

THE MULTISTATE TAX COMMISSION'S 'WORKING DRAFT' OF A PROPOSED MODEL RULE FOR A PARTNERSHIP COMPOSITE TAX RETURN APPLICABLE TO MULTIJURISDICTIONAL PARTNERSHIPS.

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*The following "working draft" of the Multistate Tax Commission's model **partnership** composite tax return is a product of the Uniformity Committee of the Multistate Tax Commission. The principal author of the model is Scott D. **Smith**, MTC assistant counsel, although other members of the staff of the Multistate Tax Commission and state representatives comprising the Uniformity Committee also participated in developing the model. Those persons interested in commenting on the model should contact Mr. **Smith** by writing to the Multistate Tax Commission at 444 North Capitol St., NW, Suite 425, Washington, DC 20001, or by calling (202) 624-8699. The views expressed in the introduction and footnotes accompanying the model do not necessarily reflect the views or position of the Multistate Tax Commission, its member or associate member states, or other members of the staff of the Multistate Tax Commission.*

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Introduction

The following is a "working draft" of a proposed model rule for a **partnership** composite tax return applicable to multijurisdictional partnerships.¹ The Multistate Tax Commission (the "commission")² has sought to address some of the problems states experience enforcing tax obligations of partners of multijurisdictional partnerships. The commission's Uniformity Committee (consisting of representatives from the state tax agencies of the commission's member and associate member states) studies problems presented by the lack of uniformity or compatibility in state tax laws and recommends possible solutions for achieving uniformity and compatibility.

As a result of changes to federal tax law occurring over the preceding decade,³ partnerships have increasingly become income-generating entities for individual partners.⁴ Although composite tax returns offer the chance for easing partner compliance obligations existing with several states, **partnership** representatives have contended that existing state **partnership** composite tax return regimes fail to provide adequate guidance, contain qualification restrictions which prevent many partnerships from filing composite tax returns, and lack uniformity which increase administrative costs of filing composite tax returns. The Uniformity Committee sought to develop a

model **[P. 811]** rule for a **partnership** composite tax return that would promote uniform reporting of state tax obligations with respect to the multistate taxation of partners, would facilitate partner and **partnership** convenience, and would promote compliance with state tax obligations.

Several states currently provide partnerships with elections to file composite tax returns on behalf of some partners.⁵ The commission's model is considerably more comprehensive (and technically complex) than composite tax returns provided by most states. There are at least three reasons underlying the model's comprehensive (and complex) nature.⁶ First, the model seeks to address the complex rules of federal **partnership** taxation as they apply to the states in light of substantial state conformity with subchapter K of the code. Second, the multijurisdictional nature of state taxation provides an added layer of complexity when the single jurisdiction concepts of the federal rules are applied on a multistate basis involving states having separate taxing authority. Third, because the types of partnerships vary, the model seeks to address various types of partnerships.

In brief, the model applies only to partnerships operating on a multistate basis and applies a "modified pass through entity" approach to determine the model's tax base (i.e., the partners' distributive shares of income, gain, deduction, and loss are combined into an aggregate net distributive share). Several optional provisions are provided for consideration, such as alternative methods for computing the **partnership**'s composite tax payment and the partners' shares of the composite tax payment, alternatives for including or excluding resident individual partners, and alternatives for including or excluding corporate partners. The model provides rules for dealing with passive activity and portfolio items, special rules applicable to particular items of **partnership** "phantom income" (i.e., income of the **partnership** that is not represented by any cash flow), and rules concerning **partnership** administrative proceedings, penalties, and assessment. Special rules governing tiered partnerships, partnerships engaged in low income housing, and publicly traded partnerships are also provided.

The model is also based on two assumptions. First, it assumes that state tax jurisdiction over nonresident individual partners (and, optionally, corporate partners) is established. Second, the model assumes a method for attributing **partnership** tax items exists for any given state, and that the state's method has been applied prior to application of the model.

It has been the commission's experience that effective multistate tax administration is enhanced by the exchange of ideas and experience. The commission hopes that publication of the model will stimulate discussion and interest. The commission, therefore, encourages interested states and private parties to respond to the technical and administrative aspects of the model.

Suggested Statutory Authorization

Certain states may consider the model more appropriate as a tax regulation. In the absence of statutory authority requiring or permitting **partnership** composite tax returns, the following provision is a suggested example of statutory authority for enacting the model as a tax regulation.

Section * * * [of the state's tax code provisions regarding partnerships]. Composite Tax Returns. A **partnership** having nonresident members and which is organized under the law of [name of state], does business in [name of state], or derives income from sources in [name of state] [may or shall] file a composite tax return. The [state tax authority] shall provide the requirements and conditions for the filing of a **partnership** composite tax return in regulations prescribed by the [state tax authority]. For purposes of this section, a **partnership** includes any business organization classified as a **partnership** for tax purposes pursuant to [insert relevant state tax code section].

'Working Draft' of the Model Statute or Regulation ⁷

Section 1. General Rule

Unless expressly excluded, a multijurisdictional **partnership** shall file a composite tax return and remit a composite tax payment on behalf of its [OPTIONAL: resident and] non-resident partners based on the aggregate net amount of each resident and nonresident partner's aggregate net distributive share of **partnership** taxable income attributable to [name of state] for the **partnership** taxable year. ⁸

Section 2. Definitions

(A) Multijurisdictional **Partnership**. The term "multijurisdictional **partnership**" means any business organization that is classified as a **partnership** for tax purposes by [name of state], **[P. 81 2]** which has members from more than a single state, and is organized under the law of [name of state], does business in [name of state], or derives income from sources in [name of state]. Any reference to "**partnership**" contained in this model shall mean a multijurisdictional **partnership**, whether general or limited, including any business organization classified as a **partnership** for tax purposes by [name of state].

(B) **Partnership** Taxable Income. The term "**partnership** taxable income" is defined by section 3.

(C) Partner's Aggregate Net Distributive Share of **Partnership** Taxable Income. The term "partner's aggregate net distributive share of **partnership** taxable income" is defined by section 4.

(D) Composite Tax Payment. [OPTION NO. 1: COMBINED COMPUTATION; FLAT TAX RATE METHOD] The composite tax payment to be remitted by a **partnership** to the [state tax authority] shall be determined by multiplying the aggregate net amount of the **partnership**'s partners' aggregate net distributive shares of **partnership** taxable income attributable to [name of state] for the **partnership** taxable year by [the rate is left to the state to determine].⁹

(D) Composite Tax Payment. [OPTION NO. 2: SEPARATE COMPUTATION; GRADUATED TAX RATE METHOD] The composite tax payment to be remitted by a **partnership** to the [state tax authority] shall be determined by multiplying the aggregate net distributive share of each partner included in the composite tax return by [a graduated rate as set forth in relevant state tax code section(s) and based upon the filing status of each partner]. The tax due with respect to each partner shall then be combined to constitute the composite tax payment.¹⁰

(E) Composite Tax Return. The term "composite tax return" is defined by section 6.

(F) Resident and Nonresident Partner. The term "resident partner" shall be defined as a partner who satisfies [insert relevant state tax code section defining residents] and the term "nonresident partner" shall be defined as a partner who satisfies [insert relevant state tax code section defining nonresidents]. For purposes of [this model], a partner which is a part-year resident of [name of state] as defined in [insert relevant state tax code/regulation defining part-year residents] shall be treated as a resident partner.¹¹

(G) Partner's Share of Composite Tax Payment. [OPTION NO. 1] A partner's share of the composite tax payment shall be equal to a fraction, the numerator of which is the partner's aggregate net distributive share of **partnership** taxable income, and the denominator of which is the combined aggregate net distributive share of **partnership** taxable income of all partners included in the composite tax return.¹²

(G) Partner's Share of Composite Tax Payment. [OPTION NO. 2] A partner's share of the composite tax payment shall be equal to each partner's individual tax liability as determined under section 2(d) [OPTION NO. 2].¹³

(H) Attributable to [Name of state]. The term "attributable" or "attributed" or similar term means the assignment of **partnership** items of income, gain, deduction, and loss to [name of state]

pursuant to [insert relevant state tax code or regulation section concerning the "sourcing" of **partnership** tax items].¹⁴

(I) General Partner. [Use existing state law definition and/or] . . . The term "general partner" shall [also] include members of a business organization classified as a **partnership** for tax purposes by [name of state] who have significant management authority relative to other members of the organization.¹⁵

(J) Limited Partner. [Use existing state law definition and/or] . . . The term "limited partner" shall [also] include members of a business organization classified as a **partnership** for tax purposes by [name of state] whose liability for obligations of the organization are limited, under the law of [name of state], to a determinable fixed amount.¹⁶

Section 3. Computation of **Partnership** Taxable Income

(A) In General. Subject to section 5, **partnership** taxable income is the combined amount of ordinary income and loss from trade or business activities of the **partnership** and distributive share items of income and loss as disclosed on [the state's version of the "United States **Partnership** Return of Income" **[P. 813]** (Federal Form 1065), Line 22, and Schedule K thereto, lines 2 through 7] required to be filed with the [state tax authority] which are attributable to [name of state].¹⁷

(B) Treatment of Aggregate Income from Passive Activities.¹⁸ After attributing **partnership** taxable income to [name of state] under section 3(a), the **partnership** must separately account for the aggregate amount of **partnership** items of income and gain derived from passive activities as defined in [insert relevant state tax code section defining passive activities or, if none, then use section 469(c) of the Internal Revenue Code of 1986, as amended], as modified by [insert relevant state tax code section(s), if any], with respect to any partner included in the composite tax return. For purposes of [this model], a limited **partnership** interest shall be presumed to be a passive activity unless the **partnership** can prove, by clear and convincing evidence, that a limited partner:

- (1) Materially participates in a trade or business activity of the limited **partnership** during the **partnership** taxable year as determined in accordance with [insert relevant state tax code section defining "material participation" or, if none, Treas. Reg. section 1.469-5T(a)(1), (5) and (6)];
- or

(2) The limited partner also holds an interest as a general partner in the **partnership** during the **partnership** taxable year.[; or]

(3) [OPTION] The limited partner is not a personal service corporation as defined in [insert relevant state tax code section or, if none, section 469(j)(2) of the Internal Revenue Code of 1986, as amended].¹⁹

(C) Treatment of Portfolio Income. After attributing **partnership** taxable income to [name of state] under section 3(a), the **partnership** must separately account for **partnership** items of income and gain that constitute portfolio income or gain as defined in [insert relevant state tax code section or, if none, then use section 469(e)(1) of the Internal Revenue Code of 1986, as amended], as modified by [insert relevant state tax code section(s), if any].²⁰

(D) De Minimis Income Threshold. After attributing **partnership** taxable income to [name of state] under section 3(a), \$[as determined by the state] per partner (the de minimis income threshold) shall be excluded from each partner's distributive share of **partnership** taxable income attributable to [name of state] for purposes of then computing each partner's aggregate net distributive share of **partnership** taxable income. The de minimis income threshold shall be applied to each partner's distributive share of **partnership** taxable income attributable to [name of state] in the following order of priority:

(1) First, against items of **partnership** income and gain derived from nonpassive activities of the partner; and

(2) Second, against items of **partnership** income and gain derived from passive activities of the partner.

Section 4. Partner's Aggregate Net Distributive Share of **Partnership** Taxable Income

(A) In General. A partner's aggregate net distributive share of **partnership** taxable income is the aggregate net amount of a partner's distributive share of:

(1) **Partnership** taxable income for the **partnership** taxable year attributable to [name of state] as determined under section 3;

(2) Offset by any deductions and losses for the **partnership** taxable year attributable to [name of state] as calculated under subsection (b).

(B) Special Rules Applicable to Deductions and Losses. Except as provided herein, each partner's distributive share of **partnership** deductions and losses attributable to [name of state] as

disclosed in [the state's version of the "United States **Partnership** Return of Income" (Federal Form 1065, including Schedule K thereto) (or Federal Form 1065 and Schedule K if the State does not require a **partnership** information return)], as modified or limited by [insert relevant state tax code section(s)], shall be used to determine each partner's aggregate net distributive share of **partnership** taxable income. The following special rules govern certain deductions.²¹

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(1) Aggregate Losses from Passive Activities.²²

(a) For purposes of determining a partner's aggregate net distributive share of **partnership** taxable income, each partner's distributive share of the aggregate amount of **partnership** losses attributable to [name of state] which are from passive activities of a partner pursuant to [insert relevant state tax code section(s) or, if none, then use section 469(c) of the Internal Revenue Code of 1986, as amended] shall only be used as a deduction against each partner's distributive share of the aggregate amount of income or gains from passive activities separately accounted for by the **partnership** under section 3(b).

(b) If a partner's distributive share of aggregate losses from passive activities exceed the partner's distributive share of aggregate income from passive activities so as to constitute a passive activity loss, as defined in [insert relevant state tax code section or, if none, then use section 469(d)(1) of the Internal Revenue Code of 1986, as amended], then the partner's passive activity loss shall not be used to offset the partner's distributive share of income from nonpassive activities nor shall it be carried forward to another **partnership** taxable year. Passive activity losses shall be passed through to the partners and claimed, to the extent allowed, on their individual tax returns.

(2) Portfolio Expenses.²³ For purposes of determining a partner's aggregate net distributive share of **partnership** taxable income, each partner's distributive share of **partnership** expenses attributable to [name of state] which constitute portfolio expenses pursuant to [insert relevant state tax code section or, if none, then use Section 469(e)(1) of the Internal Revenue Code of 1986, as amended] shall be deductible only against each partner's distributive share of portfolio income or gain of the **partnership** or other income or gain of the **partnership** which does not constitute income or gain from a passive activity of the partner in accordance with [insert relevant state tax code section or, if none, then use code section 469 of the Internal Revenue Code of 1986, as amended].

(3) Personal Exemptions. Even though a partner may otherwise be entitled to personal exemptions under [insert relevant state tax code section(s)], personal exemptions are not eligible for purposes of determining a partner's aggregate net distributive share of **partnership** taxable income. Personal exemptions may only be taken on the partner's individual tax return.

(4) **Partnership** Tax Items That Are Deductible Solely at the Election of a Partner. To the extent that a particular **partnership** tax item constitutes a deduction only if a partner elects to treat the item as deductible on the partner's individual income tax return pursuant to [insert relevant state tax code section(s), for example, with respect to the treatment of taxes paid to foreign countries or U.S. possessions (IRC section 901), mining exploration and development costs (IRC section 617), and any other similar provision], then that **partnership** tax item shall not constitute a deduction for purposes of determining a partner's aggregate net distributive share.

Section 5. Treatment of Certain **Partnership** Income

(A) Special Adjustments Applicable to Certain **Partnership** Income. When computing **partnership** taxable income for purposes of section 3, the income of a **partnership** includes items of income and gain which are realized and recognized and attributable to [name of state] from any transaction regardless of whether any money or other property is actually received by the **partnership** during the **partnership**'s taxable year; provided that the following special adjustments shall apply.

(1) [OPTIONAL] Liquidation and Termination Income. Income realized and recognized by the **partnership** as a result of a **partnership** liquidation or termination pursuant to [insert relevant state tax code section(s) concerning termination/liquidation of a **partnership**], when no cash or other property was actually distributed to any partner in the current or immediately preceding **partnership** taxable year, is excluded from **partnership** taxable income.²⁴

(2) Discharge of Indebtedness Income. Income realized and recognized by a **partnership** from a discharge of indebtedness pursuant to [insert relevant state tax code section concerning discharge of indebtedness income] which is represented by cash or a cash receivable required to be used to satisfy **partnership** indebtedness or a **partnership** debt secured by **partnership** property is excluded from **partnership** taxable income.²⁵

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(B) Election. A **partnership** may elect to include income, otherwise excluded by section 5(a), by including the income in **partnership** taxable income and by attaching an explanation to the

composite tax return. See section 6(b)(1)(A)(ii) for the effect of this election on nonresident partners.

Section 6. Composite Tax Return

(A) Requirements. A composite tax return required to be filed by a **partnership** hereunder shall conform to all of the following requirements:

(1) Partners Included. Unless otherwise excluded from the composite tax return by section 10, all partners shall be included in the composite tax return.

(2) Remittance of Composite Tax Payment. The composite tax payment required under section 2(d) for all partners included in the composite tax return must be remitted by the **partnership** and included with the composite tax return upon filing with [state tax authority].

(3) Required Information. The composite tax return shall be signed by a general partner [or, alternatively, the "tax matters partner" as described in (insert relevant state tax code section, if applicable)] and shall set forth the following information:

(a) **Partnership** taxable income attributable to [name of state] as computed under section 3 together with a copy of [the particular state's version of Form 1065 and applicable schedules (or Federal Form 1065 and Schedule K if the state does not require a state **partnership** information return)].

(b) The names of the partners included in the composite tax return and their tax identification numbers.

(c) The share of each partner's composite tax payment.

(d) Each partner's aggregate net distributive share of **partnership** taxable income attributable to [name of state].

(e) Each partner's share of **partnership** taxable income excluded under section 3(c).

(f) Each partner's share of **partnership** income excluded under section 5(a).

(g) Each partner that is a C or S corporation and their distributive share of **partnership** income.

(h) Each partner that is a tax exempt partner under section 10(c) and their distributive share of **partnership** income.

(i) The general partner [or, alternatively, the "tax matters partner" as described in (insert relevant state tax code section, if applicable)] to receive notices and to participate in audits as set forth in section 7(b) who shall be known as the "representative partner."

(j) Such other information as the [state tax authority] may require as provided by requirements and conditions set forth in forms and instructions.

(4) Credits. No tax credits shall be taken on the composite tax return, and all tax credits of the **partnership** shall be passed through to the partners as the partners by agreement may provide.

(5) Differences in Taxable Years. If the taxable year of a partner is different from that of the **partnership**, the partner's aggregate net distributive share of the **partnership**'s taxable income to be reported by the **partnership** on the composite tax return with respect to that partner shall be based on the taxable income of the **partnership** attributable to [name of state] for the taxable year of the **partnership** ending within the partner's taxable year.²⁷

(B) Effect on Partners.

(1) Nonresident Partners. If a nonresident partner is a "qualifying nonresident partner," then the nonresident partner need not file an individual nonresident tax return. If a nonresident partner is a "nonqualifying non-resident partner," then the non-resident partner must file an individual nonresident tax return [OPTION: or corporation income/franchise tax return, as the case may be].²⁸

(a) Qualifying NonResident Partner. A "qualifying non- resident partner" is defined as a nonresident partner who satisfies both of the following conditions:

(i) The nonresident partner's only taxable income attributable to [name of state] must be from the **partnership** filing the composite tax return unless the nonresident partner's other taxable income attributable to [name of state] is also reported by another **partnership** filing a composite tax return with [name of state]; and²⁹

(ii) The **partnership** must not have excluded any **partnership** taxable income from the composite tax return under section 5(a).

(b) NonQualifying Nonresident Partner. A "non-qualifying non-resident partner" is a non-resident partner who is not a "qualifying nonresident partner." [OPTIONAL] Any partner that is a C [P. 816] or S corporation, whether a domestic or foreign corporation, shall be treated as a "nonqualifying nonresident partner."³⁰

(2) Resident Individual Partners. A partner who is a resident individual as defined in section 2(f) is not relieved of any obligation to file a tax return with [name of state], and a resident individual partner is not relieved from paying tax on the resident partner's entire distributive share of **partnership** taxable income in accordance with [insert relevant state tax code section that taxes a resident partner on its entire distributive share from whatever source, if applicable].³¹

(3) Add Back to Distributive Share. For purposes of reporting distributive shares of **partnership** income and gain attributable to [name of state] on a tax return filed by a nonresident or resident partner, such distributive share shall not be reduced by such partner's share of the composite tax payment, the de minimis income threshold provided by section 3(d), or the **partnership** income excluded by section 5(a). See section 8 for the composite tax payment credit furnished nonresident partners and resident partners.

(C) Record of Composite Tax Payment. The **partnership** shall furnish a record of each partner's share of the composite tax payment on a form prescribed by [state tax authority] to each partner within thirty (30) days after the date the composite tax return is filed with [state tax authority].

(D) Time and Manner of Filing the Composite Tax Return. The **partnership** shall file the composite tax return on or before the due date for the **partnership** information return as required by [insert relevant state tax code section(s) regarding information return due date or, if no information return requirement, then: "the 15th day of the fourth month following the close of the **partnership**'s taxable year"]. Reasonable extensions of time to file the composite tax return may be granted by [state tax authority] in accordance with [insert relevant state tax code section(s) dealing with extensions of time to file]. In no event, however, will the **partnership** be provided with an extension of time to remit the composite tax payment regardless of whether the [state tax authority] may have granted an extension of time to file the composite tax return.

(E) Filing Requirement if no Composite Tax is Due. If the partners' aggregate net distributive share of **partnership** taxable income is zero or constitutes a net loss so that no composite tax payment

is required under section 2(d), the **partnership** must still file a composite tax return meeting the requirements of this section 6.³²

Section 7. Penalties; Assessments

(A) Joint and Several Liability.

(1) **Partnership** and General Partners. The **partnership** and its general partners shall be jointly and severally liable for any composite tax payments, additions to tax relating to the composite tax return, penalties, interest, and any other assessments of tax with respect to the composite tax return.

(2) Limited Partners. A limited partner shall be jointly and severally liable with the **partnership** and general partners only if the limited partner's fraudulent or willful conduct caused or contributed to an underpayment of composite tax or if the limited partner has participated in the management of the business of a limited **partnership** so as to lose its limited liability under [insert relevant reference to state **partnership** code corresponding to Unif. Limited **Partnership** Act section 7 or Rev. Unif. Limited **Partnership** Act section 303].

(B) **Partnership** Treated as Agent. [OPTION NO. 1] Each partner shall execute a power of attorney making the **partnership** the authorized agent of the partners included in the composite tax return. As such, the **partnership**, as authorized agent, shall assume responsibility for all matters relating to the composite tax return including the following: filing the return, filing amended returns, and filing requests for extensions of time; the payment of tax, penalties, and interest; assessment and collection; receiving and corresponding to notices from the [state tax authority]; and participating in an audit of the return. The designation of the **partnership** as agent shall not, however, relieve the partners of any ultimate liability for tax, additions to tax, penalties, or interest imposed by the [state tax authority] for the partners' distributive shares of income attributable to [name of state].

(B) **Partnership** Treated as Agent. [OPTION NO. 2] The filing of a composite tax return shall mean that the **partnership** is the authorized agent of the partners included in the composite tax return. As such, the **partnership**, as authorized agent, shall assume responsibility for all matters relating to the composite tax return including the following: filing the return, filing amended returns, and filing requests for extensions of time; the payment of tax, penalties, and interest; assessment and collection; receiving and corresponding to notices from the [state tax authority]; and participating in an audit of the return. The designation of the **partnership** as agent shall not, however, relieve

the partners of any ultimate liability for tax, additions to tax, penalties, or interest imposed by the [state tax authority] for the partners' distributive shares of income attributable to [name of state].³³

(C) Administrative Proceedings.

(1) Representation of **Partnership** on Audit. The representative partner designated by the **partnership** pursuant to section 6(a)(3)(I) shall represent the **partnership** in an audit of the **partnership**'s composite tax return by the [state tax authority], shall correspond on behalf of the **partnership** to any notices from the [state tax authority] under section 7(b), and shall receive on behalf of the **[P. 817] partnership** any notices from the [state tax authority] under section 7(b).

(2) Assessment Upon Audit. In the event a **partnership** is assessed with additional tax, penalties, or interest for a prior taxable year as the result of an audit, such additional tax, penalties, and interest shall constitute current taxable year tax liabilities of the **partnership** and partners and shall be added to the composite tax payment for the **partnership** taxable year immediately following the year of assessment.

(3) Representative Partner Must Keep Other Partners Informed. The representative partner shall keep each partner informed of all administrative and judicial proceedings with respect to a composite tax return filed by the **partnership** under [this model].

Section 8. Credits Relating to Composite Tax Payments

(A) Tax Credits for Nonresident Partners. A nonresident partner shall be provided a tax credit in the amount of the partner's share of the composite tax payment. This tax credit shall be applied against the tax due as set forth on the partner's non-resident income tax return which may be filed by a "qualifying nonresident partner" and which is required to be filed by a "nonqualifying nonresident partner" pursuant to section 6(b)(1) in accordance with [insert relevant state tax code section(s) regarding nonresident tax returns].

(B) Tax Credits for Resident Partners. ³⁴

(1) Share of Composite Tax Paid to This State. A resident partner shall be entitled to take its share of the composite tax payment paid to [name of state] as a tax credit on its tax return filed with [name of state] as required by [insert relevant state tax code section].

(2) [OPTIONAL] Share of Composite Tax Paid to Other States.³⁵ Resident partners shall be provided a tax credit for their share of composite tax payments made on the resident partners' behalf by the **partnership** to other states in which the **partnership** filed a composite tax return.

(A) Limitation. [ALTERNATIVE NO. 1] The tax credit provided by paragraph (2) shall not exceed this state's composite tax rate as set forth in section 2(d) [OPTION NO. 1] [or the composite tax rate applicable to each resident partner as set forth in section 2(d) [OPTION NO. 2].

(B) Credit Certification. In order for a resident partner to claim the tax credit provided in paragraph (2), the **partnership** must file with the [state tax authority] a certificate of payment which shall list each resident partner of [name of state] and their tax identification numbers, the distributive share of income for each resident partner listed that is attributable to other states in which a composite tax return was filed on their behalf, each resident partner's share of the composite tax payments paid to other states in which the **partnership** filed a composite tax return which must correspond to each partner's tax identification number, and each of the other states' composite tax rates. A copy of the credit certification shall also be provided each resident partner eligible to claim the tax credit provided by paragraph (2).

(a) Limitation. [ALTERNATIVE NO. 2] [The amount of credit permitted to be taken by a resident partner shall be left to each state adopting this model to determine. Each state adopting should enact a law or modify existing law tying this credit to existing law].

(b) Credit Certification. [The design of the credit certification shall be left to each state adopting this model].

Section 9. Special Rule for Computing Aggregate Net Distributive Share of **Partnership** Taxable Income for Certain Partners

(a) General Rule. When a partner becomes a partner in a **partnership** during the **partnership** taxable year or leaves the **partnership** during the **partnership** taxable year, then the aggregate net distributive share of **partnership** taxable income subject to [the model] for both the entering and exiting partner shall be computed under either subsection (b) or (c).

(b) **Partnership** Agreement. The partners may provide in their **partnership** agreement for a method of allocating **partnership** tax items to entering and exiting partners that shall conform to [insert state tax code section conforming to IRC section 706 or, if none, section 706 of the Internal

Revenue Code of 1986, as amended]. In the event the **partnership** agreement uses a method of allocation other than the daily pro-rata formula as described in subsection (c), then the **partnership** shall have the burden of proving, by clear and convincing evidence, on audit that the particular other method does not result in distortion of an entering or exiting partner's aggregate net distributive share of **partnership** taxable income attributable to [name of state].

(c) Pro Rata Method. The **partnership** may determine an entering or exiting partner's aggregate net distributive share of **partnership** taxable income subject to [the model] by use of the following daily pro rata formula:

(1) The **partnership** first determines what would be the partner's aggregate net distributive share of **partnership** taxable income attributable to [name of state] as if the partner was a partner in the **partnership** from the begin- **[P. 818]** ning of the **partnership** taxable year until the end of the **partnership** taxable year.

(2) The **partnership** then determines a pro rata percentage which is a fraction, the numerator of which is the number of days the partner was a partner in the **partnership** during the **partnership** taxable year, and the denominator of which is the total number of days in the **partnership** taxable year.

(3) The percentage as determined in paragraph (2) is then multiplied against the figure in paragraph (1) to determine the partner's aggregate net distributive share of **partnership** taxable income subject to [the model].

In the event the **partnership** agreement provides for a pro rata method other than a daily pro rata method for allocating **partnership** tax items to partners entering or exiting the **partnership** during the **partnership** taxable year, or if a non-pro-rata method is adopted in the **partnership** agreement and the **partnership** fails to prove on audit that it does not result in distortion, then the daily pro-rata method is required.

(D) Partner to Partner Consistency. When there has been a sale or exchange of a **partnership** interest, the **partnership** must be consistent in its use of the daily pro-rata method or any other method of allocation provided in the **partnership** agreement that does not result in distortion as described in subsection (b) and must use the same method for the selling/transferor partner and the buying/transferee partner. In the event a non-daily pro rata method of allocation provided in the **partnership** agreement distorts the aggregate net distributive share of **partnership** taxable income attributable to [name of state] in respect of one partner, then it shall also be presumed to

similarly distort the aggregate net distributive share of **partnership** taxable income attributable to [name of state] for the other partner.

Section 10. Treatment of Certain Partners and Partnerships

(A) De Minimis Partners Rule. The provisions of [this model] shall not apply to any **partnership** having [###] or fewer partners. Partners that are excluded from inclusion in the composite tax return by this section 10 shall, nonetheless, be counted for purposes of whether this de minimis exception applies to a **partnership**.³⁶

(B) Corporate Partners. [OPTION NO. 1] A partner which is a C corporation, as defined in subchapter C of chapter 1, subtitle A, of the Internal Revenue Code of 1986, as amended, or which is an S corporation, as defined in Subchapter S of chapter 1, subtitle A, of the Internal Revenue Code of 1986, as amended, shall not be included in a composite tax return under [this model] unless the corporation conducts business solely in [name of state]. See section 6(a)(3)(G) for information concerning corporate general or limited partners which must be disclosed on the composite tax return.³⁷

(B) Corporate Partners. [OPTION NO. 2] A partner that is a C corporation, as defined in subchapter C of chapter 1, subtitle A, of the Internal Revenue Code of 1986, as amended, or which is an S corporation, as defined in subchapter S of chapter 1, subtitle A, of the Internal Revenue Code of 1986, as amended, shall be included in a composite tax return under [this model].³⁸

(C) Tax Exempt Partners. Partners exempt from income tax under [insert relevant state tax code section] shall be excluded from the composite tax return. See section 6(a)(3)(H) for information concerning tax exempt partners that must be disclosed on the composite tax return.

(D) Trust or Estate Partners. A partner that is an estate as defined in [insert relevant state tax code section] or a trust as defined in [insert relevant state tax code section] shall be included in a composite tax return under [this model].

(E) Publicly Traded Partnerships. The provisions of [this model] shall apply on an elective basis only to a publicly traded **partnership**, as defined in [insert relevant state tax code section or, if none, section 7704 of the Internal Revenue Code of 1986, as amended], if it is treated as a **partnership** for tax purposes by [name of state] rather than as a corporation. See section 11 for the alternative treatment of publicly traded partnerships.

(F) Tiered Partnerships. The provisions of [this model] shall not apply to a **partnership** (lower tier **partnership**) having another **partnership** as a partner (upper tier **partnership**) if all of the following circumstances are satisfied.

(1) Lower Tier **Partnership** Mere Record Holder. The lower tier **partnership** must be acting merely as a record holder of tangible or intangible personal or real property and must flow through all items of income, gain, deduction, loss, and credit to upper tier partnerships and non-**partnership** partners, if any. [P. 819] (2) Substantial Interest. At least one upper tier **partnership** must possess a substantial interest in the immediate lower tier **partnership**. A "substantial interest" means that the upper tier **partnership** possesses an interest of at least [50] percent in each item of **partnership** income, gain, deduction, loss, and credit for any taxable year of the immediate lower tier **partnership**.³⁹

(3) Jurisdictional Rule. The upper tier **partnership** holding the real economic interests in lower tier record holding partnerships as described in paragraph (2) shall file a composite tax return governed by the requirements of [this model] with [name of state] if any lower tier record holding **partnership** is organized under the law of [name of state], derives income from sources in [name of state], or does business in [name of state].

(G) Partnerships Engaged in Low Income Housing.

(1) Exception from Application of [Model]. Except to the extent provided in paragraph (2), the provisions of [this model] shall not apply to a **partnership** which is principally engaged in the acquisition of or the operation of low income housing projects which provide low income housing credits as defined in [insert relevant state tax code section or, if none, section 42 of the Internal Revenue Code of 1986, as amended]. A **partnership** is "principally engaged" in low income housing projects if [the definition of "principally engaged in low income housing" is to be determined by the state]. /40

(2) Events of Application of [Model]. If a **partnership** described in paragraph (1) realizes and recognizes income or gains on the disposition of properties used to generate low income housing credits, then the **partnership** must file a composite tax return meeting the requirements of [this model].

(H) Partners' Filing Obligations not Waived. In the event a **partnership** or partner is excluded from the mandatory application of [this model], the partners of the excluded **partnership** or the specifically excluded partner must still comply with all filing and income reporting requirements applicable to individuals pursuant to [insert relevant state tax code section] or those applicable to corporations or other entities pursuant to [insert relevant state tax code section(s)].

Section 11. Treatment of Publicly Traded Partnerships⁴¹

(A) Application of [Model]. Unless a publicly traded **partnership**, as defined in section 10(e), elects to file a composite tax return under [this model] pursuant to section 12(e), a publicly traded **partnership** must remit a withholding tax as provided by subsection (b). For purposes of this section 11, all references to "**partnership**" shall constitute a reference only to a "publicly traded **partnership**" and all references to "unit holders" shall mean the partners of a publicly traded **partnership**, unless expressly stated otherwise.

(B) Withholding Tax. A **partnership** shall remit a withholding tax at the rate of [the rate is left to the state to determine] on non-liquidating actual distributions of money and property made on a per unit basis during the **partnership**'s taxable year which are from income or property attributable to [name of state]. The withholding tax shall be subject to the following:

(1) Time and Manner of Payment. The withholding tax shall be remitted by the **partnership** or a designated withholding agent on or before the due date for the **partnership** information return as required by [insert relevant state tax code section or, if no information return requirement, then: "the 15th day of the fourth month following the close of the **partnership**'s taxable year"]. The remittance shall be included with a form prescribed by the [state tax authority] which shall include such other information as the [state tax authority] may require as provided by requirements and conditions set forth in the form and instructions.

(2) Nominee Designation. The **partnership** may designate a nominee to act as a withholding agent of the tax required to be remitted by the **partnership** under this [P. 820] section 11 on a form prescribed by the [state tax authority] which shall include such other information as the [state tax authority] may require as provided by requirements and conditions set forth in the form and instructions.⁴²

(3) Property Distributions. If a nonliquidating distribution is made with property other than money which is attributable to [name of state], the **partnership** shall not release the property until it has funds sufficient to enable the **partnership** to pay over in money the withholding tax required to be withheld under this section 11.⁴³

(4) Exceptions From Withholding. The **partnership** or withholding agent shall not be required to **withhold** on nonliquidating actual distributions of money or property during the **partnership**'s taxable year if the **partnership** can prove, by clear and convincing evidence, that the distribution meets the conditions of subparagraphs (A) or (B).

(a) No withholding is required to the extent that a tax is required to be withheld on nonliquidating actual distributions of money or property under [insert other state tax code sections requiring withholding on certain **partnership** distributions such as those dealing with foreign partners or nonresident aliens, U.S. real property interests, recurring dispositions of crops and timber, etc., if applicable]; ⁴⁴ or

(b) No withholding is required to the extent that nonliquidating actual distributions of money or property would not constitute taxable distributions to a unit-holder under [insert relevant state tax code section(s)]. ⁴⁵

(C) Amount of Distributions Subject to Withholding. The amount of distributions made by a **partnership** during the **partnership** taxable year subject to withholding shall equal the combined value of nonliquidating actual distributions of money and property from sources attributable to [name of state] made to all unit-holders if the distributions are not excluded from the withholding tax under subsection (b)(4).

(1) Valuation. Nonliquidating actual distributions of money and property shall be valued based on the amount of money distributed and the fair market value of property distributed on a per unit basis. ⁴⁶

(2) Tiered Partnerships. ⁴⁷

(a) Deemed Distribution. In the case of an upper tier **partnership** that receives nonliquidating actual distributions of money or property from a lower tier **partnership**, any amount of tax withheld on the distributions and remitted to [name of state] by the lower tier **partnership** shall be treated as a deemed distribution by the upper tier **partnership** when the upper tier **partnership** subsequently makes a non-liquidating actual distribution of the same amount of money or the same property to its unit-holders.

(b) Application of Withholding Tax. The upper tier **partnership** shall be required to remit a withholding tax on all nonliquidating actual distributions of money and property and deemed distributions (as described in subparagraph (A)) to the extent required by this section 11.

(c) Credit. The upper tier **partnership** may credit the amount of tax withheld and remitted by the lower tier **partnership** to [name of state] on distributions by a lower tier **partnership** to the upper tier **partnership** against its withholding tax liability when making subsequent actual distributions subject to this section 11 of the money or the same property previously distributed by the lower tier **partnership**.

(D) Tax Credit for Unit-Holders. The withholding tax paid by a **partnership** under section 11(b) may be credited by a unit-holder against the unit-holder's income tax liability owed to [name of state] for the unit-holder's subsequent taxable year.⁴⁸

(E) Credit Certification.

(1) **Partnership** Payment Certification. A **partnership**, or nominee designated by the **partnership** as a withholding agent pursuant to subsection (b)(2), shall provide a record of the tax withheld with respect to each unit-holder. This record shall be provided within thirty (30) days after the **partnership** or withholding agent remits **[P. 821]** payment of the withholding tax to the [state tax authority].

(2) Unit-Holders' Payment Certification. A unit-holder seeking a credit against its income tax liability owed to [name of state] for amounts withheld by the **partnership** or withholding agent for the unit-holder's taxable year subsequent to a taxable year of the unit-holder in which the **partnership** or withholding agent withheld and paid tax must attach a proof of payment of withheld tax to its income tax return. Proof of payment consists of a copy of the "**partnership** payment certification" provided by paragraph (1).⁴⁹

(F) Application to Corporation and Tax Exempt Organization Unit- Holders. [OPTION NO. 1] Unit-holders that are corporations or tax exempt organizations as defined in [insert relevant state tax code section] shall not be subject to the withholding tax under this section 11.50

(F) Application to Corporation and Tax Exempt Organization Unit- Holders. [OPTION NO. 2] Unit-holders that are corporations are subject to the withholding tax required by this section 11. Unit-holders that are tax exempt organizations as defined in [insert relevant state tax code section] shall not be subject to the withholding tax under this section 11.51

(G) Penalties.

(1) **Partnership** and General Partners. The **partnership** and its general partners shall be jointly and severally liable for withholding taxes, penalties, and/or interest for failure to **withhold** and remit tax required by this section 11 with respect to any unit-holder.

(2) Nominee. In the event the **partnership** has designated a nominee as withholding agent, then the withholding agent, but not the **partnership** or its general partners, shall be liable for withholding taxes, penalties, and/or interest for failure to **withhold** and remit tax required by this section 11 with respect to any unit-holder. If the failure to **withhold** and remit tax required by this section 11 is caused by the negligence, wilful conduct, or fraud of the **partnership** or its

general partners, then the **partnership** and its general partners, but not the nominee, shall be jointly and severally liable.⁵²

Section 12. Effective Dates

(A) Effective Date. [Determined by the state].

(B) Existing Partnerships Provided Five-Year "Phase In." If a **partnership** is an existing **partnership** on the effective date of [this model], then [this model] shall not be mandatorily applied to the existing **partnership** for a period of five taxable years, not including the taxable year of the **partnership** for when [this model] becomes effective, following the effective date. The existing **partnership** may, however, elect to come within the terms of [this model] before the five-year period expires by filing a composite tax return meeting the requirements of [this model]. The election provided by this subsection (b) to file a composite tax return within the five-year "phase in" period for existing partnerships shall not be revoked.⁵³

(C) Existing **Partnership** Defined. An "existing **partnership**" is any **partnership** or business organization classified as a **partnership** for tax purposes by [name of state]:

(1) Having filed all necessary organizing documents required to be filed with the [appropriate state regulatory authority] that have been accepted by the [appropriate state regulatory authority] and all certificates of authority or other documents required to be issued by the [appropriate state regulatory authority] before a **partnership** or other business organization classified as a **partnership** for tax purposes by [name of state] can conduct business in or own property in [name of state] have been issued prior to the effective date of [this model]; or

(2) Having filed any necessary organizing document required to be filed with the [appropriate state regulatory authority] on or before the effective date of [this model] and all other necessary filing requirements established by the [appropriate state regulatory authority] are satisfied within 30 calendar days of the effective date of [this model].

(D) **Partnership** Organized After the Effective Date. Unless otherwise excluded from the application of [this model] by section 10, the provisions of [this model] shall mandatorily apply to all partnerships formed after the effective date of [this model] which do not fall within the definition of "existing **partnership**."

(E) Election In. A **partnership** that is otherwise excluded from the mandatory application of [this model] under section 10 or section 12(b), may elect to be included by filing a composite tax return satisfying the requirements of [this model]. Such an election shall not be revoked.

Section 13. Effect of [Model] on Estimated Taxes and Withholding Taxes. [OPTIONAL]

(A) Estimated Tax Payments. Nothing contained in [this model] shall be construed as relieving any partner for an obligation to remit estimated tax payments under [insert relevant state tax code section]. Estimated tax payments are required to be paid in the manner and in the amounts required by rules applicable to individuals as set forth in [insert relevant state tax code section]. Penalties and interest for underpayments of estimated tax shall be assessed in the same manner as provided based on the rules applicable **[P. 822]** to individuals as set forth in [insert relevant state tax code section]. /54/.

(B) Withholding Taxes. An individual resident or non-resident partner who is included in a composite tax return meeting the requirements of [this model] shall be exempt from the withholding tax on a partner's distributive share of **partnership** income as set forth in [insert relevant state tax code section]. In no event, however, will this exemption extend to the withholding tax imposed on actual distributions of money or property from the **partnership** to its partners as set forth in [insert relevant state tax code section, if applicable].

Section 14. Code References. [OPTIONAL]

All references in [this model] to sections of the [state tax code] and Internal Revenue Code of 1986, as amended, shall be construed in light of the applicable tax regulations promulgated thereunder. The [state tax code] and applicable state tax regulations shall take precedence over the Internal Revenue Code of 1986, as amended, and Federal Treasury Regulations promulgated thereunder to the extent they conflict. ⁵⁵

FOOTNOTES

/*/ Previous versions of the Multistate Tax Commission's Proposed Model Rule for a **Partnership** Composite Tax Return Applicable to Multijurisdictional Partnerships (the "model") have been disclosed to the public. Accordingly, this "working draft" should be considered a "public domain" document. The Multistate Tax Commission reserves the right to publish the model, or modifications thereof, in the future in any manner that the Multistate Tax Commission deems necessary or appropriate. This model is a "working draft" and should not be considered as a final uniformity recommendation of the Multistate Tax Commission.

¹ Unlike a **partnership** "information" return which is not a tax return, a **partnership** "composite" tax return is a return of income tax filed by the **partnership** on behalf of its partners. Some states

refer to a composite tax return as a "group" return, a "block" return, or as a **partnership** "combined" return of the partners.

² The Commission is the administrative arm of the Multistate Tax Compact. ALL. ST. TAX GUIDE section 701 et seq. (RIA 1992); ST. TAX GUIDE section 351 (CCH 1992).

³ For example, the "passive activity loss" rules of code section 469, the repeal of the General Utilities doctrine (General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), wherein the U.S. Supreme Court held that a corporation did not recognize gain or loss upon the distribution of property to its shareholders), by way of code sections 311, 336, and 337 (with respect to C corporations) and code section 1374 (with respect to S corporations), amendment of the code section 752 regulations which changed the manner in which **partnership** liabilities are reflected in the adjusted tax bases of the partners, the code section 465 "at risk loss" rules, and the change in the tax rate differentials between corporations and individuals.

⁴ The passive loss limitations have had a measurable effect on income reported by individual partners for federal tax purposes. For example, net income from partnerships reported on individual federal income tax returns for 1987 increased by \$21 billion, \$10 billion of which resulted from disallowed passive losses. See, e.g., Internal Revenue Service, "Partnerships, Passive Losses, and Tax Reform, 1981- 1987," Statistics of Income Bulletin, 31, 37, vol. 9 (Winter 1989- 1990). Net income reported by individual partners has steadily increased since 1986 and total losses reported by individual partners have steadily decreased since 1986. Internal Revenue Service, "Partnerships, Partners, and Tax Shelters After Tax Reform, 1987- 1989," Statistics of Income Bulletin, 8, 20, vol.12 (Summer 1992). See also Wall St. J., Dec. 19, 1990, at A1, col. 5 (reporting that partnerships earned \$14.5 billion in 1988 compared to losses of \$5.4 billion in 1987 and \$17.4 billion in 1986). Corporate partners have not been similarly affected because they are generally not subject to the "passive activity loss" or "at risk loss" rules.

⁵ See, e.g., CAL. REV. & TAX CODE section 18408.5 (Deering Supp. 1992) (see also California Franchise Tax Board "Group Filing Instructions California Form 540NR For Nonresident Partners"); COLO. REV. STAT. section 39-22-601 (4.5)(b) (Supp. 1991) (Colorado permits composite return filing for limited liability companies, which are treated as partnerships pursuant to Colo. Rev. Stat. section 39-22- 205, but apparently not for a true state law **partnership**); ILL. ADMIN. CODE tit. 86, section 100.5700; IOWA ADMIN. CODE Rules 701- 48.3; KAN. ADMIN. REGS. section 92-12-106; ME. RULE NO. 805; MD. ADMIN. CODE tit. 3, section 03.04.02.04; MO. ADMIN. CODE section 10- 2.190(2) (A); N.M. INC. TAX. REG. section 12:8; N.Y. ADMIN. CODE tit. 20, section 151.17; N.C. GEN. STAT.

section 105-154(b) (Supp. 1991); OHIO ADMIN. CODE section 5703-7-03; OKLA. GAZ. section 23.018.00.D.; OR. ADMIN. R. section 150-314.760; S.C. INC. TAX REG. section 117-76; UTAH ADMIN. BULL. R865-9-13I; VA. INC. TAX REG. section 630-4-391.C.; and W. VA. PERS. INC. TAX REG. section 110-21-51a.1. Other states, by administrative practice, may also provide for **partnership** composite tax return filing on an ad hoc basis by agreement between the state tax authority and the **partnership**.

⁶ A fourth reason for the model's comprehensive nature is that it contains several optional provisions upon which other parts of the model are dependent. Accordingly, if an optional provision is not applied, then other portions of the model are inapplicable.

⁷ The model contains several optional provisions. These provisions are in bold-face type. In addition, various parts of the model request additional information or material which is state specific. This information or material is represented by [brackets].

⁸ Alternatively, the model could be made elective. North Carolina is the only state that requires partnerships to file composite tax returns. See N.C. GEN. STAT. section 105-154(b). Every state providing for elective composite tax returns by statute or regulation, except Illinois, permits only nonresident partners to be included in a composite tax return. See note 5, supra. Illinois permits a **partnership** to petition for permission to include resident partners in its elective composite tax return. See ILL. ADMIN. CODE tit. 86, section 100.5700 (a) and (c). In the event the model is made elective, then states should also consider requiring nonresident partners to file an agreement with the state consenting to personal jurisdiction and agreeing to file an individual tax return. See, e.g., "Model S Corporation Income Tax Act ("MoSCITA")," section 1007(c), (d). American Bar Ass'n., Report of the Subcommittee on State Taxation of S Corporations: Model S Corporation Income Tax Act and Commentary, 42 Tax Law. 1001, 1005-1006 (Summer 1989).

⁹ This option combines the partners' individual net distributive shares of **partnership** tax items, excluding tax credits, into a single figure, and a flat rate of tax is imposed on the combined net income. Several states that permit the filing of composite tax returns require this method for computing the tax payment. See e.g., ILL. ADMIN. CODE tit. 86, section 100.5710; OHIO ADMIN. CODE section 5703-7-03(A); UTAH ADMIN. BULL. R865-9-13I.C.4.; and W. VA. PERS. INC. TAX REG. section 51a.2.

¹⁰ This option computes tax separately on each partner's "aggregate net distributive share of **partnership** income" and applies a graduated rate of tax based on each partner's filing status. The

separately computed taxes are then combined into one payment which is remitted by the **partnership**. Several States provide a similar method for computing a "composite tax." See, e.g., Cal. Rev. & Tax Code section 18405.5(a); Me. Rule No. 805.04; N.M. Inc. Tax Reg. section 12:8.7; N.Y. Admin. Code tit. 20, section 151.17(g); and Or. Rev. Stat. section 314.760; Or. Admin. R. 150-314.760(d).

¹¹ Please note that section 10(B) [OPTION NO. 2], *infra*, includes corporate partners in the composite tax return. Accordingly, although several segments of the model provide additional optional provisions in the event corporate partners are included, other provisions of the model may need the necessary references with respect to corporate partners. For example, sub-section (F) (or another sub-section) would have to define "domestic" corporations and "foreign" corporations.

¹² This option is designed to comport with section 2(D) [OPTION NO. 1], *supra*.

¹³ This option is designed to comport with section 2(D) [OPTION NO. 2], *supra*.

¹⁴ Although not all states appear to provide firm guidance, **partnership** items of income, gain, deduction, and loss are, as a general rule, attributed to a taxing state by application of the state's apportionment and allocation rules. See, e.g., ALA. TAX REG. section 810-3-24.02(2); CAL. ADMIN. CODE section 17951-4(e) (the **partnership** apportions and allocates its tax items if it operates a unitary business within and without California. Otherwise, the **partnership** must apply specific sourcing rules. CAL. ADMIN. CODE section 17951-2.); IDAHO INC. TAX REG. section 27A, 1.a.; MINN. STAT. section 290.31, Subd. 27.; NEB. DEPT. OF REV. REG. section 25- 001.003.05C.; N.M. TAXATION AND REVENUE DEPT. INC. TAX REG. section 11:5; N.D. CENT. CODE section 57-38-10; VA. INC. TAX REG. section 630-4-391.C.1.

¹⁵ Certain provisions of the model distinguish between general and limited partners. Accordingly, a definition was deemed necessary. This definition ties into existing state law and provides an additional definition for business organizations, such as limited liability companies, that are classified as partnerships for state tax purposes. This additional definition is derived from Rev. Proc. 89-12, 1989-1 C.B. 798, section 1.02.

¹⁶ This definition is derived from Treas. Reg. section 1.469- 5T(e)(3)(i)(B), the definition of a "limited **partnership** interest" for purposes of the "passive activity loss" rules.

¹⁷ Some states may not impose an annual information return filing obligation on partnerships. If so, then this section 3(A) should be modified to reference the federal Form 1065 and Schedule K and to delete the reference to the state's version thereof. Those states that do impose such an obligation generally require a **partnership** to file an annual information return if the **partnership** is organized under the laws of the state, is doing business in the state, or has income from sources in the state. See, e.g., CAL. REV. & TAX CODE section 17932(a); COL. REV. STAT. section 39-22-601(5); DEL. CODE ANN. tit. 30, section 1174(a); IDAHO CODE section 63-3030(a)(8); N.Y. TAX LAW section 658(c)(1); OR. REV. STAT. section 316.467(1); and VT. STAT. ANN. tit. 32, section 5861(a). Other states may also require a **partnership** to file an annual information return if it has partners that are residents of the state even if the **partnership** does no business in and/or derives no income from the state. See, e.g., DEL. CODE ANN. tit. 30, section 1174(b); IDAHO CODE section 63-3030(a)(8); Ind. Code section 6-3-4-10; KAN. STAT. ANN. section 79-3222; N.Y. TAX LAW section 658(c); OR. REV. STAT. section 316.467(1); VT. STAT. ANN. tit. 32, section 5861(a).

Since section 1 of the model requires "multijurisdictional partnerships" to file a composite tax return, and since section 2(A) defines a "multijurisdictional **partnership**" as, in part, a **partnership** which is organized under the law of the state, derives income from sources in the state, or does business in the State, merely because a **partnership** has a partner which is a resident of the state will not create a composite tax return filing obligation for the **partnership**. Consequently, states may desire to further consider sections 1 and 2(A) to ensure that the model comports with their existing law and/or regulations.

¹⁸ This sub-section (B) assumes a state recognizes the "passive activity loss" rules so that if a state does not recognize them, this sub-section should be deleted. The model requires a **partnership** to account for passive activity income and gain in the aggregate (and aggregate passive activity losses, see section 4(B)(1), *infra*) even though the characterization of a **partnership** item of income or gain as passive is made at the partner level. The model adopts this approach to prevent offsetting active or portfolio **partnership** tax items with passive **partnership** tax items.

¹⁹ This option is provided in the event a state determines to include corporate partners in the composite tax return under section 10(B) [OPTION NO. 2], *infra*, and recognizes personal service corporations.

²⁰ Portfolio items of income consist of interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business. Treas. Reg. section 1.469-2T(c)(3)(i). Dividends include distributions from real estate investment trusts ("REITs"), regulated investment companies ("RICs"),

and real estate mortgage investment conduits ("REMICs"). The trade or business exception to the portfolio income characterization of royalties is applied at the **partnership** level. Treas. Reg. section 1.469-2T(c)(3)(iii)(B)(3) (which requires the **partnership** to have either created the intangible or to perform substantial services or incur substantial costs associated with the development or marketing of the intangible). Of course, if a state does not recognize portfolio income, then this subsection should be deleted.

²¹ The intention of this subsection (B) is to provide generally that all deductions of the partners of which they are entitled will be used to determine each partner's aggregate net distributive share of **partnership** taxable income without specifically setting forth each deduction. For example, deductions resulting from code section 743(b) basis adjustments (e.g., special depreciation or depletion deductions pursuant to Prop. Treas. Reg. section 1.168-2(n), Treas. Reg. section 1.743-1(b)(1), and Treas. Reg. section 1.743-1(b)(2)(iii)) would be used to determine a partner's aggregate net distributive share of **partnership** taxable income.

²² If a state does not recognize the "passive activity loss" rules, then this paragraph (B)(1) should be deleted.

²³ If a state does not recognize portfolio expenses, then this paragraph (B)(2) should be deleted.

²⁴ This "phantom income" provision recognizes the exclusionary aspects of the tax benefit rule (codified for federal purposes at code section 111). For example, a **partnership** with non-resident partners may realize "tax gain" upon the disposition of property as a result of a **partnership** termination or liquidation. The "tax gain" may be primarily attributable to prior years' tax deductions (e.g. depreciation) and not to the economic appreciation in value of the property. If the **partnership** (filing a composite tax return) or partners were not able to use the prior year's depreciation deductions because no income or gain was attributable to the state in the year of deduction, then the **partnership** and partners may not have realized any tax benefit in the taxing state arising from the depreciation deductions. Because the exclusionary aspect of the tax benefit rule may or may not be adopted by a particular state (or may be adopted in modified form), the model makes the "termination/liquidation income exclusion" optional. See, e.g., T.E.M. Investment Corp. v. Mass. Comm'r. of Revenue, Mass. St. Tax Rep. (CCH) [1977-1989 Transfer Binder], section 201-406 (Mass. App. Tax Bd., Dec. 19, 1986) (exclusionary aspect of tax benefit rule recognized); Appeal of Gerald H. and Dorothy A. Bense, Cal. St. Tax Rep. (CCH) [1978-1981 Transfer Binder], section 206-166 (Cal. St. Bd. Equal., March 7, 1979) (exclusionary aspect of tax benefit rule with respect to depreciation deductions not recognized).

²⁵ This "phantom income" provision recognizes the exclusionary aspects of the discharge-of-indebtedness-income rules as applied to partners. To the extent a state conforms to code section 108, **partnership** income arising from the discharge of **partnership** indebtedness is taxable only if a partner is solvent or has not filed for bankruptcy in a title 11 proceeding in United States Bankruptcy Court. Code section 108(a)(1). Consequently, in determining whether discharge of indebtedness income is taxable, one must determine if a partner (not the **partnership**) is insolvent or is bankrupt, and then only the partner(s) which is/are insolvent or bankrupt is/are permitted to exclude discharge-of-indebtedness-income from gross income. Code section 108(e)(7)(E). It appears considerably burdensome to require a **partnership**, which may consist of several hundred, if not several thousand, partners to individually determine which of its partners are or are not insolvent or bankrupt.

²⁶ In the event a state determines that corporate partners should be included in the composite tax return by adopting section 10(B) [OPTION NO. 2], *infra*, then this subparagraph (G) should be deleted.

²⁷ At least two states condition the eligibility of a partner to be included in a composite tax return on the partner and the **partnership** having the same accounting period. See, e.g., N.M. INC. TAX REG. section 12:8.4. and N.Y. Admin. Code tit. 20, section 151.17(a). The model seeks to include as many partners as administratively feasible from the state and **partnership** perspective so the New Mexico and New York requirements are not adopted. Rather, this portion of the model is borrowed from Ohio's version of a **partnership** composite tax return. See OHIO ADMIN. CODE section 5703-7-03(B).

²⁸ The option is provided in the event a state adopts section 10(B) [OPTION NO. 2], *infra*, and includes corporate partners in the composite tax return.

²⁹ Virtually every state providing for a composite tax return has a "single source" rule that prohibits the inclusion in the composite tax return of any nonresident partner having other (nonpartnership) sources of income in the state. Illinois, however, permits the **partnership** to petition for permission to include nonresident partners not satisfying the "single source" rule. See ILL. ADMIN. CODE tit. 86, section 100.5700 (e). The model does not adopt the "single source" rule as a limit for including partners in the composite tax return because the rule does not further the underlying policy of the model: a uniform law facilitating taxpayer convenience and compliance. Therefore, instead of eliminating nonsingle source partners from the composite tax return, the model treats

these partners as "nonqualifying nonresident partners" and requires them to file an individual tax return.

³⁰ This option is provided in the event a state adopts section 10(B) [OPTION NO. 2], *infra*, to include corporate partners in the composite tax return.

³¹ If a state determines that resident partners should not be included in the composite tax return, then this paragraph (B)(2) should be deleted.

³² If the model is made elective by a state, then this subsection (E) should be deleted. Alternatively, a "short form" composite tax return or **partnership** certification that no composite tax is due could be developed if the model is made mandatory.

³³ Rather than requiring all of the partners, whose numbers may be substantial, to file a power of attorney as required by section 7(B) [OPTION NO. 1], this option simply provides that the **partnership** automatically is the authorized agent of the partners when it files the composite tax return. This [OPTION NO. 2] is modeled after ILL. ADMIN. CODE tit. 86, section 100.5702.

³⁴ If a state determines that the model should be limited to nonresident partners, then this section 8(B) should be deleted.

³⁵ As a general rule, most states require resident partners to report their entire distributive share of **partnership** tax items and pay tax thereon even though they may not all be attributable to the resident state. See, e.g., CAL. REV. & TAX CODE section 17041. The resident state may provide the resident partner with a tax credit for taxes paid to other states ("source states"). See, e.g., ARIZ. REV. STAT. Ann. section 43-1071; CAL. REV. & TAX CODE section 18001; HAW. ADMIN. RULES section 18-235-55; ILL. REV. STAT. ch. 120, section 6- 601(b)(3); IND. REG. section 6-3-1-35(a)(070)(6); KAN. STAT. ANN. section 79-32,111; N.Y. TAX LAW section 620; N.D. CENT. CODE section 57-38-10; OHIO REV. CODE ANN. section 5747.05; OR. REV. STAT. Section 316.082. This optional provision is intended to permit a resident partner to claim a credit for composite tax paid by the **partnership** on the partner's behalf to source states. It should be noted, however, that there is no constitutional requirement for the resident state to provide a credit for taxes paid to source states. *Christman v. Franchise Tax Board*, 64 Cal. App. 3d 751, 134 Cal. Rptr. 725 (Cal. Ct. App., 2d Dist., 1976).

³⁶ At least three states provide a de minimis number of partners rule in order for a **partnership** to be eligible to elect filing a composite tax return. See N.M. INC. TAX REG. section 12:8.1 (36 or more

partners); N.Y. ADMIN. CODE tit. 20, section 151.17(a) (50 or more "qualified" partners); and Ohio Admin. Code section 5703- 7-03(A) (2 or more nonresident partners).

³⁷ Several states exclude corporate partners from their elective composite tax returns. See, e.g., ILL. ADMIN. CODE tit. 86, section 100.5700 (a); ME. RULE NO. 805.01.B.; N.M. INC. TAX REG. section 12:8; N.Y. ADMIN. CODE tit. 20, section 151.17(a) and (c); OR. ADMIN. R. section 150-314.760(1); UTAH ADMIN. BULL. R865-9- 13I.C.3.; and W. VA. PERS. INC. TAX REG. section 51a.1. The inclusion of corporate partners may cause administrative burdens for states and corporate partners.

For instance, a corporate partner's net distributive share of **partnership** income subject to tax by a state may not correspond to its aggregate net distributive share of income that is taxed under the model's composite tax return regime. This can result due to income attribution differences resulting from a state's rules of apportionment and allocation as applied to the **partnership** and the corporate partner, the flow through of the corporate partner's share of the **partnership**'s apportionment factors, and the inclusion of a corporate partner's distributive share of income and factors in a combined report of a unitary business. Consequently, the corporate partner's share of composite tax paid by the **partnership** under the model may not correspond to the tax which is actually due on the corporate partner's net distributive share of **partnership** tax items. The state and the corporate partner may be subject to increased administrative burdens and costs related to processing and filing of tax returns or refund claims.

³⁸ This option is for those states desiring to include corporate partners in a composite tax return. Those states having adequate resources to contend with increased tax return filings and potential refund claims filed by corporate partners may see a need to require the inclusion of corporate partners.

³⁹ The 50-percent rule is a suggestion. Although any percentage interest used for determining the substantiality of an upper tier **partnership**'s interest may be considered arbitrary, a percentage interest other than 50 percent may better determine substantiality. Nonetheless, the substantial interest requirement is necessary in order to prevent manipulation and to ensure that the lower tier **partnership** truly is merely a record holder for the upper tier **partnership**.

⁴⁰ Such a definition of "principally engaged in low income housing" could be based upon the following suggestion: "A **partnership** is 'principally engaged' in low income housing projects if it generates low income housing credits under [insert relevant state tax code section or, if none, section 42 of the Internal Revenue Code of 1986, as amended], equal to a value that constitutes

[50, 75, 80?] percent or more of the **partnership**'s total value of items of income, gain, and credits, including low income housing credits for the **partnership** taxable year." Another possible definition would be to require that a substantial percentage (however defined) of the **partnership**'s assets qualify as "low income units."

⁴¹ This section 11 is derived from California Franchise Tax Board Notice 90-5 (August 20, 1990) and the federal withholding tax applied to foreign partners of domestic partnerships, including publicly traded partnerships, under Code section 1446 as administered by Rev. Proc. 89-31, 1989-1 C.B. 895, section 10. Publicly traded partnerships ("PTPs") are treated differently by the model than other partnerships because of special circumstances associated with PTPs. Interests in PTPs must be fungible which means that the attributes of all interests must be identical. Although the resident partner and nonresident partner distinctions are the most obvious fungibility issue when only nonresident partner distributive shares of income are subject to withholding or are included in a composite tax return, other situations also present fungibility problems for PTPs. For example, if a PTP uses a code section 754 election to adjust newly admitted unit-holders' bases under code section 743(b), these unit-holders are provided "special" depreciation or depletion deductions pursuant to Prop. Treas. Reg. section 1.168-2(n), Treas. Reg. section 1.743-1(b)(1), and Treas. Reg. section 1.743-1(b)(2)(iii). Consequently, these unit-holders receiving the special deductions will have tax calculations under a composite tax return that vary from the tax calculations of other partners. Tax calculation variances result in special, unequal distributions and a lack of fungibility. Other fungibility problems are posed by the passive activity loss limitation rules (the rules apply to some but not all partners thereby creating tax calculation differences) and special built-in gain allocations under code section 704(c) which requires allocation of depreciation deductions to partners having contributed built-in gain property to the **partnership** different from depreciation deductions allocated to noncontributing partners.

Moreover, the Internal Revenue Service may treat the payment of state income taxes by a publicly traded **partnership** on a composite tax return as a distribution. See Priv. Ltr. Rul. 9142029 (July 22, 1991) (wherein the Service ruled that the payment of state income taxes by an S corporation on behalf of its shareholders included in a state composite tax return would be treated as distributions by the S corporation).

⁴² The "nominee designation" is derived from Rev. Proc. 89-31, section 10.04 and is necessary in order to ensure that publicly traded **partnership** units retain their "fungibility." Because tax is paid by the nominee and not the publicly traded **partnership**, the units retain their fungibility since a

"special distribution" is not being made by the **partnership** with respect to one unit that is not made with respect to another unit. In addition, it is doubtful that a publicly traded **partnership** could issue the credit certification required by section 11(E) to a unit-holder whose interest(s) is/are held in a "street name" account. Often only the nominee/ broker knows the identity of unit-holders.

⁴³ Derived from Rev. Proc. 89-31, section 10.06.1. It is, however, doubtful that this provision would ever apply to a publicly traded **partnership**, but it is a part of the model in order to treat any "rare" situations in which a publicly traded **partnership** distributes property other than money.

⁴⁴ This limitation is derived from Rev. Proc. 89-31, section 10.06.2(b) and (c).

⁴⁵ This limitation is derived from FTB Notice 90-5, section 11.A. Current distributions of property are generally not taxable to the extent a state conforms to code section 731(a) unless the property distributed falls under a state statute conforming with code section 751(a) (distribution of unrealized receivables and substantially appreciated inventory items). Rather, a partner takes a carry-over basis in property distributed by a **partnership** under a state's corollary to code section 732(a). Consequently, unless a distribution of property consists of unrealized receivables or substantially appreciated inventory, the model does not impose a withholding tax on property distributions. Likewise, current cash distributions are not taxable unless they exceed a partner's basis in the partner's **partnership** interest to the extent a state conforms to Code section 731(a). A nontaxable cash distribution is simply a return of capital.

⁴⁶ Derived from FTB Notice 90-5, section 16.A and Rev. Proc. 89-31, section 10.06.3(a) with respect to the fair market valuation of actual distributions of property other than money.

⁴⁷ The treatment of publicly traded partnerships that are part of a tiered **partnership** structure involving more than one publicly traded **partnership** is derived from Rev. Proc. 89-31, section 10.06.1. For example, publicly traded **partnership** A owns an interest in publicly traded **partnership** B. B makes a cash distribution of \$100 to A and withholds 20 percent under section 11(B). A receives a net distribution of \$80 which it immediately redistributes to its unit-holders. Upon making an actual distribution of \$80, A is deemed to have made a distribution of \$100 to its unit-holders consisting of \$80 in cash and a \$20 deemed distribution on which it must also **withhold** tax. Assuming that A also must **withhold** at a 20-percent rate on the subsequent distribution, it may credit the \$20 withheld by B against its subsequent withholding tax liability under section 11(D)(1), *infra*.

⁴⁸ The tax credit for unit-holders is derived from Rev. Proc. 89-31, section 9.01.

⁴⁹ This is derived from Rev. Proc. 89-31, section 9.02.

⁵⁰ Because the model permits publicly traded partnerships to designate a nominee as a withholding agent and distributions are made to a "street name" account, distributions to all unit-holders will remain equal for fungibility purposes despite the fact that a withholding tax is paid with respect to only some units. Fungibility is determined on the basis of equality of distributions by the publicly traded **partnership** and not on the equality of tax payments. Therefore, corporation unit-holders and tax exempt organization unit-holders can be excluded from the withholding tax without compromising fungibility.

⁵¹ This option is provided for states desiring to include corporation unit-holders under the withholding tax.

⁵² Derived from Rev. Proc. 89-31, section 4.01 and section 4.02.

⁵³ This five-year "phase in" provision is provided to enable partnerships and states the time to prepare for the mandatory application of the model as far as "existing partnerships" are concerned. In the event a state determines to apply the model on an elective basis only, then this sub-section (B), as well as subsections (C), (D), and (E) should be deleted.

⁵⁴ Estimated tax payments under the model remain an obligation solely of the partners. The **partnership** is not obligated to remit payments of estimated tax. Existing composite tax return provisions for some states require the **partnership** to remit estimated tax on behalf of partners included in a composite tax return filed by the **partnership**. See, e.g., California Franchise Tax Board "Group Filing Instructions California Form 540NR For Nonresident Partners." ("The **partnership** must assure that the corresponding estimated tax and computed tax payments are made for the group by the **partnership**, and that the **partnership** submits estimated tax payments in accordance with the instructions in paragraph C."); ILL. ADMIN. CODE, tit. 86, section 100.5708 ("Estimated payments shall be made on the basis of the tax shown on the composite return."); and OR. ADMIN. R. section 150-314.760(2) ("Estimated tax payments are required if the total tax due for any partner . . . who elects to join in filing a multiple nonresident return will be more than \$500 when the return is filed.") Maine permits a **partnership**, in its discretion, to make estimated tax payments on behalf of its partners. ME. RULE NO. 805.05.

⁵⁵ This section is made optional for consideration by a state. As a general matter, state **partnership** tax law substantially conforms with federal **partnership** tax law. The extent of conformity with subchapter K of the code and the Treasury Regulations, however, may vary by state based on particular state modifications to subchapter K. Accordingly, it is the responsibility of an individual state to determine the effect that this section 14 and the references to the Internal Revenue Code throughout the model will have on the state's tax law and regulations.

DOCUMENT ATTRIBUTES

MAGAZINE CITATION

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