MULTISTATE TAX COMMISSION

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

FROM: MTC Staff

SUBJECT: Staff Report

DATE: January 11, 2018

NOTE: THIS REPORT IS PREPARED BY MTC STAFF FOR REVIEW AND DISCUSSION ONLY. AS OF THE DATE OF THIS REPORT, THE INTERESTED PARTIES HAVE NOT YET HAD A CHANCE TO REVIEW AND RESPOND TO THIS REPORT AND IT IS SUBJECT TO REVISION, IF NECESSARY.

BACKGROUND

MTC staff received a number of comments about the proposed model (as of January 10, 2018). Many involve the kinds of clarifications or resolution of conflicts that would likely be necessary in any drafting process, and could likely be agreed to here, if the draft were simply subject to more extensive review and consideration (which, due to time constraints, may not be possible). Also, a number involved the general provisions and the intersection of those provisions with existing state law, something that will have to be considered by state drafters. This report does not address these issues but cautions that those reviewing the draft should do so carefully. Instead, this report addresses the three most significant substantive issues raised concerning the partnership provisions.

SIGNIFICANT PARTNERSHIP ISSUES

1. Treatment of Amended Federal Returns Filed During the Modification Period.

During the federal partnership audit's 270-day "modification period," a partner may file federal amended returns, taking into account the partner's share of all the audit adjustments for the reviewed year and any subsequent year where the partner's tax attributes are affected. If a partner does so, and pays the resulting tax, the partnership may receive a proportional reduction in its federal partnership imputed underpayment (entity-level tax liability), with one exception. If the audit adjustment involves a reallocation of partnership items between partners, then all of the affected partners must file amended returns (reporting their share of that adjustment as well as their shares of all other adjustments) and pay the tax due, or the partnership will not receive a reduction in the imputed underpayment. If the adjustments are ultimately contested, and the partnership prevails, the partners will be entitled to a reduction in the amounts paid with their modification-period amended federal returns. For various reasons, it appears the IRS anticipates that the filing of such returns will occur frequently.

The treatment of such amended federal returns under the proposed model is unclear, however. On the one hand, it appears to allow, but does not require, a partner to file state "federal adjustment reports" (FARs, e.g. state amended returns) if the partner files amended federal returns during the modification period. Section B, which generally governs reporting federal changes, would normally require the filing of FARs where amended federal returns are filed, but that section explicitly excludes from its requirements any adjustments "arising from a partnership level audit" (or an administrative adjustment request filed by the partnership). Instead, Section C would apply. But nothing in Section B *prevents* a partner that has filed amended federal returns from filing state FARs.

In fact, Section C's partnership-pays election (subsection (3)), appears to confirm that this is a possibility. Under that section, the computation of the partnership liability will exclude the portion of the audit adjustments allocated to a partner that "has previously filed a valid Federal Adjustment Report under Section B reporting such distributive share and paid any additional [State] liability due." (See paragraph (iii)). This would be necessary only if a partner, while not required to file a state FAR, is nevertheless permitted to do so. What is meant by a "valid" FAR "under Section B" is unclear, however, since Section B, as discussed, excludes from its requirements adjustments "arising from" a partnership audit. We assume it is intended to refer to a state FAR that is consistent with an amended federal return. And, while the general rules of subsection (C)(2), which apply if no partnership-pays election is made, do not make any similar reference to partners that have already filed a state FAR, the requirements of subsection (C)(2) would not be duplicative, but instead would simply be fulfilled by a partner that had already filed the state FAR.

Nor would this voluntary treatment necessarily run afoul of the definition of the "final determination date" (Section A (9)). While under paragraph (3) of that definition, the final determination date is the date an amended federal return is filed, if the adjustment arises from a federal audit, then paragraph (1) provides that the date is when all the audit adjustments have been finally resolved. Assuming paragraph (1) controls, the filing of an amended federal return under the modification period to report audit adjustments would not trigger a final determination date until all the audit adjustments are resolved. So, again, nothing would require the partner to file state FARs simply because federal amended returns have been filed.

Nor would this appear to create any real conflict with the state composite return rules or Section C (2), which requires the filing of an amended composite return. Assuming a partner that has filed an amended federal return was, originally, included in a state composite return, that partner would have no other separate state FAR filing requirement and would presumably not choose to file a state FAR in that case. Nor would Section C (2)(iii) provide any reduction in the composite return liability on account of that partner's separate filing. Nor is it likely that such a state FAR would be considered "valid . . . under Section B."

Staff believes that there are pros and cons of having a requirement that partners file state FARs when they have filed modification-period amended federal returns. It may be that the group wants to further consider this. But, assuming this treatment is determined to be a reasonable approach, there are clarifications required as follows:

- It should be clarified that a state FAR is not required under Section B when a partner files a modification-period amended federal return.
- A partner should only be allowed to file a state FAR if the partner files an amended federal return.
- It should be clarified that the filing of a state FAR will *not* reduce the composite return liability if the partner is part of the composite filing group.
- A reduction in partnership-pays election liability amount should only be allowed to the extent that the reporting of the adjustment on the amended federal return was also allowed by the IRS as a modification to reduce the federal partnership imputed underpayment.
- The definitions of "federal adjustment" and "final federal adjustment," which are the starting point for computing the partnership-pays amount, should be clarified so that they clearly include adjustments that may have been modified (reduced) at the federal level but for which no corresponding state FAR has been filed or state tax paid. (Otherwise, the starting point for the state partnership liability would effectively be reduced under Section C (3)(ii) even though no state tax has been paid by the partner.)

2. Consideration of a Federal-Style Push-Out Election.

Under the federal push-out election, partners will receive information on the effects of their share of audit adjustments from the partnership and will compute and report the related tax on their adjustment-year return. The push-out election would include the effects of adjustments on the tax attributes in intervening years as well. Some have asked that the model consider allowing a similar treatment for state purposes.

Initially, the rationale for not including this option appears to be the difficulty inherent in making it work given that partners might file in multiple states (as resident and nonresident) and might move residences between the reviewed year and the time that the adjustments would be reportable. (Indeed, given the likely elapsed time between the reviewed year and the final determination date used for state purposes, a partner may have moved several times.) Nor would it be likely that the partners would report the push-out tax amount at the state level in the same year as the federal push-out, since there would be lag time between the two.

Also, each intervening year, the partnership apportionment factors applicable may change, which would affect the tax paid in non-residency states (and the credits due in residency states). In addition, nonresidents may have filed, originally, as part of a composite return and, presumably, the composite return approach would also simplify reporting of adjustments (an approach already used in the model). Also, the model attempts to achieve simplification by providing for a simplified federal adjustment report (which could be a streamlined return, without the need for a fully completed amended state return). Given all this, it may not simplify things much more to try to come up with a viable push-out approach.

Unless it can be shown that these kinds of state-level complications can be overcome and greater simplification achieved, it appears this may not be an effective alternative.

3. Partnership-Pays Election

Under the new federal rules, there are two things that may trigger an imputed underpayment (partnership-level liability for tax)—a federal partnership audit or an administrative adjustment request (AAR). If a partnerships discovers that it misreported items that would result in additional tax due, if corrected, the partnership may file an AAR to correct those items. It must then pay the amount of the imputed underpayment or push it out using a process similar to the process used for pushing out audit adjustments. So, reviewed-year partners will report the effects of their share of the adjustment on their adjustment year returns. Section C's partnership-pays election applies both to federal partnership audit adjustments and adjustments made by the partnership, filing an AAR.

The partnership-pays election, Section C (3), provides as follows:

> (3) Election – Partnership Pays. If an Audited Partnership makes an election under this subsection, it shall:
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> > (a) No later than 90 days after the Final Determination Date, file a completed Federal Adjustment Report, including partner level information, and notify the [State Agency] that it is making the election under this subsection;
> >
> > (b) No later than 180 days after the Final Determination Date, pay an amount, determined as follows, in lieu of taxes owed by its Direct Partners:
> >
> > (i) Exclude from Final Federal Adjustments and any positive Reallocation Adjustments the distributive share of these adjustments made to an Exempt Partner that is not Unrelated Business Taxable Income:
> >
> > (ii) Exclude from Final Federal Adjustments and any positive Reallocation Adjustments the distributive share of these adjustments made to a Partner that has previously filed a valid Federal Adjustment Report under Section B reporting such distributive share and paid any additional [State] tax liability due;
> >
> > (iii) Allocate and apportion at the Partnership level using [reference to existing multi-state business activity allocation/apportion law or regulation], all remaining Final Federal Adjustments and positive Reallocation Adjustments to [State];
> >
> > (iv) Determine the total distributive share of the allocated and apportioned Final Federal Adjustments and positive Reallocation Adjustments determined in subparagraph (iii) that are allocated to Corporate Partners or Exempt Partners subject to tax under [reference to State Law], the total distributive share allocated to Partners subject to tax under [reference to State Law applying to

individuals and/or trusts] and the total distributive share allocated to any remaining Partners, including Pass-Through Entities;

(v) For the total distributive shares of net Final Federal Adjustments plus positive Reallocation Adjustments allocated to Corporate Partners or Exempt Partners subject to tax under [reference to State Law] as determined in subparagraph (iv), multiply the total by the highest tax rate under [reference to State Law];

(vi) For the total distributive shares of net Final Federal Adjustments plus positive Reallocation Adjustments allocated to Partners subject to tax under [reference to State Law applying to individuals and /or trusts] plus the total distributive shares allocated to any remaining Partners, including Pass-Through Entities, as determined in subparagraph (iv), multiply the total by the highest tax rate under [reference to State Law applying to individuals and/or trusts];

(vii) Add to the amount determined in subparagraph (v) to the amount determined in subparagraph (vi).

This partnership-pays approach differs fundamentally from the hybrid approach normally used to tax partnership income earned by individual partners. Under that hybrid approach, the taxpayer reports 100% of the income to his home state and the share of the income earned, on a source-basis, to other states, taking a credit for taxes paid to those source states against the tax owed in the partner's home state. States may use partnership-factor-apportionment to source income when taxed to the partners. The partnership-pays approach would likely use this same partnership-factor-apportionment approach to source income. And this approach would apply the highest marginal rate to the income sourced in this manner in each state. But the difference is that, unlike the hybrid approach, the partners' home states will not be able to tax any income not taxed by source states (or taxed at lower marginal rates than the partners' home states).

So, *all things being equal*, there would be no difference between the tax paid using a hybrid approach and a partnership-pays approach using a pure source-basis. But, when a state to which the partnership would source income imposes no tax (or less tax than the residency states), then the total amount paid to partners' home states would be reduced. Note that having a partner *living* in a low or no-tax state where the partnership would not allocate or apportion income does *not* create this difference between hybrid and source approaches. It should also be noted here that not all partnership income can be constitutionally apportioned. If the income is not part of the partnerships "unitary business" to which the apportionment factors are related, then if it is to be sourced at the partnership level, it would have to be allocated under most states rules based on the partnership's domicile or other location information—or potentially, apportioned using separate partnership factors.

Obviously, there may be extreme circumstances where using "pure factor sourcing" (or partnership-level allocation) versus the hybrid approach will significantly change the tax that would otherwise be due in the partners' states of residence. For example, if a partnership does business in state A, and all its partners are in state B, then if state A imposes no tax, but state B does, using a pure partnership-level apportionment approach would result in a 100% reduction in tax in state B.

A number of states, however, do not source significant types of income using partnership allocation and apportionment factors, but instead treat that income as reportable only to a partner's state of residency (residency sourcing). This is most often the case with types of passive investment income. Where that is the case, a partnership-pays approach using residency sourcing will accurately reflect the tax that could be imposed by the home state, regardless of the rates imposed by other states where the partnership might operate. In other words, if the partnership determines the residency of each partner and their shares of partnership items and uses this information to apportion a partnership-level adjustment in those items, then the share of the income subject to tax in the home states would not be effectively reduced. So for states that use residency sourcing, any partnership-pays election should allow for the use of that same approach.

In cases where residency sourcing cannot be relied on, it has nevertheless been suggested that the extreme circumstance noted above are unlikely to come up because, in part, is not possible to engineer an otherwise artificial structure to create this type of circumstance, or that it would not be worthwhile to do so (knowing that it will only be effective for audit adjustments). One reason this may be true is that "look-through" treatment is generally given to partnership income—meaning that it is the apportionment factors of the partnership that earned the income that will be applied to that income, regardless of how many other tiers the income may pass through before being taxed. If look-through treatment is followed, then passing the income through multiple tiers, without more, will not result in changing the original character or the allocation and apportionment information related to that income. It may, however, obscure this information.

But as noted, the partnership-pays election is not limited to federal audits but would apply to AARs filed by the partnership at the federal level. Therefore, it would be more advantageous to engineer a result allowing reduction of state taxes if, by filing the AAR, the partnership is allowed to make a state-level partnership-pays election. (In that case, the effectiveness of any structure or planning implemented would obviously not depend upon the partnership eventually being audited at the federal level.)

At this point, staff recommends that the partnership-pays election be modified as follows:

- To provide that if the state would apply residency sourcing to the income at issue, then that same approach be used to source the adjustment of that income to compute the partnership's state liability under the election.
- To provide that the election is not available in the case of AARs.

In addition, there may be other safeguards that states could impose, or existing safeguards that they want to strengthen, to help avoid any potential abuse of the partnership-pays election. The group may also want to study this issue futher.