

Administrative Release No. 6

**Subject: Taxation of
Pass-through Entities Having Nonresident Members.**

I. General

Under § 10-401 of the Tax-General Article, Annotated Code of Maryland,¹ the portion of a nonresident individual's federal adjusted gross income derived from income of a business, trade, profession or occupation carried on in Maryland is subject to tax in this State. Under TG § 10-305, income derived from a trade or business carried on or attributable to this State is taxable and reportable by corporate entities. Nonresident members, including members who are individuals or entities, of a pass-through entity doing business in Maryland must report their distributive or pro rata shares of income from the pass-through entity and compute their Maryland tax on the applicable Maryland income tax returns.²

To assure compliance, in 1991 the General Assembly added § 10-102.1 to the Tax-General Article, Annotated Code of Maryland, which provides that for all taxable years beginning after December 31, 1990, any partnership or S corporation doing business in Maryland shall pay to the Comptroller a tax for each nonresident individual partner or shareholder.³ Prior to July 1,

2005, the tax imposed on the pass-through entity was on each item of net income includable in the nonresident individual member's distributive or pro rata share of pass-through entity's nonresident taxable income.

Effective July 1, 2005, the General Assembly amended TG § 10-102.1 to alter the rate of the tax imposed on pass-through entities that is paid on behalf of the nonresident individual members. The tax is equal to the sum of the top-marginal State tax rate (currently 5.75%) and the special nonresident income tax imposed under TG § 10-106.1, which is equal to the lowest county income tax rate (currently 1.25%). This rate is applied to the sum of each nonresident individual member's share of the pass-through entity's nonresident taxable income. Historically, the tax imposed was at the top marginal State tax rate as follows: 1997 and prior - 5%; 1998 - 4.875%; 1999 - 4.85%; 2000 - 4.85%; 2001 - 4.8%; 2002 through 2007 - 4.75%; 2008 through 2010 - 6.25%; 2011 - 5.5%; 2012 through 2014 - 5.75%.

Also effective July 1, 2005, the General Assembly amended TG § 10-102.1 to provide that pass-through entities that have a nonresident member that is a nonresident entity (defined as an entity that is not formed under Maryland laws and is not qualified by or registered with the Maryland State Department of Assessments and Taxation to do business in Maryland) and nonresident taxable income must also pay a tax, imposed at the rate for a corporation (currently 8.25%).⁴ This rate is applied to the sum of each nonresident entity

¹ All statutory reference are to the Tax-General Article (TG) of the Annotated Code of Maryland unless otherwise specified.

² In this release, wherever the term "pass-through entity" is used, it includes an S corporation, partnership, and a LLC not taxed as a corporation and business trust not taxed as a corporation. In this release, the term "member" means a shareholder of an S corporation, partner of a partnership, member of a limited liability company, and beneficiary of a business trust.

³ In 1992, the law was amended to provide that a limited liability company (LLC) shall be treated the same as a partnership with regard to the payment of tax on behalf of its nonresident members.

In 1999, Section 12-102 of the Corporations and Associations Article of the Annotated Code of Maryland was amended to provide for the organization and operation of business trusts. This section provides that for purposes of any tax imposed by the Tax-General Article, a business trust shall be classified as a

corporation, an association, a partnership, a trust or otherwise as determined under the Internal Revenue Code. Thus, to the extent a business trust is treated as a partnership, the business trust shall be subject to the payment of tax on behalf of its nonresident beneficiaries. In 2006, TG § 10-102.1 was amended to include a business trust, not taxed as a corporation, within its definition of pass-through entity.

⁴ The tax rate for a corporation is 7% for all taxable years beginning before January 1, 2008.

member's share of the pass-through entity's nonresident taxable income.

The pass-through entity's nonresident taxable income includes any income derived from real or tangible personal property in Maryland, any income from business that is in part or wholly carried on in Maryland, any income derived from an occupation, profession or trade carried on in part or wholly in Maryland, and any income derived from Maryland wagering. This includes any income derived from the sale or other disposition of an ownership interest in a pass-through entity where the pass-through entity owns real or personal property in Maryland or conducts a business in Maryland.

The law limits the liability of the pass-through entity to the sum of all the nonresident members' shares of the pass-through entity's distributable cash flow, which is computed on Form 510. However, the cash flow limitation does not affect the tax liability of any single nonresident member or nonresident entity member. The limitation operates solely for the relief of those pass-through entities that have taxable income attributable to the nonresident members, but do not have sufficient distributable cash flow to pay the total nonresident member tax.

If a pass-through entity calculates its tax based on the applicable tax rate applied to the total distributive or pro rata shares of its nonresident members attributable to income from Maryland sources, then it is not required to calculate the cash-flow limitation. The imposition of the tax against a pass-through entity does not change the filing requirements or the tax liability of nonresident members with income attributable to Maryland.

II. Exemptions

A. Nonresident Member

The term "nonresident member" does not include a Real Estate Investment Trust as defined by § 856 of the Internal Revenue Code and an organization exempt under the Internal Revenue Code (including IRA's, Keoghs, pension and profit-sharing plans and other such organizations).

B. Partnerships

Partnerships whose activities and assets are limited to investment in stocks, bonds, futures, options or debt obligations other than debt instruments directly secured by real or tangible

personal property are not subject to the nonresident member tax merely because the investment decisions, trading orders, research and the like are conducted by a general partner from a Maryland location. Partnerships, however, such as brokerage firms which deal with the general public, are not exempt if the business is conducted within Maryland.

C. Examples:

1. Partnership A was formed exclusively to conduct investment trading activities for its partners only, and invests exclusively in stocks, bonds, futures and options. Investment management is conducted by general partner B from a Maryland office. B receives a percentage of assets and/or income that varies according to partnership results, and is disproportionate to B's capital interest. The partnership has three nonresident partners - C, D and E. Each of the nonresident partner's share of the trading results of the partnership is proportionate to their investment capital. The partnership is required to file a Maryland income tax return, but it is exempt from the nonresident tax. C, D and E are exempt from filing nonresident income tax returns if they have no other income from Maryland sources. Partnership A should attach a brief description of its activities to its Maryland partnership return to explain the absence of the nonresident tax.

2. Partnership V owns a shopping center in Maryland as well as a substantial investment portfolio consisting of stocks, bonds and other intangible investments. Management is conducted by general partner X from a New York location. Y and Z are limited partners residing in New York. The partnership is subject to the nonresident tax. X, Y and Z are required to file nonresident income tax returns and the percentage of partnership income allocated to Maryland is determined under TG § 10-401 and relevant regulations.

III. Treatment of Tax

The law provides that the tax imposed on the pass-through entity shall be treated as a tax imposed on the nonresident members and is paid on their behalf by the pass-through entity.

The tax paid by the pass-through entity may, therefore, be treated as a tax paid by the nonresident member in computing estimated taxes and may be taken as a credit on that member's income tax return. However, any tax paid by the

nonresident members individually may not be deducted from the tax imposed on the pass-through entity.

IV. Statements to Nonresident Members

The pass-through entity must provide each of its nonresident members with a statement showing the amount of tax paid on their behalf on a Maryland Form 510 Schedule K-1, Maryland Pass-Through Entity Member's Information⁵.

V. Filing Returns

A. Partnerships and S Corporations

1. Annual Returns

Each pass-through entity doing business in Maryland must file a Pass-Through Entity Income Tax Return (Form 510). A Maryland Form 510 Schedule K-1 for each member must be submitted with the information return. The due date for the return is: for a partnership, limited liability company and business trust, the 15th day of the 4th month following the close of the entity's taxable year; and for an S corporation, the 15th day of the 3rd month following the close of the S corporation's taxable year.

See Administrative Release No. 4 (Extension of Time for Filing Maryland Income Tax Returns and Estate Tax Returns) for information on requesting an extension of time to file the return. Note that an extension of time to file the return does not extend the due date for payment of the tax.

If no money is due, file the extension request on the Comptroller's web site at www.marylandtaxes.com. If a payment is due with the extension request, Form 510E is required.

2. Estimated Tax Returns

a. Requirement to File.

A pass-through entity must file a Declaration of Estimated Pass-Through Entity Nonresident Tax (Form 510D) based on the total distributive or pro rata share of income of all the nonresident members, if the total tax is expected to exceed \$1,000.

b. Due Date.

(1) **Partnership.** A partnership, limited liability company, or business trust required to file an estimated tax return (Form 510D) shall file quarterly and pay the tax due on or before April 15, June 15, September 15 and January 15.

(2) **S Corporations.** An S corporation required to file an estimated tax return (Form 510D) shall file quarterly and pay the tax due on or before the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

(3) **Other.** **The annual return of the pass-through entity will reconcile the total estimated taxes paid with the total tax liability computed on the return.** Any underpayment of tax is due when the annual return is filed.

B. Nonresident Members

1. Except as provided in paragraph 2 of this subsection, nonresident individual members must file a nonresident individual return, Form 505. A fiduciary must file Form 504. Nonresident entity members must file a Form 500 or Form 510 as applicable. Nonresident members must report their distributive or pro rata share of income received from the pass-through entity attributable to business conducted in Maryland. Such income must be reported in the member's taxable year in which the pass-through entity's taxable year ends. Credit for taxes paid by the pass-through entity must be claimed on the same return on which the nonresident member reports the income that is subject to tax by the pass-through entity. For example, a calendar-year nonresident shareholder of an S corporation whose taxable year ends March 31, 2005, reports the pro rata share of income received from the S corporation on the 2005 nonresident return. Credit for taxes paid by the S corporation on that income must be claimed on the 2005 nonresident return. A copy of the Maryland Form 510 Schedule K-1 from the pass-through entity must be attached to the return.

2. A pass-through entity may elect to file a composite return on behalf of qualified nonresident individual members (natural persons only). All nonresident individual members who qualify and elect to be included on the composite return must agree that the pass-through entity is their agent for the receipt of any refund or for payment of any tax due. If the pass-through entity satisfies the conditions for filing a composite return, then that return shall be considered the return of each

⁵ Although this release deals primarily with nonresident members, statements must be provided to ALL members (resident and nonresident of the pass-through entity).

nonresident individual member participating in the composite return filing for all purposes, including the date on which the statute of limitations on assessment begins to run.

Amendments to composite returns must be made by the pass-through entity filing the composite return. Participating nonresident individual members may not amend the composite return or file separate returns.

VI. Composite Returns

A. Requirements

Only nonresident individual members may be included on a composite return. Nonresident fiduciary members and nonresident entity members cannot be included on a composite return.

To qualify for filing a composite return, the pass-through entity must satisfy the following requirements:

1. A nonresident individual member must elect to join in the filing of a composite return by the pass-through entity and must acknowledge his or her awareness that the income included on the composite return is taxed at the highest Maryland income tax rate of 5.75%, plus the special nonresident tax of 1.25%. A statement, verifying that the election and the acknowledgement have been made, must be attached to the return and signed by an authorized official of the pass-through entity. A composite return may be filed even though not all nonresident individual members elect to be included in the return. However, a composite return may not be filed if only one member elects to join the filing of the composite return. Similarly, a pass-through entity may not file a composite return if the entity only has one member.

2. To make the election, a nonresident individual member must be subject to Maryland income tax solely because of the income from the pass-through entity. Any nonresident individual member having taxable income derived from other Maryland sources may not make the election and must file an individual nonresident return.

3. The pass-through entity must show the percentage ownership of each nonresident individual member.

4. A schedule must be provided for total income of the pass-through entity and the amount attributable to Maryland sources.

5. The taxes paid with Form 510, 510D and 510E may be taken as a credit on the composite return for the nonresident individual members participating in the return.

6. No credits, other than the credit for taxes paid with Form 510, 510D and 510E, may be claimed on a composite return.

7. No flow-through addition or subtraction modifications, other than the modification required as a result of Maryland's decoupling from the additional depreciation allowance and special 5-year net operating loss carryback provisions (see Administrative Release No. 38), may be claimed on a composite return.

8. A schedule must be attached which includes:

a. The name, address and social security number of each nonresident individual member.

b. The filing status of each nonresident individual member.

c. The distributive income allocable to Maryland for each nonresident individual member.

d. The allowable exemptions for a nonresident individual member, which shall be equal to the sum of the allowable exemptions for a resident multiplied by a fraction:

(1) The numerator of which is the total distributive or pro rata shares of the nonresident individual members attributable to income from Maryland sources. (Line 6 of Form 510, excluding the portion applicable to nonresident fiduciary members); and

(2) The denominator of which is the total distributive or pro rata shares of the income of the pass-through entity. (Line 2 of Form 510.)

e. The amount of the standard deduction of a nonresident individual member, which shall be the maximum standard deduction allowed a resident having the same filing status multiplied by a fraction:

(1) The numerator of which is the total distributive or pro rata shares of the nonresident individual members attributable to income from Maryland sources. (Line 6 of Form 510, excluding

the portion applicable to nonresident fiduciary members); and

(2) The denominator of which is the total distributive or pro rata shares of the income of the pass-through entity. (Line 2 of Form 510.)

f. The taxable income of each nonresident individual member.

g. The income tax liability of each nonresident individual member calculated at the rate of 7%.

h. The amount of taxes paid on behalf of each nonresident individual member.

i. The balance of tax due which must be paid in full with the filing of the composite tax return.

j. The amount of any refund.

B. Forms and Attachments

Effective 2011 and forward, a pass-through entity (PTE) that files a composite return must use the new Maryland Composite Return, Form 510C, and show the name, address and Federal Employer Identification Number of the pass-through entity. The return must be signed by the president or other authorized officer of an S corporation; a general partner on behalf of a partnership; a member of a limited liability company; or a trustee or authorized officer of a business trust. Attach to the return the schedules and information referred to above.

For pass-through entity tax years 2010 and prior, the PTE would continue to use the nonresident individual return, Form 505, to file composite returns.

C. Due Date and Extension

When filing a composite return, Form 510C or Form 505, the due date is the due date for the filing of a nonresident individual return. To file an extension for the composite return, use Maryland Form 502E, the Maryland Application for Extension of Time to File Personal Income Tax Return. See Administrative Release No. 4.

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