



MULTISTATE TAX COMMISSION

### April 2018 Uniformity Committee Meeting

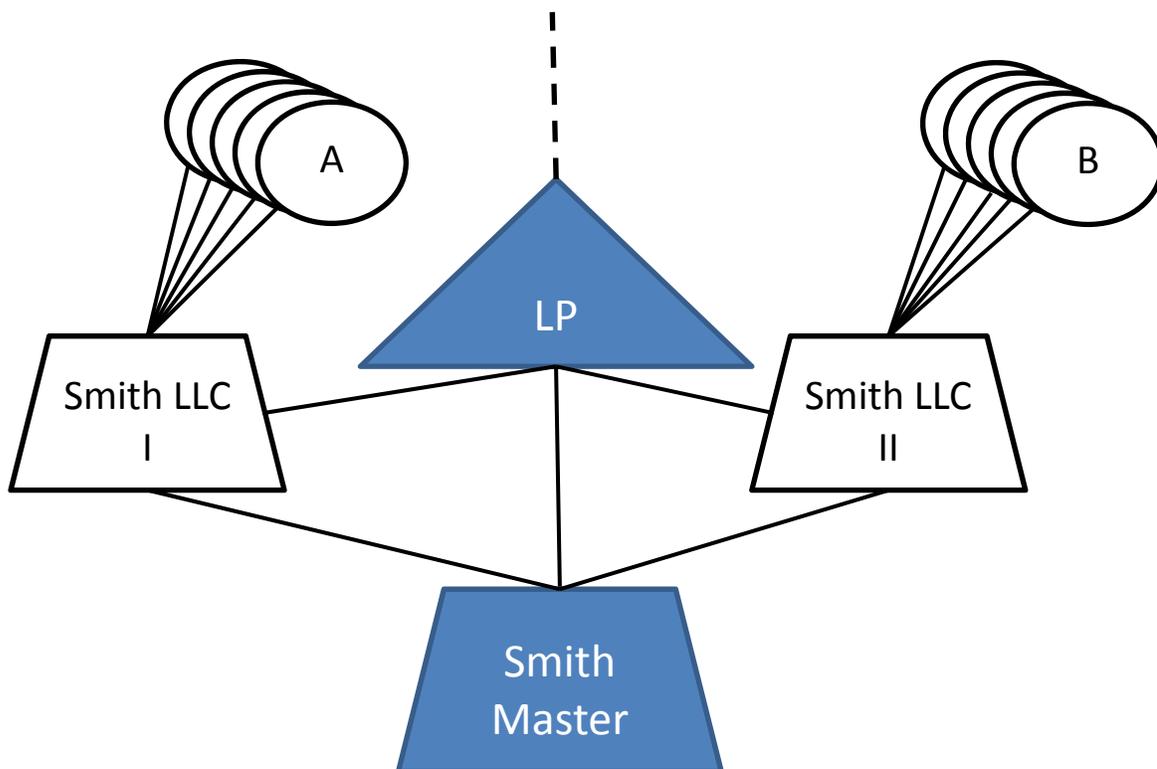
Radisson Blu Mall of America  
2100 Killebrew Drive  
Bloomington, Minnesota 55425  
Wednesday, April 25, 2018

### Partnership/RAR Model Work Group - Example

Helen Hecht, General Counsel

Several people have asked for an example that illustrates the issue that the work group has been grappling with under the proposed partnership pays election. There are a number of different examples that could illustrate the problem. The following is a simple example:

- Assume that 10 individuals, who are extended members of the Smith family and heirs to a family business, have various investments.
- In 2010, the Smith family members decided to combine these investments and also to bring in a manager to oversee them.
- To accomplish this, and other related goals, they formed the following structure:



- In this structure –
  - Each individual is a member of one of two LLCs, Smith LLC I or LLC II.
  - The two LLCs are 45% members in Smith Master.
  - LP (Manager) is an unrelated manager limited partnership (with various partners).
  - LP holds a 2% interest in and provides basic administration for Smith LLC I and Smith LLC II.
  - LP holds a 10% interest in and provides management for Smith Master LLC.
  - Smith Master invests in several other businesses and also lends money to these same businesses. It receives distributive shares, dividend, and interest income, and occasionally capital gains.
  - LP Manager makes all investment decisions for Smith Master and is entitled to a share of profits.
  - The Smith family members make no decisions for Smith Master.
  - Family members are all residents in State A
  - LP Manager itself is operated by one of its partners, which is domiciled in State B, and has no property (other than investments) or payroll.
  - Smith Master likewise has no property or payroll and, because it is managed by LP Manager, it has its domicile in State B.
  
- Original Filing:
  - Both states A and B require residents that have investment income of the type that comes (indirectly) from Smith Master to report that income 100% to the state, and do not require nonresidents to pay tax on that type of income on a source basis.
  - So the family members here report 100% of the income to state A (and pay no tax, and get no credit for tax paid, to any other “source” state).
  
- Federal Audit:
  - Assume Smith Master LLC is subjected to a federal audit.
  - Because Smith Master LLC has pass-through partners, it is subject to a centralized audit (even though it has fewer than 100 indirect partners).
  - If Smith Master LLC has adjustments – it may push out the adjustments or may pay the imputed underpayment at the entity level.
  
- Under the proposed model:
  - Regardless of what Smith Master does at the federal level, it will either:
  - Pass through the adjustments in amended state returns, or
  - Elect to pay the state tax on the adjustments at the entity level under the partnership pays election.
  
- Under the partnership pays election:

- A partnership that must report an adjustment or share of adjustment has the option to make the state partnership-pays election regardless of what it chooses to do in other states.
- The electing partnership pays on behalf of its partners (direct and indirect), and those partners have no filing/payment obligations.
- If the audited partnership passes through adjustments to pass-through partners, those partners may also make the election.
  
- Calculating the partnership pays amount for a state where the election is made (simplified):
  - Add together 100% of the share(s) of adjustments allocated to one or more partners who are residents of that state and multiply the total times the highest individual rate;
  - Add together the shares of adjustments allocated to partners who are nonresidents of that state or are pass-through partners, apportion the total, and multiply times the highest individual rate;
  - Add these two amounts together.
  
- Smith Master elects to pay state tax on federal adjustments in states A and B:
  - It would pay \$0 tax.
  - While Smith Master has indirect partners who are residents in state A, it has no direct partners who are resident in that state. Its direct partners are pass-through partners. It would therefore only apportion income to state A if it had any basis to apportion the revenue there. But neither Smith Master or LLC' have any factors in State A.
  - Smith Master would also pay no tax in state B because the income is not sourced to state B, under that state's own law. Instead, it is sourced to the residence of the indirect partners.

Note – the same type of problem can occur where the states use different methods to source income.