MULTISTATE TAX COMMISSION

TO: Members of the Partnership Work Group and the MTC Uniformity Committee

FROM: MTC Staff

SUBJECT: **Comment –** Exclusion from Partnership Pays for Share of Adjustments Reported to Direct Corporate Partners

DATE: July 9, 2018

Since our last work group call we received a comment about the proposed model's partnership pays election and the related exclusion from that election of the share of adjustments reported to corporate partners that must include them in unitary business income. The comment was concerned with whether the exclusion is sufficient. This memo summarizes that issue.

Under the proposed model, an audited partnership (or any of its tiered partners) can elect to pay tax to a particular state tax rather than having all the direct and indirect partners amend returns. But the model excludes from that partnership-pays election the share of the audit adjustments reported to direct and indirect corporate partners that must be included in the unitary business income of those partners, *provided that the electing partnership can reasonably determine that this is the case*. (The wording of that exclusion is still being discussed.) The reason for this exclusion is because such income would ordinarily be sourced by applying the state allocation/apportionment rules at the corporate level (often including a proportional share of the partnership factors). Whereas, under the partnership-pays election, they would be sourced differently.

If the corporate partner is a direct partner, the electing partnership would source the corporation's share of the adjustment by applying the state's allocation/apportionment rules applicable to multi-state business activity, *at the partnership level*, and then multiplying the result times the highest tax rate. (Again, the precise wording is still being discussed.) If the corporate partner is an indirect partner, the proposed model now would require that the corporate partner's share of the adjustment be treated in one of two ways depending on the type of income it relates to. If the adjustment is the type of income that the state would allocate/apportion for nonresidents (non-investment type income) then, again, the partnership would apply the state's allocation/apportionment rules to that adjustment at the partnership level. If the adjustment is the type of income that the state would source to the residency of an individual partner (investment type income), then that adjustment will be sourced 100% to the state unless the tax agency allows some modification based on additional information provided by the electing partnership.

(Although this provision is also under discussion and may not be as clear on whether there is *any* modification in the case where the indirect partner is a taxable corporation.)

If the adjustment would be properly reported by a direct or indirect corporate partner as part of its unitary business, then the partnership-pays calculation may tend to overstate or understate the tax due. The following simple example illustrates:

> In the reviewed year, Corp, through its own operations, did business in states A and B (which apportion income on the basis of a single sales factor and impose a 10% tax). Corp, through its own operations, had $ 80 million of sales in state A and $80 million of sales in state B. But Corp also had a 50% interest in Partnership, which did business entirely in state B. Partnership has $40 million sales in state B. Assume that Partnership has a $2 million federal audit adjustment to its taxable income in the year—and that adjustment is properly reported as part of Corp's unitary business income. If Corp itself reported its share of that $2 million to states A and B, the following is the result:
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> State A = $1 million X ($80 million/$180 million) X 10% = $44,444.
>
> State B = $1 million X ($100 million/$180 million) X 10% = $55,556
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> But if Partnership includes that adjustment in the partnership-pays calculation, the result is as follows:
>
> State A = $1 million X ($0/$40 million) X 10% = $0
>
> State B = $1 million X ($40 million/$40 million) X 10% = $100,000

State A receives less tax than it would have. But State B receives more.

What if the partnership's federal adjustment would not properly be treated as part of the corporate partner's unitary business income? If the corporate partner reported its share of the adjustment, it would follow state rules for allocating (or otherwise sourcing) that income, rather than apportioning it. Those rules might require sourcing to where the partnership's operations are located or perhaps to the corporate partner's domicile. If that share of the adjustment is included in the partnership-pays calculation, then it would be allocated/apportioned at the partnership level. So, arguably, the result in that case may be closer to the "right" result than would be the result in the case of adjustments that are part of the unitary business income.

Returning to the exclusion from the partnership-pays election, the concern raised is whether it is a sufficient safeguard to require the electing partnership to exclude adjustments (and requiring the partners instead to report them) if the partnership can reasonably determine those adjustments would be part of the unitary business income of direct and indirect corporate partners. Assuming the corporate partner is a direct partner with a controlling or substantial interest, it seems unlikely the electing partnership could reasonably argue that it has no way of determining whether that corporate partner must report its share of the adjustment as part of its unitary business income. (And that treatment would presumably follow the treatment given to that partnership income by the corporation on its original state return.) Likewise, it is unlikely a partnership in which an indirect corporate partner indirectly owns a controlling interest (through various intermediaries) could reasonably argue that it has no way to determine whether that corporation must report its share of the adjustment as part of the corporation's unitary business income.

But what about indirect corporate partners that own a substantial interest in the electing partnership, but less than a controlling interest? In that case, the electing partnership may not even know that the corporation is an indirect partner. So the partnership would either treat that share of the adjustment by allocating/apportioning at the partnership level (if the nature of the income is non-investment income under state rules) or would source 100% of the income to the state (if the income is investment income), but in that case, could ask the tax agency for a modification based on additional information provided.

If the proposed language in the model excluding adjustments for direct and indirect corporate partners is not considered sufficient, there are a few options the work group might consider. First, the provision could contain a rebuttable presumption that a direct partner that owns a greater than [some percentage] interest will include its share of the adjustment in unitary business income (so that it would be excluded from the partnership pays approach unless the partnership rebuts the presumption). Second, the provision could specify that an indirect corporate partner that indirectly owns a controlling interest in the partnership is treated as a direct partner for this purpose. Third, the provision could further provide that if the tax agency determines that an indirect corporate partner has interposed intermediary entities between itself and the partnership for the purpose of avoiding tax, it can assess the additional tax against that corporate partner equal to the tax it would have otherwise paid. That said, it is not clear that such a structure would be interposed for the purpose of avoiding tax. As the group has discussed, to be effective, such planning would first have to anticipate the under-reporting of income for federal purposes so that the partnership-pays election would even be relevant.