presence is, under the Commerce Clause, a necessary prerequisite to the obligation to collect and remit sales and use taxes on sales made to customers in that state.

[26] N.Y.C.R.R. § 1-3.2(a)(5).

[27] N.Y.C.R.R. §§ 1-3.2(6)(i), (6)(iii)(d).

[28] N.Y.C.R.R. § § 1-3.2(6)(i) and (ii).

[29] See Delaware Limited Liability Company Act § 18-701.

[30] On a possibly related note, see Wisconsin v. J.C. Penney, 311 U.S. 435 (1940) and International Harvester Co. v. Wisc. Dep't of Tax'n,, 322 U.S. 435 (1944), upholding state income tax on dividends paid to shareholders by corporations with in-state business activities.

[31] Complete Auto Transit v. Brady, 430 U.S. 274 (1977).

[32] See the "Uniform Division of Income for Tax Purposes Act," or "UDITPA."

[33] See, e.g., N.Y. Tax Law § 210(3)(a).

[34] UDITPA § 1(e), defining "nonbusiness income."

[35] N.Y. Tax Law § 210(210(3)(b).

[36] See, e.g., N.Y.C.R.R. § 3-13.3(a)(1).

[37] But see, e.g., New York's carve out for certain corporate limited partners, discussed below.

[38] N.Y.C.R.R. § 4-6.5(a)(2)(ii).

[39] GTE Spacenet Corp. v. NYS Dep't. of Tax'n & Fin., 224 A.D.2d 283 (1996).

[40] See Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425 (1980).

[41] IRC § 1362.

[42] GA. Code Ann. § 48-7-21(b)(7).

[43] See, e.g., N.Y. Tax Law § 660.

[44] N.Y.C. Admin. Code § 11-602(8)(ii).

[45] N.Y. Tax Law §§ 208(5), 210(3)(b).

[46] N.Y. Tax Law § 660(i).

[47] Pa. Stat. Ann. 72 § 7303; Pa. Code 61 § 103.1-103.19.

[48] N.Y.C. Admin. Code Chapter 5 (the "UBT"). New York State once imposed a similar tax, but it has been repealed. As discussed below, the UBT is not applicable to certain investment companies.

[49] N.Y.C. Admin. Code §§ 11-503, 11-506, 11-507.

[50] See Davis v. Kentucky, 128 C.Ct. 1801 (2008), in which a similar Kentucky add-back was upheld as not giving rise to unconstitutional discrimination.

[51] N.Y.C. Admin. Code § 11-507(3).

[52] N.Y.C. Rules § 28-06(d)(ii)(D).

[53] See, e.g., In the Matter of Proskauer Rose LLP, New York City Tax Appeals Tribunal, TAT(E)08-19 (UB) Nov. 5, 2007.

[54] N.Y.C. Admin. Code §§ 11-501(h), 11-508(f).

[55] N.Y.C. Admin. Code § 11-508(c). The former allowance of a "books and records" method no longer obtains, nor does the requirement that a taxpayer maintain a regular place of business outside the City in order to allocate income. N.Y.C. Rules § 28-07.

[56] N.Y.C. Rules § 28-07(d)(iii).

[57] N.Y.C. Rules § 28-07(h).

[58] N.Y.C. Rules § 28-07(h).

[59] N.Y.C. Rules § 28-07(j)(3).

[60] N.Y.C. Admin. Code § 11-503(j).

[61] The UBT does allow for NOL carryforwards. In addition, unused credits from lower-tier entities can be carried forward for seven years, provided there is an ongoing ownership interest of at least 80%.

[62] Texas Tax Code §§ 171.001(a), et seq.

[63] Texas Tax Code §§ 171.101(d).

[64] Proposed Rule 3.582.

[65] Proposed Rule 3.582.

[66] Proposed Rule 3.582 (b)(8).

[67] Proposed Rule 3.582. See also Texas Tax Code §§ 171.0003 and § 171.0004.

[68] Texas Tax Code §§171.0001(7) and 171.0002(a).

[69] Texas Tax Code § 171.1014.

[70] Rule 3.590(b)(2).

[71] Rule 3.590(b)(2).

[72] Texas Tax Code § 171.0001(1) and (8).

[73] Cal. Rev. & Tax. Cd. § 18662.

[74] Cal. Rev. & Tax. Cd § 18662. Compare IRC § 1446.

[75] See N.Y. Tax Law § 658(c)(4).

[76] See IRC § 752.

[77] See California FTB Informational Publication No. 1017, December 1, 2007, Q&A #33.

[78] N.Y. Tax Law § 658(c)(4).

[79] See Cal. Pub. 1017, Q&A #19.

[80] Cal. Rev. & Tax. Code § 18633.5(e).

[81] NY Forms IT-2658-E, CT-2658-E.

[82] Cal. Pub. 1017, Q&A #38, ##59-69.

[83] Cal. Rev. & Tax Code § 18666; Cal. Pub. 1017, #114.

[84] See, e.g., Ga. Code Ann. § 48-7-129.

[85] See, e.g., Cal. Rev. & Tax. Code § 18535.

[86] Delaware Limited Liability Act § 18-215.

[87] For a thoughtful discussion of similar issues, see New York State Bar Association Report #1154, Notice 2008-19 and Protected Cell Companies Outside of the Insurance Arena.

[88] In particular, the federal rules requiring that partnership allocations have "substantial economic effect" must be addressed. Treas. Reg. § 1.704-1(b).

[89] N. Y. C. R. R. § 3-13.3(a)(3).

[90] N. Y. C. R. R. § 117.5.

[91] N.Y. Tax Law § 631.

[92] Joe E. Lanzi III v. Alabama Department of Revenue, 968 So. 2d 18 (Al. Ct. of Civ. Apps., 2006), cert denied by the Alabama Supreme Court, April 13, 2007.

[93] See, e.g., 35 ILCS § 5/1501(a)(11.5); Ky. Rev. Stat. Ann. § § 141.206(12), 141.020; N.J. Admin. Code § 18:7-1.21 (relating to withholding).

[94] N.Y.C. Admin. Code § 11-510.

[95] See Section III.A.2., above.

[96] See AlliedSignal Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992); MeadWestvaco Corp. v. Ill. Dept. of Revenue, 128 S. Ct. 1498 (2008).

[97] See Mead Westvaco, supra.

[98] See AlliedSignal Corp. v. Tax Appeals Tribunal, 79 N.Y. 2d 73 (1991).

[99] See, e.g., N.Y. Tax Law §§ 209(5) and (7), as amended by the 2007, and then the 2008, Budget Bills.

[100] N.Y. Tax Law §209(2-1).

[101] N.Y. C. R. R. § 132.18(a).

[102] Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, H. R. 3359.

[103] N.Y. Tax Law § 632-a(a)(1).

[104] IRC § 457A.

[105] See Senate Finance Committee Staff Summary of S. 3335.

[106] One rare exception to federal/state conformity in the timing of recognition is New York's rule requiring residents to accelerate, for example, gain deferred under the installment method, when they are changing from resident to nonresident status. The difference with such a rule is that the amount of income has generally been fixed, it is simply the payment of tax that the federal installment sales provisions defer.

[107] In the Matter of E. Randall Stuckless, NYS TAT, DTA No. 819319.

[108] See NYSBA Tax Section Report No. 1166 "Report on Proposed Carried Interest and Fee Deferral Legislation."

[109] See Rev. Rul. 2008-12, 2008-10 IRB 520; Rev. Rul. 2008-38, 2008-31 IRB 1; IRS Ann. 2008-65, 2008-31 IRB 1; and Rev. Rul 2008-39, 2008-31 IRB 1.

[110] See N.Y.C.R.R. § 115.2 (modification adding back federal deductions claimed for state income taxes is not to exceed the federal tax benefit of such deductions.)

[111] N.Y. Tax Law § 615(f).

[112] Note also that the UBT is only partially creditable against the personal income taxes paid by New York City residents. N.Y.C. Admin Code § 11-1721.