

MEMORANDUM

To: Rick Brown, Chairman
Business Association Tax Coalition

From: CSS

Date: April 22, 2011

Re: HB 548 – Gross Income Legislation relating to Resident Members/Partners/Shareholders
of Pass-Through Entities or Beneficiaries or Trusts.

Per your request, I have reviewed HB 548. HB 548 is attempting to correct the inconsistency highlighted in *McNees v. Alabama Department of Revenue*, Administrative Law Division, in which a resident Alabama taxpayer was permitted to deduct his entire distributive share of net operating loss deductions (from whatever source) from a pass-through entity (such as a partnership, limited partnership, limited liability company and S corporations), while the regulation in effect at the time only required taxpayer to include in Alabama income the portion of the income attributable to the State of Alabama. HB548 attempts to legislatively rectify the inconsistency in gross income interpretation in two ways. First, it amends the definition of “gross income” relating to resident taxpayers under §40-18-14(4) who receive pass-through income and second, it modifies §40-18-21 with respect to the calculation of tax credit for taxes paid outside the State of Alabama.

Under HB 548, as introduced, the definition of “gross income” under Section 40-18-14(4) now expressly includes with respect to resident taxpayers, such resident’s proportionate share of any income arising from any Subchapter K entity (*i.e.*, partnership, limited partnership, limited liability partnership, or limited liability company taxed as a partnership), an Alabama S Corporation, or an Estate or Trust “regardless of the geographic source of the income.” It also clarifies that the proportionate share to be reported is defined by reference to the resident taxpayers status as a member of the Subchapter K entity, shareholder of the Alabama S Corporation or beneficiary of an estate and the relative interest in that entity owned by the individual.

Under HB 548 the amendments to §40-18-21 deal with the credits allowed to a resident taxpayer for taxes paid to other states and taxes paid to foreign countries. The first clarification in the section provides that the credit is applicable to resident taxpayers who are owners of pass-through entities for taxes paid by those entities by either the resident taxpayer or the entity on behalf of the resident taxpayer (*i.e.*, composite reporting). Furthermore, it clarifies that such credits are allowed for taxes actually paid by a resident on account of business transacted or property held, directly or indirectly (*i.e.* pass-through entities outside the State of Alabama). It also defines the “income tax” in other jurisdictions for which credits are available by GAAP adopted by the Financial Accounting Standards Board and shall include taxes based on “net worth.”

Finally, HB 548 also clarifies that the credit for foreign taxes paid is not limited to tax paid solely on income within certain 2002 North American Industry Classification System sectors and sub-sectors, which have the effect of limiting the tax credit to be taken.