



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #104

Corporate Income and Franchise Tax -- Tax Treatment of Corporate Partners and LLC Members (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 2001-03 Budget Summary: Page 28, #10]

CURRENT LAW

Under current law, a corporation that is not doing business in Wisconsin and that holds an interest in a partnership or limited liability company (LLC) that is doing business in the state is not subject to the state corporate income and franchise tax if its interest is not an extension of the corporation's business.

GOVERNOR

Modify current corporate income and franchise tax provisions related to the tax treatment of corporations that are partners or members of limited liability companies as follows:

a. Define "doing business in this state" to include owning, directly or indirectly, a general or limited partnership interest in a partnership that does business in the state or an interest in an LLC that does business in the state, regardless of the percentage of ownership.

b. Provide that, for state income and franchise tax purposes, a general or limited partner's share of the numerator and denominator of a partnership's apportionment factors would be included in the numerator and denominator of the general or limited partner's apportionment factors. Similarly, for an LLC treated as a partnership, a member's share of the numerator and the denominator of an LLC's apportionment factors would be included in the numerator and denominator of the member's apportionment factors.

These provisions would first apply to tax years for partners or LLC members that begin on January 1, 2001.

These provisions would increase corporate income and franchise tax revenues by an estimated \$7,500,000 in 2001-02 and \$5,000,000 in 2002-03. The higher figure in the first year includes one-time revenues of \$2,500,000 from reconciling estimated and final tax payments.

DISCUSSION POINTS

1. The tax treatment of corporations that are partners or LLC members depends on the location of the corporation's and partnership's or LLC's activities and whether or not the partnership or LLC is an extension of the corporation's business:

a. Corporate Partners or Members Engaged in Business Wholly within Wisconsin. A corporation that is engaged in business wholly within Wisconsin and that is a partner or member of an LLC is required to include its share of partnership or LLC net income in its Wisconsin net income or loss. For a corporation engaged in business wholly in Wisconsin, all income is subject to the Wisconsin corporate income and franchise tax.

b. Corporate Partners or Members Engaged in Business Both In and Outside Wisconsin. A corporation that is engaged in business both in and outside of Wisconsin and that is a partner or member of a partnership or LLC is generally required to include its share of partnership or LLC income in its apportionable income or loss. However, computation of the corporation's apportionment factors depends on whether or not the corporation's interest in the partnership or LLC is an extension of the corporation's business. If the partnership or LLC is an extension of the corporation's business, the corporation combines its share of the partnership's or LLC's apportionment formula factors (property, payroll and sales) in the numerator and denominator of its apportionment factors to determine the income that is allocated to the state. If the corporation's ownership interest in the partnership or is not an extension of the corporation's business, no part of the partnership's or LLC's property, payroll or sales are included with the corporation's apportionment factors.

c. Corporate Partners or Members not Engaged in Business in Wisconsin. A corporation that is not otherwise engaged in business in Wisconsin and that is a partner or a member of partnership or LLC that is engaged in business in Wisconsin is subject to taxation on its share of partnership or LLC income only if the partnership or LLC is an extension of the corporation's business. If the partnership or LLC is an extension of the corporation's business the corporate partner or member is engaged in business in Wisconsin as a result of holding an interest in the partnership or LLC. The corporation's share of the partnership's or LLC's income or loss is taxable under the state corporate income and franchise tax. In addition, the corporate partner or member includes its share of the partnership's or LLC's formula factors in determining the income that is allocated to Wisconsin. If a corporate partner or member has an interest in a partnership or LLC that is not an extension of the corporation's business, the corporation is not subject to Wisconsin income

or franchise taxation. The corporation is not considered to be engaged in business in Wisconsin based on its interest in the partnership or LLC.

2. The term "extension of the corporation's business" is not clearly defined. If the corporation is a general partner in a partnership, the partnership is deemed an extension of the corporation's business since a general partner has unlimited liability, and management and control rights in a partnership. In cases where the corporation is a limited partner or LLC member, facts and circumstances determine whether the partnership or LLC is considered an extension of the corporation's business.

3. An individual partner's or LLC member's (including nonresidents) portion of partnership or LLC income or loss that is attributable to a business located in Wisconsin, services performed in Wisconsin, or real or tangible property located in Wisconsin must be included in computing Wisconsin taxable income. For individual partners or members, business income is taxable under the Wisconsin individual income tax whether or not the individual conducts business in Wisconsin.

4. Under current law, determination of whether a corporation's interest in a partnership or LLC is an extension of the corporation's business is generally made on a case-by-case basis which makes it difficult for taxpayers to comply with and the Department of Revenue (DOR) to administer. In addition, the complexity in determining if a partnership or LLC is an extension of the corporation's business can allow businesses to restructure their operations to avoid paying corporate franchise and income taxes on income generated by Wisconsin business activities.

5. The following is an example that illustrates how a corporation could restructure its activities to avoid taxation in Wisconsin. ABC Corporation, a Delaware corporation, has been engaged in a retail business in Wisconsin. ABC Corporation restructures its activities by putting its Wisconsin retail operations into XYZ limited partnership and transferring the ownership in this limited partnership in two newly created, wholly-owned subsidiaries, S1 and S2, that are incorporated in Delaware. S1's only activity is to hold 1% general partnership interest in XYZ. S2's only activity is to hold a 99% limited partnership interest in XYZ. As a result of this restructuring, ABC is generally no longer subject to Wisconsin franchise or income tax. XYZ limited partnership is doing business in Wisconsin, but is not subject to tax because it is a pass-through entity. As a partnership, XYZ's income, losses, and deductions pass through to S1 and S2.

As noted, under current law, a corporation would be treated as doing business in Wisconsin as a result of holding an interest in a partnership that does business in Wisconsin only if the partnership is an extension of the corporation's business. S1 would be treated as doing business in Wisconsin as a result of holding a general partnership interest in XYZ, which is engaged in retail activities in the state. XYZ would be considered an extension of S1's business. S1's 1% share of XYZ's Wisconsin net income would be subject to the state income and franchise tax. However, it is likely that S2 would not be considered to be doing business in Wisconsin. XYZ would not be an extension of S2's business. Therefore, S2 would not be required to file a Wisconsin corporation tax return and its 99% share of XYZ's income would not be subject to taxation in the state. Note that if

XYZ's interests were held by individuals rather than by a corporation, the 99% share of limited partnership income would be subject to the state income tax. The example shows that, under current law, ABC corporation was able to restructure and avoid Wisconsin taxation of 99% of its income from retail activities in the state.

6. Tax practitioners have indicated that the proposed law change could have some unintended negative effects that would reduce state tax revenues. First, Wisconsin corporations whose business activities are entirely in-state other than a limited interest in an out-of-state partnership or LLC generally include all of the income from the out-of-state entity in Wisconsin net income subject to the state corporate income tax. The corporation is not treated as doing business in the state in which the partnership or LLC operates and the income from the out-of-state entity is treated as investment income taxable to Wisconsin. However, under the proposed tax law change, the corporation would be considered as doing business in the state in which the partnership or LLC was located and the corporation's income would be subject to apportionment. As a result, only a portion of the income from the out-of-state entity would be allocated to Wisconsin for tax purposes. There is also concern that the proposed law change could be subject to court challenge because the ownership interest that would be used to impose the state corporate income tax would not constitute sufficient nexus for the state to impose the tax. In addition, some believe the change would result in the state taxing income derived from business transacted in Wisconsin. This would make the corporate income and franchise tax similar to the individual income tax, rather than being a tax imposed on the exercise of a franchise or income from doing business in the state. This could lead to a court challenge that could question the state's ability to tax income from federal obligations under the corporate franchise tax.

7. The Department of Revenue has suggested modifications to the statutory provisions included in the bill. The Department recommends specifying that owning an LLC would be considered doing business in the state only if the LLC is treated as a partnership for federal income tax purposes. This would clarify that an LLC treated as a corporation would be subject to tax as a separate entity just as a subsidiary corporation is. DOR also recommends including a severability provision, such as the phrase "subject to constitutional limitations", so that any court ruling that the definition is unconstitutional when applied to a particular set of facts would not invalidate the statute in other cases.

ALTERNATIVES TO BILL

1. Approve the Governor's recommendation to modify current corporate income and franchise tax provisions related to the tax treatment of corporations that are partners or members of limited liability companies to define "doing business in this state", and specify the treatment of a partnership or LLC's apportionment factors.

2. Approve the Governor's recommendation and specify that owning an LLC would be considered doing business in the state only if the LLC is treated as a partnership for federal income tax purposes and include a severability provision in the definition of "doing business."

3. Maintain current law.

Alternative 3	GPR
2001-03 REVENUE (Change to Bill)	- \$12,500,000

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