THE TAX ADVISER

Considerations for Filing Composite Tax Returns

TAX PRACTICE MANAGEMENT

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Many states allow a passthrough entity to file a composite return on behalf of its nonresident individual owners in lieu of each owner filing his or her own nonresident return to report and pay tax on his or her share of state income from the entity. A composite return is an individual return filed by the passthrough entity that reports the state income of all the nonresident owners or, in some cases, the electing members, as one group. Filing the composite return can also relieve the passthrough entity of the withholding requirement that many states impose on passthrough entities with nonresident owners.

It sounds like a win-win for everyone involved: The state gets its money while the owners' personal filing obligations are reduced. However, taxpayers and their advisers should consider some key issues before deciding that a composite return is the best choice. Then, even if they decide a composite return is the way to go, they must consider additional issues.

Is Composite Filing the Right Choice?

Convenience vs. Higher Taxes

One primary benefit of filing composite returns is that they are convenient for a passthrough entity's owners who otherwise would have to file multiple nonresident state returns. In addition, passthrough entities' owners often face a dilemma in deciding whether to file returns in nonresident states where they may not be required to file. Adding to the dilemma is that non-resident-sourced income levels may fluctuate from year to year.

Another primary benefit arises because composite returns provide the passthrough entity's owners some relief in lower tax preparation fees, since they will be filing individually in fewer nonresident states. State tax laws are frequently very complicated and unique to each state, and the burden of filing in many states can be substantial.

However, a passthrough entity's owner needs to consider that filing composite returns may subject that nonresident income to the highest marginal rate and not allow the taxpayer to take advantage of lower graduated rates. This consideration is especially critical in a state with a high marginal tax rate, such as California (13.3% personal income tax top bracket) or New York (8.82%), and may even be higher when local levies are considered. Furthermore, because of the alternative minimum tax, the passthrough entity's owner may not get the benefit of the full itemized deduction on his or her federal return for paying the higher state income taxes.

Filing a composite return may prevent the taxpayer from taking advantage of deductions at the applicable state level or credits that he or she otherwise may have been able to use. The passthrough entity owner's filing status also needs to be considered, as filing either jointly or married filing separately may be beneficial in a state if he or she is not included on the composite return.

Statute of Limitation

It is important to determine when the statute of limitation begins for the passthrough entity's owner in the applicable state when the composite return is filed. If it is determined several years later that a passthrough entity's owner actually had income in that state (possibly from another entity) or had spent enough time in a state to be considered a resident, the statute of limitation would not have begun to run (since no return was filed). Therefore, a passthrough entity's owner should consider not participating in the composite return if he or she may have state nexus or domicile issues.

If the passthrough entity's owner spends any time in a state, detailed records should be maintained to track activity and travel within that state. States have become more aggressive in claiming that a taxpayer is a resident of a state based on time spent in the state, especially if the taxpayer owns property there. States may also try to allocate some of the wages earned by the

passthrough entity's owner as wages in that state. If that happens, the passthrough entity's owner would be ineligible to participate in the composite return in that year.

Other Considerations for Not Participating in a Composite Return

If the passthrough entity's owner is considering a change of domicile in the near future, he or she may choose not to participate in a composite return to clearly distinguish the nonresident years from the first resident year. Also, if the passthrough entity is currently experiencing a loss, the passthrough entity's owners may choose not to participate in a composite return. Prior-year losses are typically not allowed on a composite return. By filing their own individual returns, owners may be able to establish a position to take losses against future income. This, of course, depends on state laws on the use of loss carryovers. Once the losses are used up, the owners could then begin filing composite returns.

Many states base a nonresident's tax on overall income, frequently federal adjusted gross income adjusted for the state's additions and subtractions, not just the income in that state. If the passthrough entity's owner has other assets that generate deductions or losses, the tax rate could be significantly lower if the owner files his or her own individual return rather than participating in a composite tax return.

Steps After Determining That the Entity Should File a Composite Return

Engagement Letter and Representation Letter

A practitioner may be in a situation where the passthrough entity is the client but some or all of the owners of the entity are not. A key question to consider is whether preparing the composite return for the passthrough entity makes the owners clients too. The practitioner prepares the return on their behalf using information provided by them and/or the passthrough entity. Therefore, it is generally considered a best practice to treat each of them as a client as well.

Consistent with best practices, many accounting firms require clients to sign an engagement letter and a representation letter. The letters should be specific to the issue of the composite filing. A sample combined engagement/representation letter is shown here.

Powers of Attorney

Several states require passthrough entities to maintain a file of powers of attorney (POAs) executed by each electing nonresident individual authorizing the passthrough entity to include the nonresident owner in the composite return. Whether or not the state requires the passthrough entity to maintain POAs, it is in the passthrough entity's best interest to get a POA for this specific issue, as it is filing and signing a return on behalf of the owner. The tax preparer should recommend that the passthrough entity contact its legal counsel to prepare a form that the passthrough entity can use for each owner to annually authorize the entity to include the owner in the state(s) composite return for nonresidents.

Other Required Miscellaneous Forms

Many states require a nonresident owner to fill out certain forms when that owner is included in a composite filing. The state may require the forms to be maintained in the company's records or that they be sent in with the composite return. This is an easy step to overlook. Tax preparers accepting such engagements should establish an in-house resource that lists the information required by each state where the entity does business and is updated annually.

Payment of Composite Taxes by Passthrough Entities

The payment of composite taxes is typically treated as a distribution to the nonresident owners and not a corporate deduction of state income tax expense. Therefore, the tax preparer must ensure that the passthrough entity is not violating any loan or other legal covenants that restrict distributions to owners by paying composite taxes on behalf of the owners.

Unlike corporations that are accrual-basis taxpayers, individuals deduct state income taxes when paid. When preparing composite returns, it is important to provide a schedule of the composite taxes paid, with the date paid, for each owner included in the composite filing. The owners can use this schedule to determine the state income tax deduction on their federal return and possibly get a credit for other state taxes paid on their resident state return.

The payment of composite taxes can result in disproportionate distributions for several reasons, including:

- Some of the owners might have chosen not to be included in the composite returns;
- Some of the owners might be ineligible to be included in some or all of the composite filings due to residency status, income in that state from outside sources, etc.; and
- Composite taxes are not always based on a flat rate—different tax rates may apply, based on income level or filing status.

Disproportionate distributions are typically forbidden in S corporations and may violate a passthrough entity's partnership or limited liability company operating agreement. Therefore, payment of composite taxes on behalf of some owners will require payment of cash of a pro rata amount to the remaining owners to correct the effect of the potential disproportionate distributions made. An analysis should be completed before year end to determine the amount of cash that will be due to owners to correct the disproportionate distributions.

Communication Between the Passthrough Entity and Owner

The passthrough entity, as a best practice, should communicate with its owners and the owners' tax advisers to provide sufficient time to decide whether to join the composite filing and comply with different state deadlines, including requirements for estimated payments and extensions.

The passthrough entity, along with its tax practitioner, also needs to monitor the frequent changes and updates with composite filing and withholding requirements in different states. The passthrough entity may also want to consider having its tax department, if applicable, coordinate the composite and withholding information with its different tax advisers.

Tax Controversy Issues (Notices and Audits)

A passthrough entity's owner may face issues with a nonresident state's tax authority that may include correspondence audits or a more detailed examination with an assigned agent. This could happen whether the owner files his or her own nonresident individual returns or participates in the composite returns.

Another issue with state tax authorities is the issuance of notices as the result of reported withholdings from the passthrough entity that do not agree with the individual's return if the owner chose to file his or her own returns. This is especially true when a passthrough entity has lower-tier flowthrough entities that also have withheld tax payments.

Practitioners may want to consider addressing these issues in the engagement letter with the passthrough entity's owner. The engagement letter should address the practioner/firm's policy on representing a taxpayer in an audit and whether an additional charge is required for this service. (Note that this language is not included in the sample letter.)

Conclusion

Composite filing faces obstacles in different states, and some states do not allow it at all. For example, some states require a minimum number of owners to participate in a composite return. Other states place such a heavy paperwork burden on the passthrough entity that the convenience is significantly reduced. However, each year, more states are removing the barriers and making it easier for a passthrough entity's owner to participate in the composite filing. As it becomes simpler to participate, it is still crucial to analyze the relevant issues before choosing whether to participate.

EditorNotes

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