MULTISTATE TAX COMMISSION

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To: Uniformity Committee Income and Franchise Tax Subcommittee

From: Sheldon H. Laskin

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Subject: Non-income taxpayer project

Attached is the most recent draft of the MTC proposed statute regarding partnership or pass-through entity income that is ultimately realized by an entity that is not subject to state income tax. Staff wishes to point out two issues that the subcommittee might wish to consider.

1. Elimination of the reference to "business income"

At its December 2009 meeting, the Subcommittee discussed whether "trade or business" should be included in the draft statute and requested that the drafting group suggest clarifying or limiting language to more precisely define the income-producing activities of the pass-through entity that would or would not subject that entity to income taxation in states that adopt the Commission's proposal.

A primary working principle of the Subcommittee has been that pass-through income should be subject to tax at some level. And yet the proposal, as it is to apply to pass-through entities with owners that do not pay corporate income tax, should recognize the historical state tax rules that have been applied to those ownership entities. For example, the Subcommittee has indicated that the model should not be written so broadly as to subject a pass-through's income to tax if the nature of that income is of a type that the ownership entity has historically earned (and, in the case of insurance companies, has used to maintain adequate reserves to pay claims).

A good example is the situation with a pass-through that is owned by an insurance company. On the one hand, the income of a pass through entity that engages in a trade or business should be subject to state income tax if it would not otherwise be subject to tax when received by a non-taxable parent; this furthers the equitable principle that the income of all pass-through entities should be subject to tax once irrespective of whether the parent, as the ultimate recipient of the income, is subject to income tax or not. On the other hand, state statutes that tax insurance companies only with respect to insurance premiums (and not with respect to net income) were intended to exempt investment income because making investments with their premium receipts is what an insurance business does, and the tax imposed on insurance premiums essentially serves as the overriding tax with respect to all of the insurance company's operation. Having said all that, it is necessary to recognize that the nature of the insurance business has changed dramatically over the past twenty-five years. Until relatively recently, insurance companies could not own a controlling interest in a pass-through entity that was actively engaged in a trade or business.

It is one thing to recognize that investment income that is ultimately received by the corporate parent ought not be subject to tax just because the income was realized in the first instance by a pass-through entity rather than by the corporate parent itself. It is quite another thing to allow trade or business income derived from a controlling interest in a pass-through entity to escape income tax entirely merely because the corporate parent is not subject to income tax. The latter notion violates tax equity principles and channels otherwise taxable activities into non-taxable channels merely because the ultimate recipient of the income is not subject to tax.

The reference to “business income” in the prior draft was thus an attempt to limit the model to trade or business pass-through income However, the reference to “business income” without any qualifier could have unintended and negative consequences. The term “business income” is, of course, referenced in UDITPA and, in that context, is intended to define that portion of a corporation's income that is subject to apportionment rather than to allocation. But the current proposal is not intended to define a rule of apportionment. Rather, it is intended to define the circumstances under which the pass-through entity's income is subject to income tax *at all.* The importation of a term that is meant to apportion income in this very different context could result in some judicial and administrative confusion and result in an inappropriate and unnecessary inquiry into whether the income serves an operational or an investment function and, if the latter, whether it is short- or long-term investment. Those questions should be addressed under existing UDITPA principles.

The current draft is limited to addressing the prior question of whether the income can be taxed *at all.* To address that question, it is more appropriate to determine whether the pass-through engages in a trade or business such that its income should be subject to tax *somewhere*.

2. Treatment of REITs

The current draft contains a working group suggestion for one substantive change not previously discussed by the subcommittee. During a prior subcommittee meeting, members of the subcommittee suggested that the proposed model statute should clarify that, for purposes of the statute, a real estate investment trust (REIT) should be treated as a partnership or disregarded entity. While not technically a disregarded entity --- because of the disqualifying limitations imposed by IRC §856(c) – a REIT that is recognized as such by the Code functions no differently than a partnership or disregarded entity for tax purposes and the work group recommends that it be treated as such under the model statute.