Multistate Tax Commission

Pass-through Entity Compliance Work Group Report and Proposed Initiatives

Prepared for the
State Tax Compliance Initiative Steering Committee

May 28, 2004

Summary Outline

I. Introduction

A. The Compliance Steering Committee and the Pass-Through Entity Work Group

At its meeting in April, 2003, the Multistate Tax Commission (MTC) Executive Committee authorized a State Tax Compliance Initiative to develop methods of improving compliance with state taxes in three key areas:

- business income tax sheltering,
- pass-through entity owner income reporting, and
- sales and use tax compliance, including both business use tax and nexus issues.

To conduct the initiative, the Executive Committee established an MTC Compliance Steering Committee. The Steering Committee, chaired by Ms. Elizabeth Harchenko (Oregon) organized itself into three working groups, one for each of the broad topic areas identified above.

The Pass-through Entity Work Group was initially chaired by Mr. Phil Brand (DC). After Mr. Brand left the DC tax office, Ms. Harchenko took over as chair of the Work Group. Its membership has included representatives from 9 states:

Phil Brand (DC)
Elizabeth Harchenko (OR)
Tamara Harris (AZ)
Steve Wilkins (AZ)
Karen Scholz (AZ)
Rich Nicholson (CT)
Joe Thomas (CT)
Holly Wilson (CT)
Felix Jarusewic (DC)
David Dorner (IL)
Jennifer Hays (KY)
Michael Fatale (MA)
Donald Twomey (MA)
Don Hoffman (MT)
Brenda Gilmer (MT)
Jeffrey Sherman (OH)
Janielle Lipscomb (OR)

The initial focus of the work group was to develop and send a survey to MTC states to determine how they treat pass-through entities. Twenty-three states responded with helpful information. The work group followed up with a short email survey to determine the key concerns the states had about pass-through entities and the initiatives states believed would be most effective to deal with those concerns. That survey has substantially guided our recommendations here. The work group also held a meeting with stakeholders in Washington DC on October 15, 2003, but received little helpful input from the private sector.

With regard to the use of technology to ensure that owners properly report the passed through income, the work group focused on three sources. The group issued a Request for Information to private sector information technology companies for systems that might be useful in state compliance efforts. We received four responses which may be of some help to states. The work group chair and DC staff met with IRS staff to ascertain whether IRS systems might assist the states. This looks to be a good source for continued exploration. Finally, the work group has become aware of the path-breaking compliance work being done in California, New York and Pennsylvania with regard to data warehousing and databases that may provide a way for the states to work cooperatively on tracking income from pass-through entities as the income moves through layers of entities.

B. Purpose of this Report

The Steering Committee is charged with evaluating major compliance needs in the three areas set out above and developing plans to resolve those compliance needs. This report provides the Pass-Through Entity Work Group's findings on the major pass-through entity compliance needs and summarizes the key research, surveys and observations upon which those findings are based. Four proposed initiatives to address these compliance needs are presented for the Steering Committee's review and consideration.

II. Identification of Compliance Needs

The key fact about pass-through entities that makes them of such concern is that the entity which earns the income is not the entity that pays the tax. This separation provides opportunities to argue about nexus. The ability to pass income through to the owners also provides inevitable opportunities for hiding income, for not reporting income, and for sheltering income.

A. State Survey on Concerns and Initiatives Regarding Pass-Through Entities

An extensive survey was distributed to MTC states seeking information on how states treated pass-through entities. While the resulting information is useful in understanding the differences in state treatment, and perhaps a basis for a Uniformity Committee action on allocation and apportionment for pass-through entities, it did not guide us in determining a compliance strategy.

A subsequent and more directed survey was emailed to the states seeking specific guidance on compliance concerns and initiatives. The greatest concerns focused on lack of information, information about the identity and characteristics of pass-through entities, about the extent of their multistate activities, about the identity of owners, and about the relationships among related pass-through entities. The initiatives identified as most likely to be effective were mandatory withholding, IRS databases and tracking software, other common databases, a centralized filing system and technical training. Report on Survey Results attached as Appendix A.

B. Potential Technological Solutions

The work group realized early on that the ability to trace income from pass-through entity to owners, and from one tier of pass-through entities through multiple tiers of owners, would inevitably call for the use of information technology. The work group focused on two possible technological solutions, and has been the beneficiary of compliance work elsewhere for a third possibility.

1. Issuance of the RFI

The work group developed and issued a RFI to information technology companies for possible solutions for state compliance in tracking income of pass-through entities. The intent of the RFI was to gather information for use by states in individual state compliance efforts rather than a multistate solution. We received four responses, two of which described potentially beneficial compliance tools.

2. Contact with the Internal Revenue Service

Mr. Brand and his staff in DC held meetings with the Internal Revenue Service on IRS compliance systems for pass-through entities. Two sessions were held with IRS executives representing the compliance research components of the Commissioners of Small Business and Self Employed (SBSE) and Large and Mid-Size Businesses (L&MSB) of the IRS. These visits primarily focused on current estimates of non-compliance, research data and analysis of Schedule K-1 filings and descriptions of current IRS compliance initiatives.

A significant part of the IRS effort has been a matching program with data from Schedule K-1s. The IRS advised that revenue being reported from flow through entities is growing at the rate of 13% annually (up $200 million) since 2001. They are also seeing a growth in the complexity of pass-through entity structures, especially in the number of tiers being used. The L&MSB Compliance Strategy Council completed a top-down analysis on Schedule K-1s for the 2001 Tax Year as part of the effort to make better use of the data from these returns. A total of approximately 22 million pass through entity returns were received. Only approximately a quarter of Schedule K-1s were received electronically, which makes conversion of these documents into the systems for matching and other uses expensive. Seventy-nine percent of Schedule K-1s were issued to individuals; 275,000 corporations received more than 800,000 Schedule K-1s; 28,691 subsidiaries received 422,281. About 370,000 trusts received a total of almost 600,000 Schedule K-1s.

The IRS has a number of initiatives underway that will be of interest to the compliance work groups.

Automation

- An artificial intelligence modeling system has been developed to identify those pass-through entities that IRS believes are high compliance risks and thus have high revenue potential. IRS has launched a compliance research initiative feeding off the information provided by this new model. They are also engaged in design of a streamlined form K-1 to make filing less complex and data conversion at the IRS more easily accomplished.

- The AI modeling system developed by MITRE uses a software product "Analysts Notebook" This software and effort uses pattern recognition to identify prepares, practitioners and recipients as a means of choosing only those with the highest potential for change. The process also creates a visual display (Visual Links) that leads to an "enterprise risk assessment" on those entities that have the most likelihood of change. An observed visual graphic record of a very complex multi-tiered partnership that displayed in visual format the various tiers and distribution of revenue/income and losses appeared to have great promise.

Operating Divisions Commissioners Enforcement Council

- The two major Divisions SBSE and L&MSB have set up an Offshore Compliance Council due to the growth of issues and concerns in this area. This Council should be helpful as a source of additional information. The chief item of interest in this area is a compilation of data sources this group is using in their research effort supporting the efforts on shelters and pass through entities.

Compliance Laboratory-Oakland California

- IRS has established a special compliance lab in Oakland that concentrates specifically on tax shelters, flow-through entities. While the Oakland Compliance Lab is in its infancy stages, with hardware/software/user connections just being established; and final approval pending for full implementation/linkages/participation, etc. it certainly holds great promise for a coordinated compliance tool.

3. State Data Warehousing Efforts

The work group learned through the Federation of Tax Administrators and the Corporate Income Tax Shelter Work Group that a few states, particularly California, New York and Pennsylvania, have taken a lead role in developing outstanding technology-based compliance efforts. A significant part of those efforts is the creation of data warehouses that contain information on pass-though entities and their owners, often their many tiers of ownership.

In Pennsylvania, data from entities' Schedule K-1 forms that contain the owners' SSNs or EINs can be matched with returns filed, or not, by the owners and whether the income from the K-1 has been reported.

New York is developing a Multi-State Tax Shelter Application (MSTSA) database that will be available to states that have signed a Memorandum of Agreement for the sharing of information. The MSTSA will contain information on tax sheltering activities of taxpayers and allow users to view taxpayers associated as owners of pass-through entities.

California purchased a hardware/software program from AMS that has allowed them to trace the income of pass-through entities. That system was a strong component in California's study of tax sheltering.

The work group believes that smaller states might well work with these lead states in providing data and sharing the use of the databases developed from the data warehousing.

C. Work Group Findings

The Work Group identified three major compliance needs:

- ensuring payment of tax before income earned by a pass-through entity in a state is distributed outside the reach of the state;
- tracing the income distributed from (and deductions taken by) pass-through entities as it moves to owner and often through tiers of owners; and
- preventing the sheltering of income of pass-through entities through various tax-planning, tax-avoidance and tax-evasion tactics.

III. Proposed Initiatives

The work group approved four compliance initiatives for presentation to the Steering Committee.

A. Publicize and Encourage States to Adopt the MTC's Uniformity Proposal for Reporting Options for Nonresident Members of Pass-Through Entities.

Withholding by the payor of tax on distributed income remains the primary method to ensure that income of owners from pass-through entities is reported and the tax paid. This is the same primary compliance method that the federal government and the states use for most other forms of income. The Commission has already developed a Uniformity Proposal that provides for withholding on income distributed to nonresident members, where compliance is most problematic. Withholding is imposed, however, only as backup if the entity does not choose to avail itself of the convenience of a composite return reporting and paying tax for nonresident members.

Many states have already adopted various forms of withholding. Most common, and most favored by taxpayers, is withholding only if the taxpayer refuses to file a promise to pay. The Commission felt that while a promise is good, actually getting the tax paid when the income is distributed is vastly better.

The remaining effort here, then, is to publicize the MTC proposal and work with states to encourage their adoption of it.

B. Work with California, New York and Pennsylvania as Lead States in Developing a Common Database or Data Warehouse on Flow of Income from Pass-Through Entities to Owners.

As indicated by the wide range of the original MTC estimate of revenue loss due to non-compliance by owners of pass-through entities (between $1 billion and $12 billion), the largest problem here is simply not knowing what income is earned and where it is going. The complexity of the ownership tree can be enormous. A given pass-through entity can be owned by other pass-through entities, which are, in turn, owned by others, and so on ad infinitum. Into the mix can be added ownership by C Corporations, by trusts, by individuals, both foreign and domestic. Tracing where the income goes can become an impossible task.

Certain lead states have been developing data warehouses and databases that will allow the tracking of the ownership interests of pass-through entities. The work group believes that one of the best compliance tools for the states would be to work with these lead states to enhance these databases and obtain the use of the databases, possibly through a fee for service arrangement. The New York Multi-State Tax Shelter Application program that states may utilize by entering into a Memorandum of Agreement may already be on the way to provide the desired capabilities.

C. Develop Educational Resources on Pass-Through Entities for the States

The greatest concerns of the states expressed in the survey all centered on the lack of information—information about the character of pass-through entities, about the extent of their activities, about their owners, and about the interrelationships among entities with multiple ownership levels. Ms. Brenda Gilmer (MT) has begun the task of bringing together in one document a collection of references to information about all aspects of pass-through entities. The document provides jump cites to various Internet websites wherein information can be found. The work group applauds this Herculean effort by Ms. Gilmer and recommends that this document continue to be refined for eventual placement on the MTC secure Extranet website to be available to the staffs of member states.

To supplement the educational compendium, the work group recommends the development of training sessions for state auditors on how to recognize pass-through entity issues as well as a more specific training component on sophisticated methods of attacking the latest pass-through entity sheltering techniques

To implement this recommendation there will need to be a continuing group to maintain the educational compendium on the website and to develop and run training programs.

D. Create an Ongoing Liaison Group to Work with the Internal Revenue Service to Coordinate Compliance Efforts on Proper Reporting of Pass-Through Entity Income

The conferences with the IRS have confirmed that the IRS is ahead of most of the states on many of its compliance systems for pass through entities. Even the most basic step, the matching of income reported by entities on Schedule K-1s to the income reported by the owners on their returns would be an enormous help to the states. MTC Executive Director Dan Bucks recently met with IRS Commissioner Everson and had a very productive discussion on how the states and the IRS could work together. The work group strongly recommends that the Commission and the states create a liaison group to continue to forge alliances with the IRS for mutual compliance assistance with specific reference to pass-through entities.

Respectfully submitted,

Elizabeth Harchenko, Chair

Appendix A

Multistate Tax Commission Memorandum
States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Pass-through Entity Work Group
From: Frank Katz, General Counsel, MTC
Date: May 19, 2004
Subject: Report on Email Survey to States on Concerns and Tools for Gaining Greater Compliance from Owners of Pass-through Entities (Revised)

An email survey was sent out on April 6, 2004 seeking input from states on several issues: revenue losses from non-compliance by owners of pass-through entities; programs or initiatives, statutory or regulatory provisions implemented to improve compliance, and rankings of state concerns and potential initiatives. Twenty-five states sent responses, which are summarized below.

Only a few quantified revenue losses due to non-compliance. The five amounts reported, in millions, ranged from $1.3, $5.7, $8, $50, $99 to $125.

Four types of programs or initiatives were reported:

- data capture,
- special audit groups,
- project teams on pass-through entities
- listed transactions for REITs and RICs, and
- partnership delinquency programs.

Several varieties of legislative or regulatory responses were mentioned:

- the MTC uniformity proposal;
- composite returns;
- withholding of tax on distribution to members;
- a tax on the pass-through entity itself; and
- barring S corporations from being part of a consolidated return.

States were asked to rank a series of concerns about pass-through entities. I have reverse weighted the rankings (the concern ranked most important was given an 8, second, a 7, and so forth—the higher the number, the greater the concern) and collated the responses below.

Concerns	Score
a. Lack of information about the identity and characteristics of PTEs	136
b. Lack of information about the extent of multi-state activities of PTEs	123
c. Lack of information about the relationships among related pass-through entities and/or owners.	121
d. Lack of information about the owners of PTEs	119
e. Lack of clear rules specifying how allocation and apportionment principles apply to PTEs	69
f. Lack of clear rules specifying how allocation and apportionment principles apply to multi-tiered PTEs	84
g Lack of clear rules specifying alternative allocation and apportionment of tiered PTEs.	76
h. Lack of resources/materials to educate audit and enforcement staff.	84

It is evident that capturing date for data bases to track identity, ownership and income of pass-through entities is a major concern

States were also asked to rank proposed initiatives to deal with non-compliance. Using the same reverse weighting, the higher scores indicate those initiatives which states thought would be the most beneficial.

Initiatives	Score
a. Mandatory withholding	88
b. Centralized filing system	85
c. Common database	87
d. IRS data bases and software	91
e. Technical training	82
f. Model allocation and apportionment rules	68

Withholding is major, and is already required by approximately 28 states. The MTC proposal fits well with current statutes and might bring an advantageous uniformity. The Uniformity Committee is working on apportionment. The big needs seem to be finding data bases and ways of capturing data on tracking income, and then training on how all this works.

States suggested additional recommendations for initiatives.

- a direct tax on pass-through entities;
- a cross check on refund claims against members' liabilities;
- special nexus considerations;
- guidelines for separate accounting;
- information sharing;
- databases for taxpayers, issues, positions and authorities;

- treatment of public traded partnerships;
- tracking for second-tier owner withholding;
- clearer definition of business income and unitary relationship between entities and owners several tiers down; and
- common filing and reporting requirements for multistate pass-through entities.