MULTISTATE TAX COMMISSION

To: MTC Partnership Work Group and Uniformity Committee

From: MTC Staff

Subject: Staff Report – Proposed Changes to Partnership Pays Election

Date: June 15, 2018

DRAFT – FOR DISCUSSION PURPOSES ONLY

STATUS

As part of the proposed model for reporting federal adjustments, the partnership work group is considering a proposal that would allow state tax on federal adjustments resulting from partnership audits to be reported and paid at the entity level, rather than requiring all the partners to file amended state returns. But the work group has identified a potentially significant problem with this partnership-pays election when it is applied in the context of a multi-tiered partnership structure. After discussing this concern, the uniformity committee has asked the work group to continue looking for solutions. The work group agreed to allow a smaller group to brainstorm the issue, and as a result of that process, the Interested Parties have now put forward suggested changes to the partnership-pays election. This report provides a description of the problem, summarizes the suggested changes, notes some questions, and provides two simple examples.

BACKGROUND - PARTNERSHIP PAYS ELECTION

The goal of the partnership pays election is to simplify the reporting of state taxes on federal partnership audit adjustments. At the same time, the intent is that the proportion of the adjustments reported to each state in which the election is made would be approximately the same as if those adjustments were reported by the tax-paying partners. For this reason, the partnership-pays election references the existing state sourcing rules. Those rules depend on the status of the tax-paying partner—resident individual, nonresident individual, corporation, etc. They also may depend on the nature of the income—investment or non-investment (and, for corporations, business or nonbusiness). But an electing partnership may have partners that are pass-thru entities, or "tiered partners," and in that case, may not have information on the ultimate tax-paying partners.

PARTNERSHIP-PAYS ELECTION SOURCING RULES

Under the most recent draft of the proposed model, an audited partnership (or a direct or indirect tiered partner of that audited partnership) that doesn't wish to follow the default rule of amending the reviewed year state tax returns can elect to pay the tax on final federal adjustments at the entity level. The electing partnership would source the adjustments to the state in which the election is made based on the following categories, the most important for our purposes being tiered partners, below:

- *Direct* corporate partners
    - The distributive share of adjustments required to be included in unitary business income of a corporate partner are generally excluded from the partnership pays election See Sec. C(3)(c).
    - The distributive share of other adjustments made to a corporate partner are sourced based on applicable state rules for allocation and apportionment of income generally. See Sec. C(3)(b)(iii)(which includes a reference to "existing multistate business activity allocation/apportionment law or regulation").
- *Direct* resident partners
    - The distributive share of adjustments to direct resident partners are sourced 100% to the state. See Sec. C(3)(b)(v).
    - The direct resident partners are also entitled to a credit for taxes paid by the partnership to other states on their share of adjustments. See Sec. C(6)(b).
- *Direct* nonresident partners
    - The distributive share of adjustments made to direct nonresident partners are sourced based on the state's general allocation and apportionment rules. See Sec. C(3)(b)(iv)(referring to "existing non-resident partner sourcing law or regulation").
- *Tiered* partners (and therefore, all *indirect* partners)
    - The distributive share of adjustments made to tiered partners, and therefore to all indirect partners, are sourced as if the adjustment was to a nonresident partner. Sec. C(3)(b)(iv)(again, referring to "existing non-resident partner sourcing law or regulation").

EXISTING STATE SOURCING RULES FOR PARTNERSHIP INCOME

Existing state sourcing rules may differ somewhat. When they do, the model, as drafted, would track those differences. So, for example, if a state imposes a single factor apportionment formula, that difference would also be picked up as part of the partnership-pays election. But for purposes of this analysis, we make the following assumptions about general state sourcing rules for the following categories of tax-paying partners and types of partnership income:

- Corporations
  - If the partnership income is part of the corporate partner's unitary business, or if it would otherwise be considered business income, the corporate partner would source the income by: (1) including its distributive share of that income in its apportionable base income, and (2) "rolling up" a representative portion of the partnership's factors into its apportionment formula.
  - If the partnership income is non-business income, the corporate partner would source the income to a particular location (that is, "allocate" it, using a number of rules for that purpose) rather than apportioning it.
- Resident Individuals
  - The partnership income is sourced 100% to the state and the individual is given a credit for tax that may be paid to another state on a portion of that same income. However, the state of residence may require that credit be given only where the other state has consistent rules for sourcing income of nonresidents.
- Nonresident Individuals
  - "Non-investment" income – is typically sourced using the general state allocation and apportionment rules applied at the partnership level.
  - "Investment" income – no portion is sourced to the state for nonresidents (even if the partnership is doing business in the state) because, instead of applying state allocation and apportionment rules to the income, the state attributes it entirely to the location of the individual partner's residency.

It appears the reason states attribute investment income entirely to the state of an individual's residence is because it is otherwise extremely difficult to allocate or apportion such income accurately.

PROBLEM – SOURCING WHERE THERE ARE TIERED PARTNERS

Assuming the general rules above characterize an existing state's rules and if the partnership-pays election applies the rules for sourcing income of nonresidents to all tiered partners, then when the adjustment involves investment-type income, arguably, no part of the tiered partner's distributive share would be sourced to the state, This would be true even if all of the tiered partner's own partners are residents (or corporations doing business) in the state. Nor is this problem likely to be minor. We expect that a substantial amount of the adjustments that are likely to result from the federal audits of large, complicated partnerships will fall into this category of investment income.

POSSIBLE SOLUTIONS

The partnership work group and the uniformity committee have discussed ways of solving the problem. One would be for states to alter the existing sourcing rules for investment-type income, or at least do so in the context of the partnership-pays election—using the partnership's entity level allocation and apportionment information—rather than sourcing the income based solely on residency of the individual partner. As noted, however, this is inherently difficult. Assume that the income of the audited partnership is dividends from stock and interest repaid on loans in several start-up companies that are engaged in their own businesses. Should that partnership income be sourced to where those start-ups are operating? To where they have their domicile? To where the partnership's investments are managed? To the partnership's domicile? Another way to solve the problem would be for states to require that electing partnerships obtain information necessary to determine, or at least estimate, the residency or other status of the partners of their tiered partner. But this may also be difficult in many circumstances.

SECONDARY PROBLEM – ELECTION BY NON-NEXUS PARTNERSHIPS

In addition, a concern has also been raised about partnerships that might not have sufficient presence in a state to be subject to the state's jurisdiction even though they might have resident partners in that state. It should be noted that this issue of jurisdiction is an open question. But assuming that a state would lack jurisdiction over a partnership that had resident partners (presumably passive, minority interest holders), the question is whether the state should allow that partnership to make a partnership-pays election.

SUGGESTED CHANGES

The following section summarizes the suggested changes to the problem of sourcing for tiered partners under the partnership-pays election and for addressing the secondary problem of limiting the election by non-nexus partnerships.

OTHER RELEVANT BACKGROUND

In reviewing the suggested changes, is useful to remember that:

- Prior to the final determination of adjustments on which any partnership-pays amount might be computed, direct or indirect partners in the audited partnership may have filed amended federal returns and therefore would be required to file amended state returns. So the portion of adjustments reported in this way are excluded from the partnership-pays amount.

- If the partnership-pays election is not made, the default rule is that the partnership and its direct partners must file amended state returns for the reviewed year and pay any tax owed.
- If the audited partnership does not make the partnership-pays election and instead files amended state returns, any of its tiered partners may make the partnership-pays election themselves. If not, they and all of their direct partners would have to file amended state returns.
- In determining the partnership-pays amount, reallocation adjustments will not be netted. Instead, consistent with the federal treatment, the partnership-pays amount will include the under-reported (or under-allocated) amounts and the offsetting over-reported (or over-allocated) amounts will flow through the partnership's returns and K-1s to the appropriate partners in the adjustment year. (So these partners will receive the related tax benefit of those amounts under this flow-through approach.)

SUMMARY OF SUGGESTED CHANGES

The suggested changes to the partnership-pays election, as submitted, are available on the partnership work group page on the MTC website, along with the latest draft of the entire model (without the changes). The summary below sets out the critical parts of the partnership-pays election incorporating the suggested changes along with certain other relevant provisions of the latest draft. Also note, for simplicity:

- non-critical language is either omitted or *summarized in italics* and with *;
- certain terms are bolded for emphasis; and
- comments are highlighted in yellow, after the provision to which the pertain.

Section C. (3)(b) **Pay the total of the amounts under subparagraphs(b)(iii), (iv), (vi) and (vii)** . . .

(iii) . . . **for adjustments** allocated to **Direct Corporate Partners** . . . apportion and allocate such adjustments as provided under [reference to existing multi-state business activity allocation/apportion law or regulation], **times highest applicable rate** . . . ;

(iv) . . . **for adjustments** allocated to **Non-Resident Direct Partners** subject to tax [*as individuals*] . . . determine the amount of such adjustments which is [State] source income under [reference to existing non-resident partner sourcing law or regulation], **times highest applicable rate** . . . ;

(v) . . . **for adjustments** allocated to **Tiered Partners**:

(A) Determine the amount . . . which is [State] source income under [reference to existing non-resident partner sourcing law or regulation]; This appears meant as a reference to the portion of adjustments that would be considered non-investment income and would be sourced, under existing rules, using partnership allocation/apportionment information. See questions below.

(B) Determine the amount . . . which is [State] source income under [reference to existing sourcing law or regulation for income fully sourced based on a taxpayer's residency]; This is meant as a reference to the portion of adjustments that would be considered investment income and would be sourced, under existing rules, based on the residency of individual partners. See questions below.

(C) Determine the amount . . . which is [State] source income under [reference to existing sourcing law or regulation for income fully sourced based on a taxpayer's residency] that can be established, under regulation issued by [State Agency] to be properly allocable to **non-resident indirect partners**. . . .

(vi) Multiply **amounts from** Subparagraphs(A) and (B) reduced by the amount . . . in . . . (C) by the highest tax rate . . . ; See questions below.

(vii) For **remaining adjustments** allocated to **Resident Direct Partners** subject to tax under [reference to State law applying to individuals and /or trusts], multiply that amount by the highest tax rate . . . ;

. . .

(c) Final Federal Adjustments subject to this election exclude:

(i) *"*Adjustments** that must be included in the unitary business income of any **Direct or Indirect Corporate Partner** . . . ;

(ii) Any Final Federal Adjustments resulting from an Administrative Adjustment Request; . . .

(4) **Tiered Partners**. Each **Tiered Partner and each Indirect Partner** of an Audited Partnership that reported Final Federal Adjustments pursuant to Subparagraph (a)(ii) of Subsection C(2) shall be subject to the applicable election, reporting and payment requirements for Audited Partnerships and their Direct Partners under this Section C . . ..

(5) Modified Reporting and Payment Method. Subject to the approval of the [State Agency], **alternative methods may be used**.

(6) Effect of Election by Audited Partnership or Tiered Partner and Payment of Amount Due.

. . .

(b) If properly reported and paid by the Audited Partnership or Tiered Partner, the amount determined in Paragraph (b) . . . or . . . Subsection C(5), will be treated as paid in lieu of taxes owed by its **Direct and Indirect Partners** . . . . The **Direct Partners or Indirect Partners** may not take any deduction or credit for this amount or claim a refund of the amount **in this State**. Nothing in this Subsection(C)(6) shall preclude **Resident Partners** from claiming a credit against taxes paid **to this State** pursuant to [reference to State law], any amounts paid by the Audited Partnership or Tiered Partners **on the Resident Partner's behalf to another state or local tax jurisdiction** . . .

QUESTIONS ABOUT SUGGESTED CHANGES

It appears that new Sec. C(b)(v), which sources the distributive share of adjustments made to tiered partners, is meant to do the following:

- In (A) – determine the amount of the distributive share of the adjustment that is in the nature of income that would, under existing state law, be sourced to nonresidents partners through existing state allocation/apportionment rules (that is, non-investment type income) and then apply those same rules to this share of the adjustment (using the electing partnership information, factors, etc.).
- In (B) – determine the amount of the distributive share of the adjustment that is in the nature of income that would, under existing state law, be sourced based on residency (that is, investment type income) and treat this amount as though it was distributed to resident partners—that is, source it 100% to the state.
- In (C) – provide the partnership with a means to work with the state to determine (or estimate) the distributive shares of (B) that went to nonresidents, if possible, and exclude the total from (B).

If this is the intent, the language in the rules may need reviewed carefully.

Second, assuming that the tiered partnership has resident partners, the suggested changes could still affect the tax owed somewhat. Under subparagraph (A), the portion that would be sourced using existing allocation/apportionment rules if the partner were a nonresident (that is, non-investment type income) will be allocated/apportioned even if some of the indirect partners are residents. So, whereas the distributive share of adjustments made to *direct* resident partners will be sourced 100% to the state (with a credit for tax paid), the distributive share that flows through a tiered partner to an *indirect* resident partner will be allocated/apportioned. Under this approach, the state may ultimately receive less tax from indirect resident partners since, under the credit-for-tax-paid, the tax in the state of residency is reduced only to the extent tax is actually paid (and not just because some portion of the adjustment might have been allocated or apportioned) to another state.

Given that the partnership-pays election is meant to simplify reporting of the tax owed on adjustments, however, the concern over this difference is not likely be as great. But it does appear that indirect resident partners should not be entitled to any credit for tax paid to another state following these same rules (since no other state would tax the same income on an unapportioned basis). Therefore, the allowable credit under in Sec. C(b)(6) would need to be limited to "direct" resident partners.

Finally, it is not clear exactly how corporations would be treated under the suggested changes as the examples below illustrate.

SIMPLE EXAMPLES – APPLYING SUGGESTED CHANGES

Assume:

- X is an audited partnership with a final federal audit adjustment of $4 million
- X has 25% of its apportionment factors in States 1, 2, 3, and 4
- X has two equal tiered partners, Y and Z
    - Y has two equal partners – Adams and Baker,
        - Adams is a resident of State 1
        - Baker is a resident of State 2
- Z has two partner equal partners Corp. and Davis
    - Corp. is a multistate business domiciled in State 3
    - Davis is a resident of State 3
- State 1 imposes no tax and States 2, 3, and 4 impose a 10% tax
- States 2, 3, and 4 have the same allocation/apportionment rules and source investment income solely based on residency

Example 1:

Assume that the $4 million is non-investment income (and is business income to Corp.). Had it been reported by the indirect partners, correctly, the following would have been the result.

- Adams – would have reported $250,000 to States 2, 3, and 4 (based on X's 25% apportionment factors), paying tax of $25,000 to each. He would owe no tax in State 1 (residence) because it imposes no tax.
    - State 2 gets $25,000
    - State 3 gets $25,000
    - State 4 gets $25,000
- Baker –would have reported $1 million to State 2 (residence), for a tax of $100,000 but would get a credit for $25,000 in tax paid to States 3 and 4.
    - State 2 gets $50,000
    - State 3 gets $25,000
    - State 4 gets $25,000

- Corp. – assume that when the factors of X are rolled up, Corp. has 20% of its factors in State 1, 20% in State 2, 40% in State 3, and 20% in State 4
  - State 2 gets $20,000
  - State 3 gets $40,000
  - State 4 gets $20,000
- Davis – would have reported $1 million to State 3 (residence) taking a credit for $25,000 in tax paid to States 2 and 4.
  - State 2 gets $25,000
  - State 3 gets $50,000
  - State 4 gets $25,000
- Totals:
  - State 2 = $120,000
  - State 3 = $140,000
  - State 4 = $120,000
  - Total = $355,000

Because it has only tiered partners, and because the income is non-investment income, if X makes the partnership-pays election in States 2, 3, or 4 it would source the $4 million adjustment to each state based on its apportionment factors:

- State 2 gets $100,000
- State 3 gets $100,000
- State 4 gets $100,000
- Total = $300,000

The amount here is $55,000 less because of two differences. First, the effect under the partnership-pays election is to apportion the share of the adjustment to Baker and Davis's states of residence rather than reporting 100% to those states with a reduced credit for taxes paid (because State 1 imposes no tax). Second, under the partnership-pays election, the share of the adjustment that would have been apportioned by Corp. using its combined factors is now apportioned using X's factors alone. (This also assumes that Corp.'s share would not be excluded from the partnership pays election.)

Example 2:

Assume that the $4 million is investment income (and is nonbusiness income to Corp.). Had it been reported by the indirect partners, correctly, the following would have been the result.

- Adams – would have reported $1 million to State 1 (his residence), for a tax of $0.
- Baker – would have reported $1 million to State 2 (her residence), for a tax of $100,000.

  - State 2 gets $100,000
- Corp. – assume that Corp. allocates the income to its domicile.
  - State 3 gets $100,000
- Davis – would have reported $1 million to State 3 (residence).
  - State 3 gets $100,000
- Totals:
  - State 1 - $100,000
  - State 2 - $100,000
  - State 3 - $200,000

Again, because it has only tiered partners, and because the income, now, is assumed to be investment income, if X makes the partnership-pays election in States 2, 3, or 4, determining the results will be more complicated.

Assume that X were to make the partnership-pays election in States 2, 3, or 4 without presenting any information on the amounts that would be attributed to nonresidents. In that case, the full $4 million would be sourced to States 1, 2, and 3, each. But assume instead, that X is able to present information about the residency of its indirect partners Adams, Baker, and Davis. In that situation, the distributive share of the adjustment to the nonresidents in each state would be subtracted from the full $4 million before the tax is applied. This leaves the question of how the distributive share to Corp. would be treated. Because the income here is assumed to be non-business income, it would not be excluded from the partnership-pays election. But unless the electing partnership is able to show where that income would otherwise be sourced (generally under rules for allocating non-business income) that amount would not be subtracted from the $4 million in any state.

SUGGESTED CHANGE – NON-NEXUS PARTNERSHIPS

The interested parties have also suggested two versions of option language that would limit the partnership-pays election to those partnerships over which the state has jurisdiction. Both would reference partnerships not subject to any reporting or payment obligation and one would allow the election, even in that case, under the discretion of the state.

RECOMMENDATIONS

Staff recommends that we continue to work on the suggest changes to the partnership-pays election to clarify the language, limit the credit for taxes paid to direct resident partners, and provide additional information for how corporate partners of tiered partnerships will be treated.