

RULES OF
DEPARTMENT OF REVENUE

CHAPTER 810-3-24.2

Taxation of Pass-Through Entities

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810-3-24.2-.01 Composite Returns of Pass-through Entities.

(1) Definitions. The following terms shall have the following meanings for purpose of these regulations.

(a) Subchapter K Entity. The meaning defined in §40-18-1, Code of Alabama 1975, which does not include a single member limited liability company.

(b) Composite Return. A return on a form prescribed by the Department which contains information concerning the distributive share of income for each of the nonresident members and which reports the amount of composite payment made on behalf of each nonresident member.

(c) Composite Payment. A payment of Alabama income tax made by the pass-through entity on behalf of its nonresident members; calculated on the nonresident member's distributive share of the pass-through entity's income, computed in accordance with §40-18-24; and, paid in the manner prescribed by the Department.

(d) Pass-through Entity. A partnership or other entity classified as a Subchapter K entity under §40-18-1. Neither estates nor trusts, including business trusts, are included in this definition or are subject to §40-18-24.2, except in their capacity as a nonresident member of a pass-through entity or lower-tier pass-through entity.

(2) Requirements for a Composite Return and a Composite Payment.

(a) Effective for taxable years beginning on or after January 1, 2009, a pass-through entity is required to file a composite return and make composite payments on behalf of its nonresident owners or members if there are one or more nonresident owners or members at any time during the taxable year.

1. Transition Rule. For tax years beginning from January 1, 2009 through December 31, 2009, a pass-through entity may reduce the amount of its composite payment required by this section only to the extent that the nonresident member made tax payments or estimated tax deposits to Alabama in regard to the nonresident member's income from the pass-through entity.

2. Documentation of the composite payment reduction allowed in 1 above must be provided as an attachment to the applicable composite return. In accordance with (c) below, after January 1, 2010 NRA agreements executed by the pass-through's owners become ineffective for all future tax periods.

(b) The allocation and apportionment requirements established by the Multistate Tax Compact, codified in Chapter 27, Title 40, Code of Alabama 1975,

and all rules pertaining to the Multistate Tax Compact are applicable to composite returns required to be filed by pass-through entities.

(c) In computing the amount of the composite payment, the pass-through entity shall apply the maximum tax rate provided in §40-18-5 to each nonresident member's distributive share of income, to include both separately stated income and nonseparately stated income. The nonresident member's distributive share of separately stated expenses, deductions, and losses should not be considered in computing the amount of the composite payment. The nonresident member's distributive share of income shall be computed in accordance with §40-18-24.

1. Tax-exempt Entities. The pass-through entity is not required to compute and remit a composite payment for an entity that is exempt from Alabama income taxation, in accordance with §40-18-32, Code of Alabama 1975. If the tax-exempt entity is specified in §40-18-32 and is also a nonresident owner or member of the pass-through entity, the pass-through entity is required to disclose the tax exempt entity's name and taxpayer identification number on the composite return filed for the taxable year, as is required for all nonresident owners or members. The amount of the composite payment would be zero, unless the income is considered unrelated business taxable income in accordance with 26 U.S.C. §512 or the income is otherwise specifically subject to the composite payment requirement of §40-18-24.2, Code of Alabama 1975.

2. Certain Affordable Rental Housing Projects. Pass-through entities that are engaged solely in the business of operating one or more affordable rental housing projects are exempt from the composite payment requirements of §40-18-24.2, Code of Alabama 1975, if making the composite payment would cause the pass-through entity to be in violation of a federal law or a U.S. Department of Housing and Urban Development (HUD) regulation, regulatory agreement, or directive concerning the disbursement of project funds or other funds to a project owner or on behalf of a project owner. Pass-through entities that have one or more nonresident owners or members and are subject to this exemption must file a composite return. The composite return must have attached a complete explanation as to why the exemption applies to the pass-through entity.

(d) In computing the amount of the composite payment, a pass-through entity may not offset the income or gain of a nonresident owner or member with the loss of another owner or member.

(e) In computing the amount of the composite payment, a net operating loss carryforward may not be used to offset income or gain.

(f) Composite returns and composite payments are due on the fifteenth day of the fourth month following the close of the pass-through entity's taxable year.

1. The entity is granted an automatic five month extension of time for filing the composite return.

2. An entity that fails to file the required return by the extended due date may not be granted an automatic extension the following (ensuing) year, but may be required to request the extension in writing. If a written request is required, the request must be made to the Commissioner of Revenue or to his designee, and must explain the reason for the request and the reason for failing to timely file the return in the previous year. The request also must state that the entity has no outstanding debts owed to the Department.

3. An extension of time granted to file the return is not an extension of time for payment of tax. The amount of tax due must be paid on or before the original due date of the return without regard to the extension to file the composite return.

(g) Payment of the tax shall be made in accordance with the payment procedures established by the Alabama Department of Revenue, which requires the use of electronic funds transfer for payments in excess of certain amounts.

(h) Penalties for underpayment of tax and applicable interest will be imposed as provided by Alabama income tax law.

(i) Amended composite returns reporting an overpayment of tax or an additional tax due for a taxable year may be filed by the extended due date for filing the Alabama partnership income tax return for the same taxable year.

(j) Any refund request claimed after the extended due date for filing the composite return and any additional payment determined due after the extended due date for filing the composite return must be reported on the Alabama income tax return of the nonresident owner or member.

(k) Every pass-through entity that is credited with a composite payment on a composite return must also file a composite return to properly report the composite payment.

(l) An annual composite return is due for a Qualified Investment Partnership (QIP), only if the QIP is required to remit a composite payment for a nonresident member.

(m) A publicly traded partnership as defined by U.S.C. §7704(b) doing business in Alabama that is treated as a partnership for federal income tax purposes shall provide the Department with a list of the names of each of its owners or unitholders together with their addresses, taxpayer identification numbers, and each owner or unitholder's distributive share of Alabama source

income during the tax year. The information shall be provided in lieu of the composite return in an electronic format that can be sorted and that is approved by the Department. A publicly traded partnership that fails to file a report timely with the Department is presumed to have established reasonable cause for the waiver of the failure to timely file penalty to the extent that the penalty assessed exceeds or would exceed \$500 per day of delinquency up to a maximum of \$25,000.

(n) Special situations and circumstances such as short years; changes in ownership; and, unforeseen taxpayer-specific complications resulting from the first year of implementing the new composite payment requirements may be addressed on a case-by-case basis. Requests for relief should be submitted to the Department describing the circumstances and type of relief sought.

(o) Any consent agreements filed by a subchapter K entity, as defined in §40-18-1, Code of Alabama 1975, for its nonresident members prior to the passage of the Entertainment Industry Incentive Act of 2009 (Act 2009-144) by the Alabama Legislature are void, effective for tax years beginning after December 31, 2009.

Author: Ed Cutter, CPA

Authority: Sections 40-2A-7(a)(5) and 40-18-24.3, Code of Alabama 1975

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810-3-24.2-.02 Qualified Investment Partnerships.

(1) Definitions.

(a) Qualified Investment Partnership (QIP). A partnership or other entity classified as a subchapter K entity, or a business trust as defined in §40-18-1, Code of Alabama 1975, that for a tax period which begins on or after January 1, 2009, meets the gross income and asset requirements for a Qualified Investment Partnership as required by §40-18-24.2, Code of Alabama 1975; and, for which an authorized officer, partner, member or manager of the entity has certified for the tax period that the entity meets the gross income and asset requirements. The proper form of the QIP certification and the due date for filing the certification are explained in this regulation.

1. The following restrictions apply concerning entities eligible to be a QIP:

(i) There is a rebuttable presumption that an entity is disqualified as a QIP as abusive when 50 percent or more of the ownership interest or voting interest of an entity is owned or controlled, directly or indirectly, by a corporation, as defined in §40-18-1, Code of Alabama 1975, or a controlled group of corporations, as defined in 26 U.S.C. §1563, at any time during the tax period. For purposes of this definition, own or control means to own or control directly, indirectly, beneficially, or constructively fifty percent (50%) or more of the voting power or value of an entity. The Department will review written applications or requests that this presumption not be applied to a particular entity's situation on a case-by-case basis.

(ii) An entity that, at any time during a tax period, holds or derives gross income from any qualifying investment security in which it is a dealer shall not qualify as a QIP for that tax period. An entity is a dealer in qualifying investment securities if it regularly purchases qualifying investment securities from or sells securities to customers in the ordinary course of a trade or business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in qualifying investment securities with customers in the ordinary course of a trade or business. The definition provided in 26 U.S.C. §475(c) can also be relied upon to determine if an entity is a dealer in qualifying investment securities.

(iii) An entity that is a publicly traded partnership that is taxed as a corporation for Alabama income tax purposes at any time during the tax period cannot be a QIP for that tax period.

(iv) A common trust fund, as defined in 26 U.S.C. §584, cannot be a QIP.

(v) An unincorporated entity that has elected out of the provisions of Subchapter K in accordance with 26 U.S.C. §761, at any time during a tax period, cannot be a QIP for that tax period.

(b) Qualifying Investment Securities (QIS). Financial investments as defined by §40-18-24.2, Code of Alabama 1975, that must be owned by an entity; and must make up a specified percentage of the entity's total assets; in order for the entity to qualify as a QIP, in accordance with §40-18-24.2, Code of Alabama 1975.

1. The term "qualifying investment securities" does not include:

(i) An investment in a captive REIT, as defined by §40-18-1, Code of Alabama 1975.

(ii) An interest in a partnership unless the partnership is a Qualified Investment Partnership, as defined in §40-18-24.2, Code of Alabama 1975.

(iii) Loans, other than bonds, debentures, loan participations, repurchase agreements and other debt securities that are characterized as loans.

(iv) Deposits with a financial institution or bank that is not regulated by the United States government, or by any other political subdivision thereof.

(c) Tax Period. Same definition as "taxable year" as defined in §40-18-1.

(2) QIP Requirements.

(a) All of the following requirements must be met for a tax period in order for an entity to qualify as a QIP for the tax period:

1. Asset Test. No less than 90% of the cost of the total assets owned by the entity consists of qualifying assets: qualifying investment securities; office facilities; and, tangible personal property reasonably necessary to carry on the activities of the entity as an investment partnership in the State of Alabama.

2. Gross Income Test. No less than 90% of the gross income of the entity consists of qualifying gross income: interest; dividends; distributions; management fees paid by owners of the entity; and gains or losses from the sale or exchange of qualifying investment securities (QIS).

3. Certification. An authorized officer, partner, member, or manager of the entity certifies that for the tax period the entity meets the Asset Test and

the Gross Income Test, in the proper form and by the proper time as specified in this regulation. The certification must be filed as a part of the annual Alabama partnership income tax return for the entity, on Alabama Schedule QIP-C, by the due date of the Alabama partnership income tax return for the entity. Filing a certification with a composite return for an entity is not a proper filing of the QIP certification.

(b) Required QIP Filings.

1. A QIP must file an annual Alabama partnership income tax return, properly reporting the required K-1 information for each resident member and each nonresident member, which held an interest in the QIP, at any time during the tax period.

2. A QIP must file an annual composite income tax return, as required by §40-18-24.2, Code of Alabama 1975, if the QIP is required to make a composite payment for a nonresident member.

(c) Application of the Asset Test.

1. For purposes of applying the Asset Test, the cost of an asset shall be determined for Alabama income tax purposes without regard to depreciation or amortization of the asset, except that the cost of an asset shall include any accrued interest or discount, and shall be reduced by any premium amortization, that has been recognized in the computation of Alabama taxable income of the entity and that is included on the entity's balance sheet as of the date the asset cost is determined.

2. The Asset Test is applied for each tax period, and is computed using the ratio of the entity's cost of qualifying assets to the entity's cost of its total assets, expressed as a percentage; as of the beginning of the tax period and as of the end of each month of the tax period. The average of the percentages is then computed. The average is referred to as the Average Qualifying Asset Percentage for the Tax Period.

(d) Application of the Gross Income Test.

1. The Gross Income Test is applied for each tax period, and is computed using the ratio of the entity's qualifying gross income to its total gross income, expressed as a percentage. The ratio is referred to as the Qualifying Gross Income Percentage.

2. Calculations for the Gross Income Test are to be based on information from the Alabama partnership income tax return filed by the entity for the tax period.

3. Gross income means income minus costs of sales or basis in an asset sold or traded, but without reduction for any other expenses or deductions.

4. Gross income does not include any item of income that is excluded in computing the Alabama taxable income for the entity.

5. The Gross Income Test is calculated using the method of accounting used for Alabama income tax purposes for the tax period.

6. Gross income derived from an investment in a qualifying investment partnership, subchapter S corporation, trust or estate shall be characterized as if the entity received the income directly.

7. Gross income derived from a qualifying investment partnership, subchapter S corporation, trust or estate for purposes of the Gross Income Test shall be net of related expenses and computed in accordance with Alabama income tax law.

Author: Ed Cutter, CPA

Authority: Sections 40-2A-7(a)(5) and 40-18-24.3, Code of Alabama 1975

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810-3-24.2-.03 Other Qualified Investment Partnership Matters.

(1) Every nonresident member of a Qualified Investment Partnership (QIP) that has Alabama source income must file an Alabama income tax return and report the Alabama source income even if the income earned in Alabama is included on a composite return filed by the QIP, unless the member is a nonresident individual who has no other Alabama source income. For a nonresident individual to have the benefit of any net operating losses generated by a QIP, the nonresident individual must establish those losses by filing an Alabama individual income tax return.

(2) The QIP Alabama income tax reporting requirements do not change the Alabama income tax return filing requirements for business entities.

(3) In accordance with §40-18-24.3, Code of Alabama 1975, a nonresident member of a QIP will be exempt from Alabama income tax on its distributive share of QIP income unless the nonresident member actively participates in the day-to-day management of the QIP or the QIP invests in the qualifying investment securities of an entity that is majority owned by the nonresident member.

(a) The term “majority owned” is defined in §40-18-24.3, and references the attribution rules of 26 U.S.C. §318.

(b) Income from a QIP is taxable to a nonresident member of the QIP if the income is from investment activity that is interrelated with an Alabama trade or business in which the nonresident member owns an interest even if the primary activities of the trade or business are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities.

(c) Income from a QIP is taxable to a nonresident member of the QIP if any part of the qualifying investment securities of the QIP are acquired with the working capital of an Alabama trade or business in which the nonresident member owns an interest.

(d) A financial institution, as defined in §40-16-1, Code of Alabama 1975, is taxed on its distributive share of income from a QIP if it participates in the management of the investment activities of the QIP; if it is engaged in a unitary business with another taxpayer that participates in managing the investment activities of the QIP; or, if the financial institution has income from Alabama sources.

(e) A corporation, as defined in §40-18-1, Code of Alabama 1975, is taxed on its distributive share of income from a QIP if it participates in the management of the investment activities of the QIP; if it is engaged in a unitary business with another taxpayer that participates in managing the investment activities of the QIP; or, if the corporation has income from Alabama sources.

(4) The allocation and apportionment requirements set out in the Multi-state Tax Compact, codified in Chapter 27, Title 40, Code of Alabama 1975, and all rules pertaining to such laws are applicable to Alabama income tax returns and composite returns required to be filed by pass-through entities, including those required to be filed by Qualified Investment Partnerships.

(5) Business Trust. The term “business trust” is defined in §40-18-1, Code of Alabama 1975.

(a) For federal income tax purposes, a business trust is classified as a business entity, not as a business trust. The business entities that a business trust may be classified include only: disregarded entity; partnership; or, corporation.

1. A business trust that has made a federal election to be treated as a corporation, at any time during the tax period, cannot qualify as a QIP for the tax period.

2. A business trust that is treated as a disregarded entity for federal income tax purposes, at any time during the tax period, cannot qualify as a QIP for the tax period.

3. A business trust that is treated as a partnership for federal income tax purposes can qualify as a QIP, if the entity satisfies the requirements of Alabama Regulation Number 810-3-24.2-.02, Qualified Investment Partnerships.

(6) In order to correct the effect and result of a tax-avoidance or a tax abusive arrangement, or series of transactions, the Commissioner of Revenue shall have the authority to distribute, apportion, or allocate the gross income of any pass-through entity, QIP, or pass-through entity member in order to clearly, fairly, and equitably reflect the income of any entity, pass-through entity, QIP, or QIP member, whose income may have been significantly distorted by the application of the tax-avoidance or tax abusive arrangement, or series of transactions. The Commissioner of Revenue may recast QIP transactions if it is determined the transactions do not have a substantial business purpose or it is determined that the form of the transactions yield results that have the substance of tax-avoidance or tax abuse.

(7) The Commissioner of Revenue may revoke an entity’s QIP status if it is determined that the entity did not meet the QIP requirements.

Author: Ed Cutter, CPA
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