

## MEMORANDUM

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**TO**           **Members, Alabama State Bar Tax Section**

**FROM**       **Bruce P. Ely (Chair, State Legislation Committee); James E. Long, Jr.**

**DATE**       **June 15, 2009**

**SUBJECT**   **Act 2009-144: New Composite Return Filing Requirements for Alabama Subchapter K Entities with Nonresident Owners**

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Although Acts of Alabama 2009-144, signed into law on March 24 by Governor Riley (the "Act"), is more commonly known as the "Film Incentives Bill" – for the more publicized and politically-popular aspects of the legislation – the Act contains both good news and bad news for nonresident partners.\*

Following the national trend, *most* partnerships, LLCs, and other entities taxed under Subchapter K of the Internal Revenue Code and doing business in Alabama will now be required to file annual composite tax returns and remit Alabama income tax on behalf of their nonresident partners for all tax years beginning on or after **January 1, 2009**. *Tax Section members should quickly review, and encourage their clients and local CPA firms to quickly review, their partnership agreements and LLC operating agreements for possible amendments to incorporate these changes. Withholding provisions may now be appropriate.*

Under prior law, the Subchapter K entity was not required to file a composite tax return if the nonresident partner simply filed a consent agreement with the Alabama Department of Revenue ("ADOR"), agreeing to file an income tax return to report and pay tax annually on such partner's distributive share of Alabama-source income from the entity. But the trap for the unwary was this: if the nonresident partner filed the consent form, then later didn't pay the tax to the ADOR, the *entity* – and, indirectly, the other partners – became liable for the tax, interest, and any applicable penalties. *Ala. Code* § 40-18-24.1.

With certain exceptions discussed below, the composite return obligations are now mandatory under the Act. The former consent agreement/back-up composite return provisions were simultaneously repealed for Subchapter K entities but were retained for **Alabama S corporations** and their nonresident shareholders. Nor are **estates or trusts** subject to the new requirements. The ADOR supported the Act because of the revenue loss the State has suffered over the years due to the lack of mandatory composite returns or withholding by partnerships, especially with respect to the smaller nonresident partners for whom it simply was not cost-effective to track down. The composite return provisions are based on a model act issued by the Multistate Tax Commission, of which Alabama is an active member.

Because the Act's provisions were amended during House committee deliberations to be *retroactive to January 1, 2009*, Subchapter K entities whose nonresident partners had filed

\*All references herein to "partners" mean and include members of LLCs classified as tax partnerships.

consent agreements need to quickly familiarize themselves with the now mandatory composite return provisions, and watch for revised forms and proposed regulations to be issued by the ADOR. These entities also should promptly consider implementing withholding on distributions to their nonresident partners, subject to the terms of the partnership or LLC operating agreement. Withholding is authorized, although not required, by the Act.

Under the Act, Subchapter K entities are required to file an annual composite return on behalf of their nonresident partners, unless one of the exceptions discussed below applies, by the due date of the entity's annual Alabama information return. The Act's definition of "nonresident" is the same as prior law for individuals and business entities, plus the Act includes nonresident trusts and estates as partners subject to composite reporting. The composite return must report and accompany the Alabama income tax payment (at the highest marginal rate applicable to individuals, *i.e.*, 5%) on the nonresident partner's distributive share of income from the Subchapter K entity that is apportioned and allocated to Alabama at the entity level. The *entity* is liable for the income tax due to the ADOR, including any interest and penalties, but the entity is not liable to any partner for any amount it may withhold from distributions during the year in order to fund the composite tax payment. When the nonresident partners file their own Alabama income tax returns, they will receive credit for the income tax paid on their behalf by the partnership. Nonresident *individual* partners, however, are not required to file their own Alabama income tax return if their only Alabama income is from the partnership.

**Composite Return Exemptions for Certain Partnerships:** The Act's composite return requirements do *not* apply to a Subchapter K entity that qualifies either as a "qualified investment partnership" ("QIP"), or as a publicly-traded partnership ("PTP") as defined by section 7704(b) of the Internal Revenue Code. A QIP is specially defined under the Act as a Subchapter K entity: (a) with at least 90% of the cost of its assets consisting of qualified investment securities ("QIS"), office facilities and related personal property necessary to perform its investment activities; and (b) at least 90% of its gross income consisting of interest, dividends, distributions, management fees, and gains and losses from the sale or exchange of QIS. QIS include common and preferred equity, debt securities, financial institution deposits, derivatives and other related financial instruments, as well as partnership/membership interests in partnerships or LLCs that also qualify as QIPs.

*The Act also provides that Alabama income tax will not be due from nonresident partners with respect to their distributive shares of Alabama-source income related to the QIS, provided that they do not actively participate in the day-to-day management of the business.* The Act's QIP exemption is designed to be an economic development tool for investment funds and their managers, and should also resolve many of the lingering issues with nonresident partner nexus after the Alabama Court of Civil Appeals' 2006 landmark decision in *Lanzi v. State Department of Revenue*, thereby protecting these investors from further nexus attacks by the ADOR.

Finally, the Act authorizes the ADOR to exempt certain other nonresident partners, such as tax-exempt entities, from the composite return requirements, either by ruling or regulation. Most states that impose composite return requirements applicable to nonresident owners provide similar exemptions for tax-exempt entities, and at least twelve states specifically exempt QIPs by statute, with several others providing QIP safe-harbors by regulation or administrative practice.