MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: MTC Uniformity Committee
From: Sheldon H. Laskin
Date: November 19, 2010
Subject: Non-income taxpayer project

Attached please find 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 income tax. The Income and Franchise Tax Uniformity Subcommittee recommends that this committee approve the draft for adoption by the Committee. Three points bear noting.

First, the Income and Franchise Tax Subcommittee's proposed model drops the reference to "business income" that was included in a prior draft. As explained in more detail in the attached memo to the subcommittee dated October 5, 2010, the subcommittee concluded that including the reference could result in administrative and judicial confusion as the term is intended to describe income that is subject to apportionment, whereas the current proposal is designed to address the question of whether such pass-through income is subject to tax *at all.* Apportionment issues should be addressed under current law.

Second, in response to the suggestion of a subcommittee member, the subcommittee's proposed model clarifies that the model is intended to include REITS. While not technically pass-through entities, REITS function as such and therefore should be treated as such under the model. This issue is also addressed in more detail in the attached memo.

Third, the Committee should be aware that representatives of the insurance industry have recommended deferring adoption of the model pending a study of possible unintended consequences. Industry has suggested that state insurance commissioners be invited to participate in this study. Staff has in fact attempted to interest state insurance commissioners in becoming involved in this project from its inception. Neither individual insurance commissioners nor representatives of the National Association of Insurance Commissioners have indicated an interest in doing so. Furthermore, the issue industry raised is to suggest that subjecting this income to tax could expose insurance companies in states that adopt the model to retaliatory premium tax in other states. Members of the subcommittee have expressed a belief that this is unlikely, because insurance company income would not be subject to tax under the model. Instead, it is the income of the pass-through entities in which the non-income taxpayer has an interest that would be subject to tax.

MTC proposed statute regarding partnership or pass-through entity income that is ultimately realized by an entity that is not subject to income tax

As Approved by the Income & Franchise Tax Uniformity Subcommittee

October 19, 2010

When 50 per cent or more of the capital interests or profits interest in an entity for which deductions would be allowed under section 162 of the Internal Revenue Code, 26 U.S.C. 162 and that would otherwise be treated as a partnership or disregarded entity for purposes of [*insert applicable state tax or taxes*] is owned, directly or indirectly, by *[identify each entity type that is not subject to income tax and that state wants to cover under this provision, such as "an insurance company,", with a citation to the state tax statute applicable to each such entity type]*, the net income [*or alternative tax base*]that passes through to such [name each entity type identified above, e.g. "insurance company."] shall be taxed to the partnership or disregarded entity as if the partnership or disregarded entity were a corporation subject to tax under chapter [*insert state statute]*To the extent applicable, income that is taxable to the partnership or disregarded entity pursuant to this section, and any related tax attributes and activities, shall be included and taken into account in a combined report filed under [*insert state statute*]. As used herein, the term "partnership or disregarded entity" shall include a real estate investment trust (REIT) within the meaning of Section 856 of the Internal Revenue Code of 1986, as amended.

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To: Uniformity Committee Income and Franchise Tax Subcommittee

From: Sheldon H. Laskin

Date: October 5, 2010

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. <u>Treatment of REITs</u>

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.