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 choose 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.