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Wisconsin: Dividends-received deduction allowed foreign limited partnership under federal check-the-box rules

The Wisconsin Tax Appeals Commission ruled in favor of a taxpayer in a dispute addressing whether amounts received from a foreign limited partnership (that had elected to be treated as a corporation) were distributions eligible for a dividends-received deduction under Wisconsin law.

The case is: *Deere & Co. v. Wisconsin Department of Revenue* (August 22, 2019)

KPMG observation

The ruling has applicability beyond the taxpayer in this case, in that other companies with similar foreign structures may have been audited on the same issue. It is unclear at this time whether the Department of Revenue will file an appeal.

Background

The taxpayer was the sole owner of a single member limited liability company (SMLLC) disregarded for U.S. federal income tax purposes.

Together, the taxpayer and the SMLLC formed a Luxembourg entity that was akin to a limited partnership. For U.S. federal income tax purposes, the Luxembourg entity had "checked the box" to be an association that was taxable as a corporation. Because the SMLLC was a disregarded entity for U.S. federal income tax purposes, the taxpayer was treated as the sole owner of the Luxembourg entity.

During the audit period, the Luxembourg entity made distributions to the taxpayer. For U.S. income tax purposes, because the SMLLC was a disregarded entity, these distributions were considered as having all been received by the taxpayer, and a dividends-received deduction was claimed by the taxpayer for all (100%) of these distributions on its Wisconsin returns. On audit, the Department of Revenue denied

the dividends-received deduction on the basis that the state's deduction did not extend to distributions from a foreign entity that was akin to a foreign limited partnership.

The taxpayer appealed to the Commission.

Arguments by the parties

Under Wisconsin law, the federal dividends-received deduction is replaced with a state-specific rule that allows corporations to deduct from income those dividends received from a corporation with respect to its common stock if the corporation receiving the dividends owns, directly or indirectly, during the entire tax year at least 70% of the total combined voting stock of the payor corporation.

- The taxpayer argued before the Commission that because the Luxembourg entity had checked the box, it had been transformed into a corporation and therefore, for tax purposes, its ownership interests were now in the form of common stock. As such, distributions from the entity to the taxpayer were dividends on common stock eligible for Wisconsin's dividends-received deduction.

- The Department of Revenue, on the other hand, argued that the Luxembourg entity remained composed of partnership capital interests so it could not have issued common stock. In the Department's view, because no common stock existed, the distributions were not dividends, but were simply distributions to partners with respect to their partnership interests. In the alternative, the Department argued that even if the Luxembourg entity were treated as a corporation, its stock was not "common stock" so that the distributions were not eligible for the state's dividends-received deduction.

Commission's ruling

As noted by the Commission, under Wisconsin law, a "corporation" includes an entity that has elected for federal income tax purposes to check the box to be treated as a corporation. The Commission thus determined that for Wisconsin tax purposes, the Luxembourg entity was a corporation. Under federal law, the effect of a check-the-box election is that the partnership is deemed dissolved and the partners (now shareholders) retain stock in the new corporation. The Commission concluded that because Wisconsin had adopted the check-the-box election treatment, it must for tax purposes, "accept the deemed transactions which facilitate that deemed transformation."

Further, it was noted that the Department's own guidance (Publication 119) as in effect during the audit years clarified that the rules regarding LLCs treated as corporations also applied to limited liability partnerships. The Commission observed that the Department must respect its own guidance in effect during the relevant audit period.

The Commission further rejected the Department's contention that the stock at issue was not "common stock" so that the distributions were not eligible for the dividends-received deduction. In the Commission's view, there was "no indication" that more than one class of stock was created, and it therefore concluded that the stock was common. Thus, the distributions made to the taxpayer were, for tax purposes, dividends made with respect to common stock eligible for Wisconsin's dividends-received deduction.

KPMG observation

The Department of Revenue has denied the dividends-received deduction on audit for a number of different taxpayers with structures that include "check-the-box" foreign entities. As noted above, the Department has not indicated whether it will appeal the Commission's decision in this matter.

The Department also may provide further guidance on its website or in its quarterly publication—the Wisconsin Tax Bulletin. Companies with fact patterns similar to that of the taxpayer in this matter need to consider whether they have been assessed on a dividends-received deduction adjustment, the degree to which the Commission's holding may be applicable to them, and what would be appropriate steps to take to protect their position.

For more information, contact a tax professional with KPMG's State and Local Tax practice:

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