SENATE BUDGET AND APPROPRIATIONS COMMITTEE

STATEMENT TO

SENATE, No. 1962

STATE OF NEW JERSEY

DATED: DECEMBER 14, 2000

The Senate Budget and Appropriations Committee reports favorably Senate Bill No. 1962.

This bill closes a gap in the administration of the taxes imposed on the owners of limited partnerships and limited liability companies.

Limited partnerships and limited liability companies are relatively new forms of business entities that have become popular because they combine some of the tax advantages of a pass-through entity, such as a general partnership (e.g., lack of an entity-level tax and a distributee-level tax on distributed earnings), and the sort of limited liability for owners that is provided by the corporate form of organization. However, it appears that the use of some of these entities in New Jersey that were created to avoid a double level of taxation is resulting in the avoidance of even a single taxation of their income derived from their New Jersey activities.

This situation is not without precedent. When the New Jersey tax rate on Subchapter S corporations was lowered in 1993, an administrative mechanism was put in place to assure the fair taxation of the owners of those corporations. The Subchapter S corporation owners were given a choice of consenting to the normal New Jersey taxation of the income they derived or, if they did not so consent, of having the S corporation withhold their taxes.

This bill provides a similar mechanism for the taxation of limited corporate owners of limited liability companies and limited partnerships. A limited liability company, foreign limited liability company, limited partnership or foreign limited partnership that is classified as a partnership for federal tax purposes is required to obtain the consent of each of its owners that are not individuals, trusts or estates subject to the "New Jersey Gross Income Tax Act", N.J.S.54A:1-1 et seq. (for example, each owner that is itself a corporation) that this State has the right and jurisdiction to tax the entire income derived from the business. A business that does not have the consent for one of that group of its owners must pay corporation business tax on its nonconsenting owner's share of the business's New Jersey income.

Under the bill, a limited liability company, foreign limited liability company, limited partnership or foreign limited partnership that (1) is classified as a partnership for federal tax purposes, (2) properly complies with the requirement to obtain consents from its corporate owners and (3) pays the taxes of any of its corporate owners that do not consent to New Jersey taxation is relieved of any other obligations under the corporation business tax. A business that does not comply with the consent and payment requirements becomes a corporation business taxpayer itself.

FISCAL IMPACT

This bill forecloses an avenue of corporation business tax avoidance. No information is currently available about the level of business use of the method, so no estimate can be made of the amount of revenue loss curtailed. The Office of Legislative Services notes, however, that the professional literature on state taxation of business organizations and their owners reports that, as would be expected of such new business types of business organizations, the taxability of the corporate owners of these new limited partnerships and limited liability companies is not well established under case law. This literature suggests a number of creative arguments that could be used to dispute the taxability of limited liability company and limited partnership owners under state corporate income tax laws. While the amount of corporation business tax revenue that would be at risk of challenge is not currently known and cannot be accurately estimated, it is not unreasonable to assume that there would be some challenges to taxation. This bill curtails those routes of tax avoidance.