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Louisiana Revised Statutes Section 47:201.1 and the Taxation of Nonresident Partners: An Alternate Proposal

Susan Kalinka*

During its 2000 session, the Louisiana Legislature added Section 47:201.1 to the Louisiana Revised Statutes.¹ Section 47:201.1 is designed to ensure that a nonresident owning an interest in a partnership or LLC that transacts business in Louisiana will pay Louisiana income tax on the nonresident's distributive share of the entity's Louisiana income. The requirements of Section 47:201.1 apply to partnerships in commendam, registered limited liability partnerships, and LLCs that are classified as partnerships.² For convenience, this article will refer to all such entities as "partnerships," and all owners of interests in such entities as "partners."

Section 47:201.1 closes an important loophole. The Louisiana income tax law always has required nonresident partners to pay tax on their shares of Louisiana income earned by a partnership. However, before Section 47:201.1 was enacted, there was no way to ensure that nonresident partners actually would pay the tax.

This article discusses the new law and the steps that must be taken to comply with its requirements. The new law offers taxpayers a choice that should be considered carefully. While Section 47:201.1 is designed to ensure payment of Louisiana income tax by nonresident partners, it does not ensure collection of tax from owners of interests in single-member LLCs or other entities that are disregarded as separate entities from their owners for tax purposes ("disregarded entities"). Section 47:201.1 also creates some ambiguity as to whether it applies to corporate partners. It is likely that the Louisiana Legislature will reconsider the statute and its application to corporate partners and owners of interests in disregarded entities. However, if the law is to be amended, the Louisiana Legislature should consider another method for collecting Louisiana income tax from nonresident partners and members of disregarded entities. This article suggests a more effective method of taxing partnerships and disregarded entities. The proposal advocated by this article would make applicable to a partnership or disregarded entity rules similar to the rules that apply to S corporations under the Louisiana Corporation Income Tax Act.

Partnerships and S corporations are pass-through entities for federal tax purposes. In general, a partnership or S corporation does not pay federal tax on its income.³ Instead, each partner pays tax on its distributive share of partnership

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1. 2000 La. Acts No. 21.

2. La. R.S. 47:201.1(A)(1), (2)(a) (Supp. 2001).

3. I.R.C. §§ 701 (2000) (partnership), 1363(a) (2000) (S corporation). An S corporation, however, may be subject to federal income taxation if it realizes any net built-in gains on the disposition of certain property or has excess net passive income. I.R.C. §§ 1374 (2000) (built-in gains tax), 1375

income and each shareholder pays tax on a pro rata share of the S corporation's income.⁴ Similarly, disregarded entities, such as single-member LLCs⁵ and qualified subchapter S subsidiaries⁶ do not pay tax on their income. Instead, the owners of such entities pay the tax.

Most states follow the federal rules in treating partnerships, S corporations, and disregarded entities as pass-through entities.⁷ Only a few states tax a partnership or an S corporation as a separate entity.⁸

If a state taxes a partnership or S corporation as a pass-through entity, there may be constraints on the state's ability to collect the tax directly from nonresident partners, S corporation shareholders, or owners of disregarded entities. There is some concern that a state may not have jurisdiction to seek the tax directly from a nonresident partner, S corporation shareholder, or disregarded entity owner. While the jurisdictional limitation is probably more of a concern than necessary, there are practical limitations that prevent a state from seeking the tax from a nonresident that does not have any assets in the state.

Section 47:201.1 of the Revised Statutes avoids these limitations by adopting the method used in many other states for collecting tax from nonresident partners and S corporation shareholders. Under Section 47:201.1, the partnership must withhold and pay to the state the tax on a nonresident's share of the partnership's income unless the nonresident partner agrees to be responsible for payment of the tax. Like the withholding statutes of other states, Section 201.1 permits, but does not require, the partnership to file a composite return, reporting and paying tax on a nonresident's share of the entity's income.⁹

The withholding requirement can be problematic, especially for S corporation shareholders. The payment of a nonresident shareholder's state income tax by an S corporation is treated as a constructive distribution to the nonresident shareholder.¹⁰ If the S corporation neglects to distribute a pro rata amount of cash or property to its resident shareholders in a year in which it pays tax on behalf of nonresident shareholders, the corporation will be considered to have more than one class of stock.¹¹ In that case, the corporation's subchapter S election will terminate.¹²

(2000) (tax on excess net passive income).

4. I.R.C. §§ 702(a) (2000) (partners), 1366(a) (2000) (S corporation shareholders).

5. Treas. Reg. § 301.7701-2(a) (2000).

6. I.R.C. § 1361(b)(3)(A) (2000). For a definition and discussion of qualified subchapter S subsidiaries, see *infra* notes 97-98 and accompanying text.

7. Prentiss Willson, Jr. & Mark Windfeld-Hansen, *State Taxation of Pass-Through Entities: General Principles*, 1500 Tax Management 0003, 0033 (1997).

8. See *id.* at 0004-5, 0034 and statutes cited therein.

9. For a discussion of some of the statutes requiring a partnership to withhold and pay tax on a nonresident partner's share of partnership income, see James Edward Maule, *State Taxation of S Corporations*, 1510 Tax Management 0094-0097. The composite return provisions are discussed *id.* at 0025-0026. For a detailed analysis of the states that authorize the filing of composite returns, see Worksheet I, *id.* at 6101-04.

10. Treas. Reg. § 1.1362-1(l)(2)(ii) (2000).

11. *Id.*

12. I.R.C. §§ 1361(b)(1)(D), 1362(d)(2) (2000).

While the withholding requirement is not as troublesome for partnerships as for S corporations, it poses potential problems in the partnership context. If a partnership pays state income tax on behalf of its nonresident partners, but not on behalf of its resident partners, accounting entries must be made each year to adjust the partners' capital accounts, or else offsetting distributions must be made to the resident partners to compensate them for the benefit the partnership conferred on the nonresident partners unless the nonresident partners reimburse the partnership. A partnership's payment of the tax may divert partnership funds that would better be used to invest in partnership operations.

In lieu of filing composite returns and paying Louisiana income tax on behalf of a nonresident partner, Section 47:201.1 permits the partnership to file an agreement by the nonresident partner in which the nonresident partner agrees to file Louisiana income tax returns and pay tax on the nonresident's share of partnership income. In this respect, the Louisiana statute is similar to statutes in other states that require nonresident S corporation shareholders to submit to the state's taxing jurisdiction.¹³ Unlike the Louisiana alternative, however, these S corporation statutes require the nonresident shareholders to agree to be subject to the state's taxing jurisdiction as a condition of permitting the S corporation to be treated as a pass-through entity. If an S corporation transacts business in such states, the shareholders must monitor all stock dispositions. If a nonresident acquires stock in the corporation, steps must be taken to ensure that the new shareholder signs an agreement submitting to the state's taxing jurisdiction. Otherwise, the S corporation may lose its status as a pass-through entity for state income tax purposes.

Louisiana has a different method of taxing an S corporation. The Louisiana income tax law allows an S corporation to be treated as a pass-through entity only to the extent that the shareholders actually pay tax on their pro rata shares of the corporation's Louisiana income. Nonresident shareholders are not required to agree to be subject to the state's taxing jurisdiction in order to ensure pass-through taxation, at least with respect to income allocable to resident shareholders. If a nonresident shareholder does not pay the tax on the nonresident's share of the corporation's Louisiana income, the corporation must pay the tax.

As explained above, the withholding and payment of state tax by an S corporation is treated as a constructive distribution to a nonresident shareholder. In contrast, the Louisiana Corporation Income Tax Act treats the tax as an obligation of the corporation. The Louisiana income tax law also eases the administrative burden of collecting tax from nonresident shareholders of an S corporation.

A partnership is a pass-through entity for Louisiana income tax purposes.¹⁴ Until the Louisiana Legislature enacted Section 47:201.1 of the Revised Statutes, however, the state had not adopted a withholding requirement or any other method to ensure that a nonresident partner would pay tax on the partner's distributive

13. Willson & Windfeld-Hansen, *supra* note 7, at 0037.

14. La. R.S. 47:201, 202 (1990).

share of the partnership's Louisiana income. While Section 47:201.1 resolves a number of concerns about the state's ability to tax a nonresident partner, the statute could be improved by adopting a method of taxing partnerships and disregarded entities that is similar to the rules that Louisiana uses for taxing the income of an S corporation transacting business in Louisiana.

The Louisiana rules for taxing S corporations provide administrative convenience and may protect the corporation from an inadvertent termination of its subchapter S election. However, S corporation shareholders must plan ahead to avoid other problems that may arise as a result of the Louisiana tax law. This article provides planning suggestions for shareholders in an S corporation transacting business in Louisiana. If Louisiana adopts the proposal for taxing nonresident partners advanced by this article, the same planning suggestions should be considered for taxpayers using the partnership form to conduct a Louisiana business.

I. THE NEED FOR SECTION 47:201.1: JURISDICTION TO TAX

The ability of a state to impose a tax on the income of a nonresident is limited by the United States Constitution. In order for a state to impose a tax on a person's income, the person or the income must have a sufficient "nexus" with the state.¹⁵ A state may impose a tax on the income of an individual who is a resident of the state, no matter where the individual's income is earned, without violating any principles of federal constitutional law.¹⁶ Accordingly, Louisiana imposes a tax on the income of individuals "domiciled, residing, or having a permanent place of abode in Louisiana . . . from whatever source derived . . ."¹⁷ While a nonresident partner is expected to pay the tax on the nonresident's share of the partnership's Louisiana income under the Louisiana income tax provisions,¹⁸ there may be a question as to whether the State of Louisiana has jurisdiction to seek payment for

15. In *Mobile Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-37, 100 S. Ct. 1223, 1231 (1980), the Supreme Court of the United States explained:

For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a "minimal connection" between the interstate activities and the taxing State, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise.

16. *New York ex rel. Cohn v. Graves et al.*, 300 U.S. 308, 57 S. Ct. 466 (1937).

17. La. R.S. 47:290(B)(1990). To ease the burden of the double taxation that might occur where the income of an individual derived from another state is subject to tax in the state from which the income is derived, Louisiana permits a resident individual to claim a credit against the individual's Louisiana income tax liability for income tax paid to another state with respect to that income. La. R.S. 47:33 (1990). It does not seem, however, that a shareholder of an S corporation who is a resident of Louisiana may claim a tax credit for the taxes imposed on the corporation by another state, regardless of whether the amount of tax is computed with respect to the shareholder's pro rata share of that income. Under Louisiana Revised Statutes 47:33, the credit is allowed only to a resident individual. Where the tax is imposed by another state on the S corporation with respect to the corporation's income, it seems that a credit will not be available to the shareholder. No Louisiana cases could be found on this issue.

18. La. R.S. 47:290(B) (1990).

the tax from the nonresident.¹⁹ The State of Louisiana may tax a nonresident on Louisiana income derived from property located in the state and from a business operated by the nonresident in Louisiana without violating constraints on the reach of state taxation under the United States Constitution²⁰ or any federal law.²¹ However, there may be a question as to the reach of the state's jurisdiction to tax a nonresident when the income is attributable to property owned by, or a business that is operated by, a partnership in which the nonresident is a partner.

A number of state courts and revenue agencies assume that a nonresident partner or LLC member has a sufficient nexus with the state through the business operations of the partnership or LLC to allow the state to assert its jurisdiction to tax the nonresident member.²² State courts have justified the taxation of a nonresident partner on grounds that do not apply to partners in partnerships formed under the Louisiana partnership law or the Revised Uniform Partnership Act, to LLC members, or to S corporation shareholders. Currently, there is no federal jurisprudence concerning the issue of whether a state may impose a tax on a nonresident S corporation shareholder, partner, or LLC member for the nonresident's share of the entity's income that is earned in the state.

The federal cases all concern a state's ability to tax a nonresident shareholder on distributions of a C corporation's income earned in the state. A C corporation is subject to a different taxing regime than a pass-through entity. Unlike a pass-through entity, a C corporation pays tax on its income when the income is earned.²³ The income of a C corporation is subject to a second tax when it is distributed to shareholders as dividends.²⁴ As explained earlier, a pass-through entity, such as an S corporation, partnership or LLC, generally does not pay tax on its income. Instead, the owners of the interests in the pass-through entity pay tax on the entity's income, regardless of whether that income is distributed to them. While the federal

19. For a discussion of the theories that may be asserted to justify taxation of nonresident LLC members and a rebuttal of each of the theories, see Payson R. Peabody, *Asserting Jurisdiction Over Nonresident LLC Members in the State Arena*, 10 J. of Multistate Tax'n and Incentives 6 (July 2000); Christina Edson Pritchard, *Nexus Considerations for Limited Liability Companies Under the Check-the-Box Regime*, 98 State Tax Today 182-20, Doc. 98-28496 (Sept. 21, 1998).

20. In *Shaffer v. Carter*, 252 U.S. 37, 57, 40 S. Ct. 221, 227 (1920), the Supreme Court explained: As to residents [a State] may, and does, exert its taxing power over their income from all sources, whether within or without the State. . . . As to nonresidents, the jurisdiction extends only to their property owned within the State and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources.

21. *But see* 15 U.S.C.A. §§ 381-384 (1997) (prohibiting a state from taxing income derived within the state by any person from interstate commerce if the only business activities within the state by or on behalf of the person during the taxable year are (1) the solicitation of orders for sales of tangible personal property if the orders are sent outside the state for approval or rejection and if approved, are filled by shipment or delivery from a point outside the state and/or (2) the solicitation of orders in the state in the name or for the benefit of a prospective customer if the orders by the customer enable the customer to fill the orders by shipment or delivery from a point outside the state).

22. For a recent survey of state revenue departments regarding whether they would tax members of LLCs that are treated as pass-through entities for federal tax purposes, see Pritchard, *supra* note 19.

23. I.R.C. § 11 (2000); La. Rev. Stat. Ann. § 47:287.11 (A) (Supp. 2001).

24. I.R.C. §§ 61 (a) (7) (2000), 301 (c) (1) (2000); La. R.S. 47:290 (1990).

cases are inconclusive as to whether a state may directly tax a nonresident that owns an interest in a pass-through entity on the nonresident's share of the entity's undistributed income, they offer some guidance. The United States Supreme Court has held that a state may impose an income tax on distributions to nonresident shareholders by a C corporation of the C corporation's income derived from sources within the state. In *Wisconsin v. J.C. Penney Co.*,²⁵ and *International Harvester Co. v. Wisconsin Department of Taxation*,²⁶ the Supreme Court upheld a tax imposed on a corporation for "the privilege of declaring and receiving dividends" out of corporate income derived from property located and business transacted within the state of Wisconsin. The payor corporation was required to withhold and pay tax to the state of Wisconsin on distributions to both resident and nonresident shareholders.

In *International Harvester*, the Supreme Court explained that a state may tax the income of a nonresident that is attributable either to property located in the state or to events or transactions that occur within the state. The Court held that a state "may impose the burden of the tax either upon the corporation or upon the shareholders who derive the ultimate benefit from the corporation's . . . activities [within the state]."²⁷

The quoted language may be broad enough to support a state tax on a nonresident's share of income earned by a pass-through entity that conducts business within the state. However, both *J. C. Penney* and *International Harvester* concerned a state tax on a shareholder's receipt of corporate distributions, and not a state tax imposed on a shareholder's share of the corporation's undistributed income.²⁸ Because the United States Supreme Court has never ruled on the issue of whether a state may impose a tax directly on a nonresident's share of the undistributed income of a pass-through entity that is earned within its borders, there may be a question as to whether a state has jurisdiction to impose such a tax.

Nevertheless, at least two state supreme courts have indicated that such a tax will be upheld. In *Meyer v. Charnes*,²⁹ Colorado sought to tax a nonresident shareholder on distributions from an S corporation. The case was decided in favor of the taxpayer because there was no Colorado statute authorizing the taxation of such distributions. However, in dicta, the Supreme Court of Colorado indicated that the state legislature had the authority to enact legislation to tax a nonresident shareholder of an S corporation on income generated by the corporation's Colorado business.³⁰ It seems that the Colorado Supreme Court based its conclusion on the theory that the business income of an S corporation is not "passive" dividend

25. 311 U.S. 435, 61 S. Ct. 246 (1940).

26. 322 U.S. 435, 64 S. Ct. 1060 (1944).

27. *Id.* at 441, 64 S. Ct. at 1063.

28. In *International Harvester*, 322 U.S., at 443-44, 64 S. Ct., at 1064-65, the Court explained that "[s]o long as the earnings actually arise [within the state], and their withdrawal from the state and ultimate distribution, in whole or in part, to the stockholders are subject to some state control, the conditions of state power to tax are satisfied."

29. 705 P.2d 979 (Co. Ct. App. 1985).

30. 705 P.2d at 983.

income because it is attributable to the shareholder's direct work, including management of the corporation's business.³¹ This conclusion is questionable, especially with respect to a nonresident shareholder whose distance from the state may impede the shareholder from actively participating in the management of the corporation's business in the state.

In *Kulick v. Department of Revenue*,³² the Supreme Court of Oregon held that a state tax on each nonresident shareholder's pro rata share of the distributed and undistributed Oregon income earned by an S corporation did not violate due process because the practical effect of the tax was the same as if the state had imposed a withholding tax on the corporation for the nonresident's share of its Oregon income. The court concluded that in demanding that the shareholders of a closely held corporation contribute to the state a tax on financial gains derived from sources within the state, the Oregon law did not take the shareholders' property without due process of law.³³ *Kulick*, however, did not involve the state's collection efforts against the nonresident shareholders. It only involved the issue of whether the tax itself was constitutional.

Absent a ruling by a federal court, there is some uncertainty as to whether a nonresident partner or S corporation shareholder has a sufficient nexus with a state so as to permit the state to impose a tax on the nonresident's share of the entity's undistributed income. While less concern has been expressed concerning the jurisdiction of a state to tax a partner's distributive share of partnership income derived from sources within its boundaries, there still are no federal cases offering guidance on this issue.

States assert their jurisdiction to tax a nonresident partner's distributive share by relying on the theory that a partnership is an aggregate of its partners, rather than a distinct entity.³⁴ Thus, each partner is deemed to be participating in the partnership's business that is conducted in the state.³⁵ In contrast, an S corporation is an entity separate from its owners; for federal tax purposes, at least, the business of an S corporation is not imputed to its shareholders.³⁶ Accordingly, an S corporation shareholder may not be deemed to be transacting business in a state in which the corporation is transacting business.

While states also have asserted jurisdiction to impose taxes on nonresident limited partners,³⁷ there is a question as to whether such jurisdiction exists.³⁸ The

31. See, e.g., *Cohen v. State Department of Revenue*, 593 P.2d 957 (Colo. 1979) (subchapter S distributions are not "dividends" for purposes of Colorado state income tax).

32. 624 P.2d 93 (Or. 1981).

33. 624 P.2d at 98.

34. *Willson & Windfeld-Hansen*, *supra* note 7, at 0020.

35. See, e.g., *Weil v. Chu*, 120 A.D.2d 781 (N.Y. App. Div. 1986), *aff'd*, 70 N.Y. 783 (1987) *cert denied*, 485 U.S. 901, 108 S. Ct. 1069 (1988).

36. See, e.g., *Tech. Adv. Mem. 97-20-003* (Jan. 15, 1997) (S corporation's dairy business could not be attributed to a shareholder in order to allow the shareholder to claim ordinary loss deductions with respect to commodity futures transactions that were entered into to hedge against the cost of the corporation's cattle feed ingredients).

37. See authorities cited in John A. Biek, *Ohio and Illinois Courts Address State Income Tax Nexus of Limited Partners*, 3 J. of Passthrough Entities 13 (Sept./Oct. 2000).

38. See, e.g., *UCOM, Inc. v. Tracy*, Ohio BTA, No. 97-K-880, Ohio St. Tax Rep. CCH ¶ 402-896

business and/or property of a partnership should not be imputed to a limited partner. Unlike a general partner, a limited partner generally may not participate in the management of the partnership's business. If a limited partner participates in the control of the partnership's business, the limited partner risks losing its protection from liability for partnership debts under state limited partnership law.³⁹

In fact, it is questionable whether a general partner in a partnership formed under the Louisiana partnership law or the Revised Uniform Partnership Act ("RUPA") may be deemed to be transacting business in a state in which the partnership is transacting business. Similar jurisdictional concerns arise in the LLC context. Like an S corporation, a partnership formed under RUPA, a Louisiana partnership, and an LLC are entities separate from their owners.⁴⁰ Courts have held that for federal tax purposes, the business of a partnership (or an entity classified as a partnership) is not attributed to its partners.⁴¹ Thus, the aggregate theory upon which many states assert jurisdiction to tax nonresident partners is not appropriate if the partnership is formed under RUPA, Louisiana law or LLC law.

Section 47:201.1 of the Revised Statutes is designed to eliminate any jurisdictional problem that may arise with respect to the state's taxation of a nonresident partner's share of partnership income. The Louisiana rules for taxing an S corporation also are designed to prevent a constitutional challenge to the state's jurisdiction to impose a tax on a nonresident shareholder. The S corporation rules offer an advantage over Section 47:201.1, however, because the S corporation rules ease the administrative burden on the Department of Revenue's collection efforts.

The Louisiana rules for taxing the income of an S corporation are designed to accommodate certain aspects of subchapter S that do not raise concerns for

(May 26, 2000) (business of a limited partnership transacting business in Ohio was not attributed to nonresident limited partner for purposes of Ohio corporate franchise tax). *See also* 34 Tex. Admin. Code §§ 3.546(c)(12)(B), 3.554(d)(20) (2000) (foreign corporation that is a limited partner in a limited partnership is not doing business in Texas for purposes of both the taxable capital and earned surplus methods of the Texas franchise tax); N.J. Reg. 18:7-7.6(b), (c) (2001) (foreign corporate limited partner does not acquire corporation business tax nexus on the operations of the partnership unless the limited also is a general partner in the limited partnership, takes an active part in the control of the partnership business, or meets the "doing business" criteria set forth in N.J. Reg. 18:7-1.9).

39. Rev. Unif. Ltd. Partnership Act § 303(a) (amended 1985) (limited partner who participates in the control of the partnership's business is liable to third persons who transact business with the partnership, reasonably believing that the limited partner is a general partner). *See also* La. Civ. Code art. 2843 (partner in commendam does not have the authority of a general partner to bind the partnership, participate in the management or administration of the partnership, or to conduct business with third parties on behalf of the partnership), art. 2844 (partner in commendam who participates in the management or administration of the partnership becomes liable as a general partner to persons transacting business with the partnership who reasonably believe that partner in commendam is a general partner).

40. Unif. Partnership Act § 201(a) (amended 1997), 6 U.L.A. 52 (Supp. 2000); La. Civ. Code art. 2801 (2000); Unif. Ltd. Liability Co. Act § 201 (1995).

41. *See, e.g.,* Madison Gas & Electric Co. v. Comm'r, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980) (costs (other than costs of construction) incurred in connection with the construction of an electric power plant were start-up costs, amortizable under I.R.C. § 195 (2000); if the partners had incurred the costs as co-owners, the costs should have been the costs of expanding an existing business and deductible under § 162(a) when incurred).

partnerships. Nevertheless, the S corporation rules easily could be modified to apply to a partnership. Like Section 47:201.1, the Louisiana Corporation Income Tax Act requires an S corporation to pay Louisiana income tax on behalf of its nonresident shareholders who do not pay the tax. Unlike the partnership provision, however, the Louisiana Corporation Income Tax Act treats the S corporation as the person primarily liable for payment of the tax. If a nonresident shareholder actually reports and pays Louisiana income tax on the shareholder's pro rata share of the S corporation's Louisiana income, the S corporation may exclude the income in computing its Louisiana income tax liability. Not only do the Louisiana rules ensure that the tax will be collected without raising jurisdictional issues, but the Louisiana rules also are designed to prevent an S corporation from violating the only-one-class-of-stock requirement under subchapter S of the Internal Revenue Code.⁴²

II. REVISED STATUTES SECTION 47:201.1

Section 47:201.1 of the Revised Statutes is effective for all taxable years beginning after December 31, 2000.⁴³ Under Section 47:201.1, a partnership is required to file composite returns and make composite payments of tax on behalf of any or all of its nonresident partners who do not agree to file individual Louisiana income tax returns, and to timely pay the Louisiana income tax due on their share of the partnership's Louisiana income.⁴⁴ For this purpose, the term "composite return" means a return that is filed by a partnership on behalf of its nonresident partners that reports and remits the Louisiana income tax of the partner.⁴⁵ The payment of Louisiana income tax by the partnership is referred to as the "composite payment."⁴⁶

The parties, however, have a choice under Section 47:201.1. A partnership that has one or more nonresident partners must either (1) file a composite return each year and pay the tax due on the nonresident partner's share of the partnership's Louisiana income or (2) file with the Louisiana Department of Revenue, on behalf of each nonresident partner, a written, binding agreement in which the nonresident partner agrees to file a nonresident individual return in accordance with Louisiana income tax law and to make timely payments of Louisiana income tax with respect to the nonresident partner's share of the partnership's income (the "agreement").⁴⁷

In most cases, the latter alternative will be preferable. If the partnership does not file the nonresident partner's agreement each year, the partnership must file a

42. For a discussion of the only-one-class-of-stock rule, see *infra*, notes 65-75 and accompanying text.

43. 2000 La. Acts No. 21 § 2.

44. La. R.S. 47:201.1(A)(1), (C) (Supp. 2001).

45. La. R.S. 47:201.1(A)(2)(b) (Supp. 2001).

46. La. R.S. 47:201.1(A)(2)(c) (Supp. 2001).

47. La. R.S. 47:201.1(B), (C) (Supp. 2001).

composite return and pay tax on the partner's share of Louisiana income at the highest rate of tax for individuals (currently six percent).⁴⁸ The partnership's payment of tax on behalf of the nonresident partner is treated as a loan from the partnership to the nonresident partner. The statute authorizes the partnership to recover a reimbursement from the nonresident for the Louisiana tax paid by the partnership, plus interest and penalties.⁴⁹

The tax paid by the partnership is treated as having been paid by the nonresident partner.⁵⁰ If the partnership's payment exceeds the amount of Louisiana income tax that the nonresident partner actually owes, the nonresident may file a request for a refund or use the payment as a credit against amounts that may be paid by the partnership with respect to the nonresident partner's share of Louisiana income earned by the partnership in future years.⁵¹ In either case, the nonresident partner will be required to file a Louisiana income tax return.

Thus, the parties' choice to have the partnership file a composite return on behalf of a nonresident partner places a burden on both the partnership and the nonresident partner. Each year, the partnership is subject to an additional filing requirement; it must use partnership funds to pay the tax on a nonresident's share of partnership income at the highest rate of tax; and it must seek reimbursement from the nonresident partner. If the partnership does not seek reimbursement from the nonresident partner, the partnership must make adjustments to the partners' capital accounts to reflect the partnership's payment benefitting some, but not all of the partners. On the other hand, if the partnership files the nonresident partner's agreement, the partnership will not have to pay taxes on behalf of the partner. In that case, the burden of collecting the tax from the nonresident falls upon the Department of Revenue, and not the partnership. Moreover, the initial filing of the agreement satisfies the partnership's filing responsibilities for all future years. If a partnership timely files the nonresident partner's agreement, the partnership is considered to have timely filed the agreement for all subsequent taxable periods.⁵²

In some cases, however, it may be more convenient for a partnership to file composite returns, especially if the partnership has many nonresident partners. Filing a composite return relieves the partnership of the obligation to ascertain whether each of the nonresident partners has filed an agreement.

Partnerships transacting business in Louisiana should be sure to comply with the requirements of Section 47:201.1 with respect to the 2001 tax year. If the partnership does not timely file a nonresident partner's agreement, the partnership is liable for the composite tax, plus interest and penalties.⁵³

48. La. R.S. § 47:201.1(D)(1), 47:296(C) (Supp. 2001).

49. La. R.S. 47:201.1(D)(2) (Supp. 2001).

50. La. R.S. 47:201.1(D)(3) (Supp. 2001).

51. *Id.*

52. La. R.S. 47:201.1(C)(2)(a) (Supp. 2001).

53. La. R.S. 47:201.1(C)(2)(b) (Supp. 2001).

III. PROBLEMS UNDER SECTION 47:201.1

Section 47:201.1 should be amended. The law is uncertain in its application and it fails to cover a number of entities that, like partnerships, are pass-through entities whose nonresident members may be outside the state's taxing jurisdiction. If the Section 47:201.1 is to be amended, however, it might be worthwhile for the Louisiana Legislature to consider adopting a different method for taxing nonresident owners of interests in pass-through entities.

It is not certain whether Section 47.201.1 applies to corporate partners. The law should be amended to clarify the legislature's intent concerning the taxation of corporate nonresident partners. Section 47:201.1 requires the partnership to file composite returns and pay a composite tax at the highest "individual" rate on behalf of any nonresident partners "who" do not agree to file an individual Louisiana income tax return. The reference in the statute to the individual tax rates and the use of the pronoun "who" could be interpreted to require only the payment of tax on behalf of individual nonresident partners. On the other hand, the pronoun "who" easily could be interpreted to refer to a corporation. Because a corporation cannot file an individual Louisiana income tax return, the statute could be interpreted to require a partnership that has one or more nonresident corporate partners to pay a composite tax (at the highest individual rate) on behalf of its nonresident corporate partners, without giving the partnership the option of filing an agreement with the Department of Revenue.

There is, albeit unlikely, a third alternative. The Department of Revenue could, as a matter of administrative convenience, give a partnership the option of either filing a composite return on behalf of a nonresident corporate partner or of filing the corporation's agreement to pay Louisiana corporate income tax on the corporation's share of the partnership's Louisiana income.

The Department of Revenue has adopted a literal interpretation of the statute. A proposed regulation issued in June 2001 provides that corporate members may not be included in composite returns filed by an LLC.⁵⁴ Instead, the regulation recites that each corporate member of an LLC is required to file a Louisiana income and franchise tax return and to report all sources of income, including income from the LLC on its return.⁵⁵ Thus, the statute, as interpreted, fails to provide a method of avoiding jurisdictional issues with respect to nonresident corporate partners.

Regardless of whether the Department of Revenue has the authority to allow nonresident corporate partners to enter into agreements with the state in lieu of composite filing, the Legislature should amend Section 47:201.1 to provide that a nonresident corporate partner must be included in a composite return unless the partnership files an agreement executed by the officers of the

54. LAC 61:I.1401 (C), 27 La. Reg. 949 (June 20, 2001). The proposed regulation is discussed in detail in Susan Kalinka, *Louisiana Composite Return Statute and Proposed Regulation: A Good Start with Room for Improvement*, 21 State Tax Notes 447 (Aug. 6, 2001).

55. *Id.*

corporation agreeing that the corporation will pay the tax on the corporation's distributive share of the partnership's Louisiana income. If a corporation is included in a composite return, the composite payment on behalf of the corporate partner should be computed by multiplying the highest corporate income tax rate times the corporate partner's distributive share of the partnership's Louisiana income. The omission of nonresident corporate partners from the composite return requirement undermines the effectiveness of section 47:201.1.

In enacting Section 47:201.1, the Louisiana Legislature also overlooked an important class of nonresidents that own interests in pass-through entities other than partnerships. The new collection provision does not apply to nonresidents that own interests in disregarded entities, such as single-member LLCs and qualified subchapter S subsidiaries ("QSubs"). Section 47:201.1 requires the filing of composite returns or nonresident agreements by "partnerships," defined to include partnerships and LLCs taxed as partnerships for state income tax purposes.⁵⁶ Single-member LLCs and QSubs are not taxed as partnerships; instead they may be disregarded as entities separate from their owners for purposes of state income tax.⁵⁷

Because of the jurisdictional concerns with taxing directly a nonresident owner of an interest in a disregarded entity, the Department of Revenue may have difficulty collecting the tax on the disregarded entity's Louisiana income. In that case, a nonresident may easily avoid taxation on Louisiana income by forming a disregarded entity to conduct its Louisiana business transactions.

It is likely that the Louisiana Legislature will consider some of the problems discussed above. However, if legislation is required, the Louisiana Legislature should consider a different method for taxing nonresident partners and members of disregarded entities. The Louisiana rules for taxing the income of an S corporation could easily be applied to a partnership or a disregarded entity. The S corporation rules not only have all of the advantages of Section 47:201.1, but they also provide a more efficient means for collecting the tax.

IV. LOUISIANA TAXATION OF S CORPORATION INCOME

For Louisiana tax purposes, an S corporation is a taxable entity.⁵⁸ Under the Louisiana Corporation Income Tax Act, an S corporation reports its income as if it were a C corporation.⁵⁹ Thus, an S corporation must report and pay tax on its Louisiana taxable income.⁶⁰ However, in computing its Louisiana taxable income, an S corporation may exclude a percentage of its Louisiana net income.⁶¹

56. La. R.S. 47:201.1(A)(2)(a) (2001).

57. I.R.C. § 1361(b)(3)(A)(ii)(2000)(Qsub); La. R.S. 12:1368(1990); Treas. Reg. §§ 301.7701-1(a)(4), -2(a)(2) (as amended in 1996) (single-member LLC).

58. La. R.S. § 47:287.732(A) (1990).

59. *Id.*

60. La. R.S. 47:287.11(A), (B) (1990).

61. La. R.S. 47:287.732(B)(1) (1990).

The excludable percentage of an S corporation's Louisiana net income is determined by multiplying the S corporation's Louisiana net income for the taxable year by a fraction, the numerator of which is the number of the corporation's issued and outstanding shares of capital stock that are owned by Louisiana resident shareholders on the last day of the corporation's taxable year, and the denominator of which is the corporation's total number of issued and outstanding shares of capital stock on the last day of the corporation's taxable year.⁶² For this purpose, no share of stock is counted in the numerator unless its owner has filed a correct and complete Louisiana individual income tax return as a resident for the taxable year of the owner which includes the last day of the S corporation's taxable year.⁶³

The Louisiana Corporation Income Tax Act permits an S corporation to exclude from its Louisiana taxable income each resident shareholder's pro rata share of that income because the tax on income of an S corporation that flows through to its shareholders who are residents of Louisiana may be collected directly from the resident shareholders without implicating jurisdictional concerns. Because of the lack of constitutional constraints in collecting tax from Louisiana residents, the Louisiana Department of Revenue generally seeks payment of the tax on a resident's share of an S corporation's Louisiana income directly from the resident shareholder, rather than from the S corporation.⁶⁴

For purposes of S corporation taxation, the term "Louisiana resident" includes a nonresident shareholder who has (1) filed a correct and complete Louisiana individual income tax return that includes the nonresident shareholder's share of the S corporation's income, and (2) paid the tax due on that income.⁶⁵ Thus, if each of the resident and nonresident shareholders reports and pays tax on the shareholder's pro rata share of the S corporation's Louisiana income, the corporation is not required to pay Louisiana corporate income tax.

The rules concerning the taxation of an S corporation's income permit shareholders of an S corporation to enjoy pass through taxation and at the same time, ensure that the State of Louisiana may collect tax on a nonresident shareholder's pro rata share of an S corporation's Louisiana income. For Louisiana income tax purposes, the income of an S corporation flows through to its shareholders.⁶⁶ Accordingly, the Louisiana income of an S corporation, on which

62. La. R.S. 47:287.732(B)(2) (1990).

63. La. R.S. 47:287.732(B)(2), (3) (1990).

64. The Louisiana Department of Revenue is easily able to receive information from the Internal Revenue Service concerning the taxable income of Louisiana residents. *See* I.R.C. § 6103(d)(1) (2000) (authorizing the disclosure of federal income tax returns and return information to "any State agency, body, or commission, or its legal representatives, which is charged under the laws of such State with responsibility for the administration of State tax laws. . . .")

65. La. R.S. 47:287.732(B)(4) (1990).

66. Louisiana Revised Statutes 47:296(A) (1990) imposes an income tax on the Louisiana income of every individual, whether resident or nonresident. Louisiana residents who are individuals are required to pay state income tax on income from whatever source derived; whereas nonresidents are required to pay state income tax on income earned or derived from sources within the state of Louisiana. La. R.S. 47:290(B) (1990). In defining taxable income, income generally is defined by reference to income that must be reported by the individual for federal tax purposes. La. R.S. 47:290(A), 47:293(1)

the corporation is required to pay state income tax, may be reduced by each shareholder's pro rata share of that income, provided that each shareholder pays tax on the income. The Louisiana rules avoid any potential jurisdictional and/or practical problems in collecting the tax on the amount of an S corporation's Louisiana income allocable to its nonresident shareholders.

V. THE ONLY-ONE-CLASS-OF-STOCK REQUIREMENT

A corporation that has more than one class of stock may not be an S corporation.⁶⁷ If an S corporation had one class of stock when it made its subchapter S election but later has more than one class of stock, the subchapter S election terminates on the date that the only-one-class-of-stock rule is violated.⁶⁸ Once a subchapter S election has terminated, the corporation (or any successor corporation) is not eligible to make another subchapter S election for five years.⁶⁹ While the Internal Revenue Service (the "Service") has authority to waive an inadvertent termination of a subchapter S election⁷⁰ or consent to a new S election before the expiration of the five-year period,⁷¹ there is no certainty that such a waiver or consent will be granted.

If a corporation's subchapter S election terminates and later is reinstated without a waiver by the Service, the corporation may be subject to built-in gains taxes and a tax on excess net passive income in later years. Under the built-in gains tax, an S corporation that was classified as a C corporation before its most recent subchapter S election may be required to pay an entity-level tax at the highest corporate rate (currently thirty-five percent) on net recognized gains from the disposition of property held during the period of time prior to the effective date of its subchapter S election.⁷² The tax on excess net passive income (also imposed at a rate of thirty-five percent) applies to the excess net passive income of an S corporation that has accumulated earnings and profits from years during which it or a predecessor corporation was a C corporation.⁷³ Both the built-in gains tax and the tax on excess net passive income apply in addition to the tax that the shareholders must pay on their pro rata shares of the S corporation's income.⁷⁴

(1990). Because the federal tax rules require an S corporation shareholder to report and pay tax on the shareholder's pro rata share of the S corporation's income under I.R.C. § 1366(a) (2000), an S corporation shareholder must include his or her pro rata share of the S corporation's income on the shareholder's individual income tax return.

67. I.R.C. §§ 1361(b)(1)(D), 1362(a) (2000).

68. I.R.C. § 1362(d)(2) (2000).

69. I.R.C. § 1362(g) (2000).

70. I.R.C. § 1362(f) (2000).

71. I.R.C. § 1362(g) (2000).

72. I.R.C. § 1374 (2000).

73. I.R.C. § 1375 (2000).

74. I.R.C. § 1366(a) (2000). The amount of built-in gains tax and tax on excess passive income paid by the corporation reduces the amount of income that passes through to the shareholders. I.R.C.

Treasury regulations provide that, in general, an S corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.⁷⁵ If state law requires an S corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders, the payment or withholding of the tax constitutes a constructive distribution to the shareholder on whose behalf the tax is paid or withheld.⁷⁶ Thus, the withholding of state income tax on behalf of some, but not all, of the corporation's shareholders may confer disproportionate rights to distributions among the shareholders, thereby violating the only-one-class-of-stock requirement.

In cases where a state imposes a withholding requirement on an S corporation, the corporation can avoid violation of the only-one-class-of-stock requirement by distributing proportionate amounts to each of its shareholders in order to offset the amounts that are deemed to be distributed to the nonresident shareholders.⁷⁷ Thus, if an S corporation with one or more nonresident shareholders and one or more resident shareholders transacts business in a state that requires the S corporation to withhold tax on a nonresident's share of the corporation's income derived from sources within the state, the corporation must determine the amount that has been withheld on behalf of the nonresident and distribute to the resident shareholders an appropriate amount to ensure that the shareholders' rights to distributions and liquidation proceeds are proportionate to their shareholdings.

The Louisiana Corporation Income Tax Act seeks to avoid this problem by imposing the tax at the corporate level, rather than at the shareholder level. Louisiana Revised Statutes 47:287.732(A) imposes the tax on an S corporation. To allow the corporation's income to flow through to its Louisiana shareholders and to nonresident shareholders who have paid Louisiana state income tax on their share of the corporation's Louisiana income, Section 47:287.732(B) allows an S corporation to exclude the portion of its income for which the shareholders have paid tax.

Louisiana's method of taxing an S corporation's income never has been tested with respect to the only-one-class-of-stock rule. It is not certain whether the corporation's payment of state income tax on Louisiana income allocable to a nonresident shareholder will be treated as a constructive distribution to the shareholder. Nevertheless, the corporation's payment should not be treated as a constructive distribution because in paying the tax, the corporation satisfies its own obligation. Under the Louisiana Corporation Income Tax Act, liability for payment of the tax is placed on the corporation, as well as on the nonresident shareholders. In an analogous context, the Internal Revenue Service (the "Service") has ruled that where a corporation redeems stock from a retiring shareholder, the fact that the corporation, in purchasing the shares, satisfies the continuing shareholder's

§§ 1366(f)(2), (3) (2000).

75. Treas. Reg. § 1.1361-1(l)(1) (as amended in 1996).

76. Treas. Reg. § 1.1361-1(l)(2)(ii) (as amended in 1996).

77. *Id.*

executory contractual obligation to purchase the redeemed shares does not result in a constructive distribution to the continuing shareholder, provided that the continuing shareholder is not subject to an existing primary and unconditional obligation to perform the contract.

In Revenue Ruling 69-608,⁷⁸ the Service considered several examples in which a corporation redeemed the stock of one shareholder and the nonredeeming shareholder also had agreed to purchase the redeemed shares. One of the examples involved A, who had agreed to purchase all of the outstanding stock of X corporation from X's sole shareholder, B. The contract between A and B provided that the contract could be assigned by A to a corporation and that, if the corporation agreed to be bound by the terms of the contract, A would be released from the contract. A organized Y corporation to which A assigned the stock purchase contract. Y borrowed funds and purchased B's stock pursuant to the terms of the contract. Later, Y merged into X, and X assumed the liabilities that Y incurred in connection with the purchase of B's stock. The Service ruled that Y's purchase of B's X stock did not result in a constructive distribution to A because A was not personally subject to an unconditional obligation to purchase the stock.

The tax results in other examples considered in the revenue ruling were less favorable to the nonredeeming shareholder. In one such example, an agreement between two shareholders provided unconditionally that within 90 days of the death of either shareholder, the survivor would purchase the decedent's stock from his estate.⁷⁹ When one of the shareholders died, however, the survivor caused the corporation to assume the contract and redeem the stock from the decedent's estate. The Service ruled that the assignment of the contract to the corporation followed by the redemption by the corporation of the decedent's stock would result in a constructive distribution to the surviving shareholder because immediately on the death of the other shareholder, the surviving shareholder had a primary and unconditional obligation to perform the contract.

Thus, the issue raised by Revenue Ruling 69-608 on the payment by an S corporation of tax on a shareholder's pro rata share of the corporation's Louisiana income is whether the corporation's payment of the tax satisfies a primary and unconditional obligation of the shareholder. Because the obligation to pay tax on a nonresident shareholder's pro rata share of an S corporation's Louisiana income may be satisfied either by the corporation or by the shareholder, the payment of the tax by the corporation should not result in a constructive distribution to the shareholder.

Section 47:296 of the Louisiana Revised Statutes imposes a tax on the "Louisiana income of every individual, whether resident or nonresident."⁸⁰ At the same time, the Louisiana Corporation Income Tax Act provides that "[c]orporations shall be taxed on their Louisiana taxable income, except as otherwise exempted."⁸¹ An S corporation is exempted from taxation on a nonresident shareholder's share of

78. Rev. Rul. 69-608, 1969-2 C.B. 42, Situation 6.

79. Rev. Rul. 69-608, Situation 2.

80. La. R.S. 47:296(A) (1990).

81. La. R.S. 47:287.11(B) (1990).

the S corporation's income only if the nonresident shareholder (1) has filed a complete and correct Louisiana individual income tax return that includes the nonresident's share of the S corporation's income and (2) has paid the tax due thereon.⁸² Thus, an S corporation that pays Louisiana income tax on a nonresident shareholder's share of the corporation's Louisiana income is satisfying its own obligation, rather than a primary and unconditional obligation of the nonresident shareholder. Accordingly, the payment of the tax by the corporation on behalf of nonresident shareholders should not cause the corporation to be treated as having more than one class of stock. Admittedly, the corporation's obligation to pay the tax is secondary and conditional. The corporation is required to pay the tax on a nonresident's share of corporate income only if the nonresident shareholder fails to pay. By negative implication, it could be argued that the primary obligation to pay the tax falls on the nonresident shareholder. The statute recites that the tax is imposed "on the Louisiana income of every individual."⁸³ The statute also recites that "[i]t is intended that for any taxable year . . . [nonresident] individuals having income earned within or derived from sources in this state shall be taxed on their Louisiana income for that year."⁸⁴

Nevertheless, the statute should be interpreted to provide that the obligation belongs to both the nonresident shareholder and the corporation and that the payment of the tax by either satisfies the other's obligation to pay the tax. The Department of Revenue, to which administration of the Louisiana income tax is entrusted by statute,⁸⁵ consistently has interpreted the S corporation statute so as to allow a nonresident shareholder to exclude from the shareholder's Louisiana taxable income the shareholder's pro rata share of an S corporation's Louisiana income if the corporation pays tax on that amount.⁸⁶ Indeed, the S corporation rules are designed to avoid any jurisdictional and/or practical problems that might arise if the Department of Revenue were required to seek payment of the tax directly from nonresident shareholders. Thus, the shareholder's liability to pay the tax is neither primary nor unconditional.

Louisiana's method of taxing an S corporation should prevent the problems that may arise under state withholding tax statutes. However, the imposition of tax at the corporate level may cause an economic loss for resident shareholders who do not anticipate the problem.

VI. ECONOMIC CONSIDERATIONS

If the shareholders of an S corporation transacting business in Louisiana do not plan carefully, the corporation's payment of tax on a nonresident shareholder's pro rata share of the corporation's Louisiana income may reduce the amount of

82. La. R.S. 47:287.732(B)(4) (1990).

83. La. R.S. 47:296(A) (1990).

84. La. R.S. 47:290(B) (1990).

85. La. R.S. 47:295 (1990).

86. Telephone interview with Michael D. Pearson, then Director of Corporation, Income, and Franchise Taxes, Louisiana Department of Revenue and Taxation (Apr. 6, 2000).

corporate assets available for distribution to both nonresident and resident shareholders. The loss of corporate assets also reduces the value of each shareholder's stock. The only-one-class-of-stock rule prevents the S corporation from making disproportionate distributions to the resident shareholders to compensate them for the decline in the value of their stock resulting from the nonresident's failure to pay the tax.

Resident shareholders should take steps to protect the value of their stock and the S corporation's assets from erosion. For example, before transferring assets to an S corporation, the shareholders should enter into an agreement requiring any nonresident shareholder that fails to pay tax on the shareholder's pro rata share of the S corporation's Louisiana income to restore to the corporation the amount of tax paid on that income. The agreement also should provide for damages in the case of failure to timely pay the tax. Requiring a nonresident shareholder to pay tax on the shareholder's pro rata share of the corporation's Louisiana income also avoids any problems that might result if the corporation's payment of the tax is treated as a constructive distribution.

It may be easier to convince nonresident shareholders to agree to pay the Louisiana income tax on their pro rata share of the corporation's tax if they are advised of the tax rate differential between the Louisiana corporate and individual income taxes. The highest rate of tax that applies to the Louisiana income of a corporation is eight percent.⁸⁷ In contrast, the highest rate of tax that applies to an individual's Louisiana income is six percent.⁸⁸ To the extent that an S corporation is not permitted to exclude its Louisiana income, the S corporation must pay tax on that income at the corporate rates.⁸⁹ Moreover, an S corporation that pays tax on a nonresident's share of corporate income will not be entitled to claim a deduction for federal tax paid on the income that otherwise would be available to the nonresident shareholder under the Louisiana income tax rules.⁹⁰ Thus, if an individual nonresident shareholder, rather than an S corporation, pays Louisiana income tax on the shareholder's pro rata share of the S corporation's Louisiana income, there may be a larger amount of corporate assets available for distribution to the nonresident shareholder, thereby enhancing the value of the nonresident shareholder's stock.

While the Louisiana rules for taxing the income of an S corporation require careful planning, they offer advantages that may not be realized in a state that

87. La. R.S. 47:287.12 (1990).

88. La. R.S. 47:296(C) (1990).

89. La. R.S. 47:287.732(A) (1990).

90. See La. R.S. 47:293(7) (1990) (defining "tax table income" for nonresident individuals by allowing a deduction for a proportionate amount of federal taxes paid (i.e., federal taxes paid on income allocated and apportioned to Louisiana)), La. R.S. 47:296(C) (1990) (imposing Louisiana income tax on Louisiana tax table income). An S corporation may not take advantage of the deduction for federal taxes paid by a corporation under Louisiana Revised Statutes 47:287.85(A) with respect to a nonresident shareholder's pro rata share of the S corporation's Louisiana income because an S corporation generally does not pay federal income tax on amounts that pass through to its shareholders. I.R.C. § 1363(a) (2000).

imposes a withholding requirement or a requirement that nonresident shareholders must sign agreements to submit to the state's taxing jurisdiction as a condition of pass-through taxation. In states that impose a withholding requirement, careful planning is required to maintain the corporation's subchapter S election, either for federal or for state income tax purposes. In fact, state withholding statutes generally require the S corporation to pay tax on a nonresident shareholder's pro rata share of corporate income at a flat rate, often at the highest rate of tax that applies to individuals.⁹¹ If a state requires an S corporation to withhold tax at a flat rate on a nonresident's pro rata share of corporate income, the amount of the offsetting distributions made to resident shareholders must be computed with respect to the same rate, even if a lower rate of state tax applies to the income of the resident shareholders.

Thus, a withholding requirement may impose an economic burden on an S corporation and its shareholders. The amount of tax withheld and the offsetting distributions also reduce the amount of corporate income available for investment in an S corporation's business. If an S corporation transacts business in a state that imposes a withholding requirement, it may be necessary for the corporation to require capital contributions from its shareholders to pay the tax.

A state withholding requirement also imposes an accounting burden on an S corporation and its shareholders. Each year, as the S corporation withholds and pays tax to the state on behalf of its nonresident shareholders, it must compute the amount of the distribution that it must make to each of its resident shareholders.

In contrast, the adverse consequences that may result under the Louisiana rules are limited to the economic arrangement of the shareholders. If nonresident shareholders fail to pay Louisiana income tax, the S corporation will retain its status as a pass-through entity, at least with respect to the resident shareholders. If the corporation's payment results in an economic loss to the resident shareholders, they may be able to rearrange corporate affairs to account for the loss. For example, if the resident shareholders are employees of the corporation, it may be possible to raise their salaries in the event that the corporation is required to pay tax on income allocable to the nonresident shareholders.⁹² The adverse tax consequences of a termination of a corporation's subchapter S election and potential exposure to built-in gains taxes and a tax on excess net passive income

91. For a discussion of the state statutes requiring S corporations to withhold tax, see Maule, *supra* note 9, at 1510:0094-1510:0096.

92. The additional salary paid to the resident shareholder-employees could be treated as a constructive dividend to the employees if the increase in salary causes the salary to be unreasonably large. If the additional salary is unreasonable, the S corporation will not be permitted to deduct the excessive amount. See I.R.C. § 162(a)(1)(2000) (allowing a taxpayer to deduct a reasonable allowance for salaries). In the event that the deduction is disallowed and the salary payment is treated as a constructive distribution, the corporation may be treated as having more than one class of stock if a principal purpose of the agreement authorizing the increase in salary is to circumvent the only-one-class-of-stock requirement under subchapter S. Treas. Reg. § 1.1361-1(l)(2)(i)(1992). As explained above, violation of the only-one-class-of-stock requirement may cause the corporation's subchapter S election to terminate.

may be worse for S corporations transacting business in states that impose a withholding requirement than the economic loss to resident shareholders who fail to protect themselves from adverse economic consequences under the Louisiana rules.

Under the Louisiana rules, it is easier to prevent adverse consequences than under a regime that imposes a withholding requirement or a requirement that nonresident shareholders submit to the state's taxing jurisdiction as a condition of pass-through taxation. To avoid economic loss under the Louisiana rules, resident shareholders should enter into a one-time agreement requiring that all nonresident shareholders pay tax each year on their pro rata shares of the S corporation's Louisiana income.⁹³ To avoid termination of the corporation's subchapter S election in a state that imposes a withholding requirement, the S corporation must make offsetting distributions to resident shareholders each year that the corporation pays state income tax on behalf of a nonresident shareholder. To avoid the loss of pass-through status under state tax law in a state requiring nonresident shareholders to submit to the state's taxing jurisdiction as a condition of pass-through tax status, transfers of stock must be monitored constantly to ensure that new nonresident shareholders comply with the state requirement.

The Louisiana S corporation rules easily could be expanded so as to govern the taxation of income of a partnership transacting business in Louisiana. While both the S corporation provisions and Section 47:201.1 address the jurisdictional concerns with respect to imposing a tax on nonresident and also allow the pass-through entity to avoid complications that may arise under the withholding requirement by permitting nonresidents to pay the tax instead of the entity, Section 47:201.1 imposes a greater administrative burden on the Louisiana Department of Revenue than the S corporation provisions. Under the S corporation provisions, the S corporation pays the tax unless the nonresident shareholder pays. In contrast, Section 47:201.1 allows the partnership to avoid taxation merely by filing the nonresident partner's agreement to pay the tax. If the nonresident partner does not pay pursuant to the agreement, the Louisiana Department of Revenue has no recourse against the partnership. Instead, the Department of Revenue must go to a foreign jurisdiction and seek payment directly from the nonresident. The Department of Revenue hires collection agencies in other states to enforce tax payment by nonresidents. Thus, collection of the tax from a nonresident partner who fails to pay may cost the state more than the collection of the tax directly from the partnership.

VII. PROPOSED LEGISLATION

Legislation concerning the taxation of a partnership's income should be drafted to account for the possible limitation on the state's jurisdiction to tax, as

93. If the corporation is formed under Louisiana law, a shareholder agreement is binding on all future shareholders as long as the agreement is referenced on the stock certificates and a copy of the agreement is kept at the corporation's registered office. La. R.S. 12:29, 12:57(F) (1990).

well as the practical difficulty in collecting tax on a nonresident partner's distributive share of a partnership's Louisiana income. The rules concerning the taxation of an S corporation's Louisiana income serve as an excellent model.

If the Louisiana Legislature adopts the proposal to tax a partnership like an S corporation, the partners may enter into a one-time agreement requiring nonresident partners to pay tax directly to the state. In that case, the burden of paying the tax is placed on the nonresident partners, and no accounting adjustments are required at the partnership level to compensate resident partners for the payment of tax on behalf of the nonresident partners. In addition, the partnership will not be required to disburse funds that otherwise might be invested more advantageously in the partnership's business.

There are some differences between a partnership and an S corporation that must be taken into account in drafting legislation that will impose tax on a partnership's Louisiana income. For example, an S corporation may not have as a shareholder a person other than an individual, an estate, or one of several types of trusts.⁹⁴ In contrast, there is no limit on the types of persons who may be partners in a partnership. In addition, an S corporation may have only one class of stock.⁹⁵ Because of the only-one-class-of-stock limitation, each shareholder includes in income the shareholder's pro rata share of an S corporation's income.⁹⁶ In contrast, a partnership may make special allocations of items of partnership income, deduction, and credit among the partners.⁹⁷ Thus, it would not be advisable to provide that a partnership, like an S corporation, may exclude from its Louisiana income a percentage of Louisiana net income computed with respect to "a ratio, the numerator of which is the number of issued and outstanding shares of capital stock of the S corporation which are owned by Louisiana resident individuals on the last day of the corporation's taxable year."⁹⁸ Instead, Section 47:201 of the Louisiana Revised Statutes should be amended to delete that language and provide as follows:

§ 201 Partnerships

A. Taxation of partnership. A partnership shall be taxed and required to comply with this Chapter as a corporation other than an S corporation. The provisions of the Louisiana Corporation Income Tax Act shall apply as if the partnership had been required to file an income tax return with the Internal Revenue Service as a C corporation for the current and all prior taxable years, in accordance with federal law.

B. Partnership exclusion. This Subsection provides an exclusion to a partnership as follows:

94. I.R.C. § 1361(b)(1)(B) (2000).

95. I.R.C. § 1361(b)(1)(D) (2000).

96. I.R.C. § 1377(a)(1) (2000).

97. I.R.C. § 704(b)(1) (2000). To be respected by the Internal Revenue Service, an allocation of partnership income must have "substantial economic effect." I.R.C. § 704(b)(2) (2000). See Treas. Reg. §§ 1.704-1(b)(2), -2 (as amended in 1999).

98. La. R.S. 47:287.732(B)(2) (1990).

(1) In computing Louisiana taxable income pursuant to this Chapter, a partnership may exclude an amount of such Louisiana net income for the taxable year as provided in R.S. 47:201(B)(2).

(2) The excludable amount of Louisiana net income is determined by adding the following:

(a) The distributive share of the Louisiana net income of the partnership allocable to each resident individual partner who has for the taxable year of inclusion filed a correct and complete Louisiana income tax return as a resident;

(b) The distributive share of the Louisiana net income of the partnership allocable to each nonresident individual partner who has for the taxable year of inclusion filed a correct and complete Louisiana individual tax return, which includes his distributive share of the partnership's income, and has paid the tax shown to be due thereon; and

(c) The distributive share of the Louisiana net income of the partnership allocable to each partner other than an individual partner that has for the taxable year of inclusion filed a correct and complete Louisiana income tax return, which includes its distributive share of the partnership's income, and has paid the tax shown to be due thereon.

(3) For purposes of Paragraph (2) of this Subsection:

(a) "Taxable year of inclusion" means the taxable year of the partner which includes the last day of the partnership's taxable year for which the exclusion is claimed.

(b) The term "individual" includes estates and trusts.

(c) The term "distributive share" has the same meaning as applies to that term for purposes of Section 702 of the Internal Revenue Code.

(d) A partner other than an individual partner shall be treated as having paid the Louisiana income tax on its distributive share of a partnership's Louisiana net income if the partner or the owners of the interests in the partner have paid such tax.

(4) Should a partnership incur a Louisiana net loss, as described in R.S. 47:287.91, a portion of such loss shall be excluded from carry-back or carry-over treatment notwithstanding the provisions of R.S. 47:287.86. The applicable portion of the Louisiana net loss shall be the amount of the partnership's net loss that is included by each partner on a correct and complete Louisiana income tax return filed for the taxable year of inclusion.

The same issues that concern the taxation of a nonresident partner are present with respect to the taxation of a nonresident owner of an LLC that has only one member (a "single-member LLC") or a nonresident owner of a qualified subchapter S subsidiary ("QSub"). The foregoing proposal does not address the taxation of a nonresident owner of a single-member LLC or a QSub that transacts business in Louisiana; such entities are not classified as partnerships for tax purposes.

A single-member LLC that is not classified as a corporation is disregarded as an entity separate from its owner (a "disregarded entity").⁹⁹ If a single-member LLC is treated as a disregarded entity, it is taxed as a sole proprietorship (if the owner is an individual) or as a division or branch (if the owner is a corporation, partnership, or other entity).¹⁰⁰ Thus, all of the income of a single-member LLC that is classified as a disregarded entity is included in the income of the owner.

A QSub also is treated as a disregarded entity for federal income tax purposes.¹⁰¹ A QSub is a wholly-owned subsidiary of an S corporation for which the S corporation has made an election to treat the corporation as a QSub.¹⁰² For federal income tax purposes, all of the assets, liabilities, and items of income, deduction, and credit of a QSub are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation shareholder of the QSub. Thus, the income of a QSub passes through to the S corporation shareholder to be included in the income of the S corporation's shareholders.

The ability of taxpayers to form disregarded entities creates an even greater potential for evasion of Louisiana income tax than that available for nonresident partners. Under Louisiana income tax law, a partnership that has a nonresident partner is required to file an informational tax return with the Louisiana Department of Revenue.¹⁰³ Thus, the Department may at least be aware that the partnership has Louisiana income and also has nonresident partners. Section 47:201 recites that partners "shall be liable for income tax . . . in their separate or individual capacities."

Louisiana has no provision requiring a disregarded entity to file a Louisiana income tax return or a Louisiana informational tax return. Therefore, the Department of Revenue may not even be aware that a disregarded entity has Louisiana income. Thus, any nonresident individual, corporation, partnership, or other entity transacting business in Louisiana may escape Louisiana income tax by forming a single-member LLC to conduct its Louisiana operations. If the owner of a disregarded entity transacting business in Louisiana is a nonresident, there currently is no way of collecting tax on the disregarded entity's Louisiana income.

To ensure that the Department of Revenue will collect the tax on the Louisiana income of a disregarded entity such as a single-member LLC or QSub, the Louisiana Legislature should enact a new statute (Section 47:201.1 of the Louisiana Revised Statutes). The new statute should read as follows:

§ 201.1 Disregarded Entities

A. Taxation of disregarded entity. A disregarded entity shall be taxed and required to comply with this Chapter as a corporation other than

99. Treas. Reg. §§ 301.7701-1(a)(4)(as amended in 1996); 301.7701-3(a)(as amended in 1999).

100. Treas. Reg. § 301.7701-2(a) (as amended in 1999).

101. I.R.C. § 1361(b)(3)(A) (2000). For a discussion of some of the possible methods of taxing a QSub under the current Louisiana corporate income tax statute, see Susan Kalinka, *Lack of Legislation Gives Broad Discretion to the Louisiana Department of Revenue Concerning the Taxation of a Qualified Subchapter S Subsidiary in Louisiana*, 59 La. L. Rev. 425 (1999).

102. I.R.C. § 1361(b)(3)(B) (2000).

103. La. R.S. 47:201 (1990).

an S corporation. The provisions of the Louisiana Corporation Income Tax Act shall apply as if the disregarded entity had been required to file an income tax return with the Internal Revenue Service as a C corporation for the current and all prior taxable years, in accordance with federal law.

B. Disregarded entity exclusion. This Subsection provides an exclusion to a disregarded entity as follows:

(1) In computing Louisiana taxable income pursuant to this Chapter, a disregarded entity may exclude an amount of such Louisiana net income for the taxable year as provided in R.S. 47:201.1(B)(2).

(2) The excludable amount of Louisiana net income is determined by adding the following:

(a) The Louisiana net income of the disregarded entity allocable to a resident individual owner who has for the taxable year filed a correct and complete Louisiana income tax return as a resident;

(b) The Louisiana net income of the disregarded entity allocable to a nonresident individual owner who has for the taxable year filed a correct and complete Louisiana individual tax return, which includes the disregarded entity's income, and has paid the tax shown to be due thereon; and

(c) The Louisiana net income of the disregarded entity allocable to an owner other than an individual that has for the taxable year filed a correct and complete Louisiana income tax return, which includes the disregarded entity's income, and has paid the tax shown to be due thereon.

(3) For purposes of Paragraph (2) of this Subsection:

(a) The term "disregarded entity" means an entity that is disregarded as an entity separate from its owners for income tax purposes. Such term includes an entity with a single member that is not classified as a corporation.

(b) The term "individual" includes estates and trusts.

(c) An owner of a disregarded entity other than an individual owner shall be treated as having paid the Louisiana income tax on the disregarded entity's Louisiana net income if the owner or the owners of the interests in the owner of the disregarded entity have paid such tax.

(4) Should a disregarded entity incur a Louisiana net loss, as described in R.S. 47:287.91, a portion of such loss shall be excluded from carry-back or carry-over treatment notwithstanding the provisions of R.S. 47.287.86. The applicable portion of the Louisiana net loss shall be the amount of the disregarded entity's net loss that is included by the owner on a correct and complete Louisiana income tax return filed for the taxable year.

The proposed statutory language should be sufficient to ensure that the Louisiana income of a partnership or a disregarded entity does not escape Louisiana income tax. Pass-through entities, such as partnerships, LLCs, and S corporations may own interests in a partnership or a disregarded entity. Under the proposal, the Louisiana income tax attributable to the pass-through entity's

distributive share of a partnership's Louisiana income will be paid by the partnership, unless: (1) the pass-through entity reports and pays tax on its distributive share of the partnership's Louisiana income or (2) the owners of the pass-through entity report and pay tax on their distributive shares of the entity's distributive share of the partnership's Louisiana income. Similarly, the Louisiana income tax on the Louisiana income of a disregarded entity will be paid either by the pass-through entity that owns the interest in the disregarded entity or by the owners of the interests in the pass-through entity.

If the proposal is adopted, partners in partnerships transacting business in Louisiana should take care to amend their partnership agreements to take into account the possibility that nonresident partners may not pay tax on their distributive shares of the partnership's Louisiana income. Unlike an S corporation, a partnership may make disproportionate distributions without jeopardizing its status as a pass-through entity. Thus, a partnership's payment of Louisiana income tax on income allocable to a nonresident partner may be treated either as a loan to the nonresident partner or as an equity distribution to that partner. If the partnership agreement does not require the nonresident partner to pay the tax, it may treat the partnership's payment as a constructive distribution to the nonresident partner and adjust capital accounts accordingly. In such a case, the partnership also may make an offsetting distribution of cash to the resident partners.

Another advantage may be achieved by adopting the proposed legislation instead of simply amending Section 47:201.1. If the proposal is adopted, the Louisiana Legislature may repeal Sections 47:202 through 47:220.2 of the Louisiana Revised Statutes, concerning the taxation of partners. These provisions have not been amended to correspond to the current partnership tax provisions of the Internal Revenue Code. It is likely that the legislature retained these provisions because, under Sections 47:201 and 47:201.1, the unamended provisions may serve an important purpose.

In general, however, Sections 47:202 through 47:220.2 have been superseded because they conflict with the prevailing rule that a taxpayer's income is determined for state income tax purposes by reference to the federal income tax rules. Retention of the statutes creates confusion. For example, Louisiana Revised Statutes 47:204(C) provides that a partner's distributive share of items of income, depreciation, depletion, gain, or loss with respect to property contributed by a partner is allocated among the partners as if the property had been purchased by the partnership, unless (1) the partnership agreement provides that such items will be shared so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of the contribution or (2) absent a provision in the partnership agreement, the property contributed to the partnership consists of undivided interests in property. Section 47:204(C) no longer is compatible with Section 704(c) of the Internal Revenue Code, which was amended to provide that "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners as to take account of the variation between the basis of the property to the partnership

and its fair market value at the time of the contribution"¹⁰⁴ For federal income tax purposes, allocations of income, gain, loss, and deduction with respect to property contributed by a partner are no longer determined by the partnership agreement.

Louisiana Revised Statutes 47:206(C)(2)(a)(ii) provides that the taxable year of a partnership does not close with respect to a partner who dies. In contrast, Section 706(c)(2)(A) of the Internal Revenue Code provides that "[t]he taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise)."

Louisiana Revised Statutes 47:209 provides that "no gain or loss shall be recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." While the Internal Revenue Code used to contain the same rule, Section 721(b) now provides that a contributing partner shall recognize gain on a transfer of property to a partnership that would be treated as an investment company, and Section 721(c) provides that under regulations, a contributing partner shall recognize gain if the gain, when recognized, will be includible in the gross income of a person other than a United States person.

Under Louisiana Revised Statutes 47:211, the basis of property contributed to a partnership by a partner is the adjusted basis of the property to the contributing partner at the time of the contribution. In contrast, Section 723 of the Internal Revenue Code allows the partnership to increase the basis of contributed property by the gain, if any, recognized by the contributing partner under Section 721(b).

Louisiana Revised Statutes 47:213 provides rules for determining the basis of property distributed to a partner. In particular, Louisiana Revised Statutes 47:213(C) provides rules for determining the basis of property when several items of property have been distributed to the same partner in the same transaction. The rules in the Revised Statutes correspond to former Section 732(c) of the Internal Revenue Code. Section 732(c) was amended several years ago, but Louisiana Revised Statutes 47:213(C) has not been amended to correspond to the federal amendments.¹⁰⁵

A number of other provisions have been added to the federal partnership tax statutes of the Internal Revenue Code that have not been adopted by Louisiana. Thus, the Louisiana partnership tax provisions are inconsistent with the Internal Revenue Code.

When a partner determines the amount of Louisiana income tax that the partner must pay for any taxable year, the partner generally must compute the partner's income in the same manner as the partner computes its income for federal tax purposes. Under the Louisiana income tax law, a taxpayer's income generally is defined by reference to the definitions of income under the Internal Revenue Code.¹⁰⁶ The Internal Revenue Code provides that each partner includes in income

104. I.R.C. § 704(c)(1)(A) (2000).

105. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 105th Cong., 1st Sess. § 106 (a) (1997).

106. See, e.g., La. R.S. 47:287.61 (1990) (gross income of a corporation); 47:287.63 (1990) (allowable deductions of a corporation); 47:287.65 (1990) (net income of a corporation); 47:287.69

the partner's distributive share of partnership income and/or loss, as determined under the Internal Revenue Code, including Section 704(c).¹⁰⁷ Thus, a number of the Louisiana partnership tax provisions are inconsistent with the general rules of the Louisiana income tax law. Moreover, because taxpayers compute their income for Louisiana income tax purposes by reference to income as it is defined under federal tax law, it is not necessary for the Louisiana income tax law to contain any provisions determining the amount of a partner's distributive share of partnership income.

It is likely that the Louisiana Legislature retained Sections 47:202 through 47:220.3 of the Revised Statutes because of a state constitutional concern. The Louisiana Constitution provides, in part:

No General Reference. A bill enacting, amending, or reviving a law shall set forth completely the provisions of the law enacted, amended, or revived. No system or code of laws shall be adopted by general reference to it.¹⁰⁸

While the provisions of the Louisiana income tax law defining taxable income by reference to the Internal Revenue Code have never been challenged in court, there is some concern that they would not withstand a constitutional attack. Accordingly, the Louisiana income tax law contains a number of provisions, including Sections 47:202 through 47:220.2 of the Revised Statutes, that have been superseded by the provisions referencing the Internal Revenue Code. If the references to the Internal Revenue Code are held unconstitutional, the superseded provisions should be effective until the Louisiana Legislature amends the state tax law.

The proposed legislation eliminates the constitutional concern. The reference to the Internal Revenue Code in the proposal does not adopt a system or code of laws by general reference; instead, the proposal refers specifically to only one section of the Code.

Admittedly, the definition of the term "distributive share" under section 702 of the Internal Revenue Code requires an understanding of other provisions of subchapter K of the Internal Revenue Code. Nevertheless, the proposal does not adopt all of subchapter K. Accordingly, the proposal should survive a potential constitutional attack because it does not adopt a "system or code of laws . . . by general reference to it."

VIII. CONCLUSION

Louisiana's method of taxing S corporations is not unique. However, only a few other states impose an entity-level tax on an S corporation's income earned

(1990) (Louisiana taxable income of a corporation); 47:287.736 (1990) (income of a real estate investment trust); 47:290 (1990) (income of an individual); 47:182 (1990) (income of an estate or trust generally computed in the same manner and on the same basis as in the case of an individual).

107. I.R.C. § 702(a) (2000).

108. La. Const. Art. 3, § 15.

within the state that is allocable to a nonresident shareholder, unless the nonresident fails to report and pay tax on the income.¹⁰⁹ The Louisiana rules resolve a number of potential problems in collecting tax on a nonresident shareholder's pro rata share of an S corporation's Louisiana income.

The Louisiana rules require shareholders to plan ahead to ensure that a resident shareholder's pro rata share of an S corporation's assets is not eroded by the corporation's payment of tax on its Louisiana income that is allocable to a nonresident shareholder. However, the burden placed on shareholders to plan ahead under the Louisiana rules may be less problematic than the accounting burden on and the risk encountered by S corporation transacting business in a state that imposes a withholding requirement on S corporations.

If a state imposes a withholding requirement, the S corporation must make offsetting distributions of cash or property to resident shareholders and possibly nonresident shareholders to account for the constructive distributions made to the nonresident shareholders that are in the highest income tax bracket. Otherwise, the corporation's subchapter S election will terminate. The Louisiana rules are designed to prevent such an inadvertent termination.

The proposals advocated in this article with respect to the taxation of pass-through entities transacting business in Louisiana may provide similar benefits to both the Louisiana Department of Revenue and to the owners of the interests in the entity. Because it is likely that the Louisiana Legislature will amend Section 47:201.1 of the Revised Statutes, the Legislature should consider taxing all pass-through entities under rules similar to the Louisiana S corporation rules. If the Louisiana Legislature adopts the S corporation rules for taxing partnerships and LLCs, partnership agreements and LLC operating agreements should be amended to require any nonresident partner or member to reimburse the entity for any tax that the entity is required to pay on behalf of the nonresident partner or member.

109. See, e.g., Idaho Code § 63-3022 (2000) (shareholders may elect to have S corporation pay tax on their distributive shares of corporation's Idaho income); Okla. Stat. § 2365 (2000) (S corporation taxable on its Oklahoma income allocable to nonresident shareholders).