MULTISTATE TAX COMMISSION

TO:	Members of the Partnership Work Group and the MTC Uniformity Committee
FROM:	MTC Staff
SUBJECT:	Partnership Work Group Staff Report
DATE:	May 18, 2017

NOTE: THIS REPORT WAS PREPARED BY MTC STAFF FOR REVIEW AND DISCUSSION ONLY.

This report is to follow up on a recommendation in the April 5, 2017 staff report. (See that report here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/Analysis-of-Partnership-Issues-Recommendation-4-5-17.pdf.aspx.)

The April 5th report made a recommendation that the work group not address partnership income apportionment issues, at least initially. But the prospect of partnership level assessment, even in the limited context of certain IRS audits, is likely to create issues that the group may need to consider. The following is a partial list of these issues:

Inability to Roll-Up Factors, Offset Partnership Results, or Combine Entities When Apportioning Partnership Income -- Corporate and Individual Partner Issues

There are a number of different issues in this area. Suffice it to say, state rules for dividing the income of partnerships are based on pass-through treatment and if entity-level assessment is required instead, this potentially creates a number of issues. The issues will vary depending on whether the partners are corporations or individuals (and trusts and estates).

A simple (extreme) example illustrates a key issue for assessing taxes at the partnership level that would otherwise be paid by corporate partners: X, a corporation, is a controlling-interest partner in Partnership, which has numerous minority partners. X does all of its business in State A, but Partnership does all its business in State B. If State A is like most states, it may require that the income and factors of Partnership be "rolled-up" and included on X's return in proportion to X's share. But assume Partnership is audited by the IRS. If Partnership elects to pay the audit adjustment at the entity level, there would presumably be no way to effectively combine X's own income and factors with its share of Partnership's adjustment (and factors) to apportion the adjustment for State A's purposes. If apportioned at the partnership level, State A would receive no amount of adjustment.

Another simple example illustrates how partnership-level assessment can affect state taxes that would otherwise be paid by individual owners. Assume that State A has an income tax and State B does not. X, Y, and Z all reside in State A and are partners in XYZ1 and XYZ2. XYZ1 does business in State A and XYZ2 does business in State B. Now assume XYZ1 pays XYZ2 an intercompany charge with the purpose of reducing XYZ1's taxable income to zero.

State tax professionals will, no doubt, recognize this scenario as a possible form of tax planning arrangement. Under the pass-through system, however, the effect of this particular scenario is mitigated. The income of both entities would simply be allocated to the partners and reported by them, 100%, to their state of residence. If the partners paid tax to another state, they would be entitled to take a credit for tax paid. But since XYZ2, the profitable entity, earns its income in a state without an income tax, the partners would not pay tax or receive any credit.

Assume XYZ2 is audited by the IRS and elects to pay tax on any adjustment at the partnership level. Again, most states existing rules would not allow or require XYZ1 and XYZ2 to be combined when apportioning their income. (And this is a scenario where rolling up the income and factors to the partners would not work.) Note that this same issue could well arise even when there is no overt tax-planning strategy in place. It is simply the difference between the pass-through tax treatment and entity-level taxation under the current rules.

This same sort of issue also has the potential to negatively affect individual partners' taxes—but the partners themselves may be able to mitigate those effects. Assume partner X owns two partnerships – 1 and 2. Partnership 1 reports a small amount of income while Partnership 2 reports a substantial loss. Under the pass-through system, X can offset these results on X's own tax return. If Partnership 1 is audited by the IRS and is determined to owe additional tax, and if the partnership were to pay the liability at the entity level, X might lose the ability to further offset that income (although the loss might be available to offset future income). But presumably X could simply elect to file an amended return during the so-called 270-day modification period and use the loss to offset the audit adjustment.

It is tempting to say that some kind of combined filing is the solution in this case, when the partnership pays the audit adjustment at the entity level. But state combined filing is predicated on the unitary business principle. Partners, however, are not prevented from offsetting losses against income or gains because the partnerships giving rise to those items are not unitary.

Multi-Tiered Partnership Issues

Multi-tiered partnerships also raise a number of apportionment issues. A very simple example illustrates one of these issues. Assume A and B own Partnership 1, which is a partner (along with others) in Partnership 2, which is a partner (along with others) in Partnership 3. Also assume that this structure is designed to allow special allocations to certain lower-tier partners but that the three partnerships are otherwise engaged in the same business. If the IRS audits Partnership 3 and makes a re-allocation adjustment, it would presumably affect Partnerships 1 and 2, and partners A and B. But if Partnership 3 pays the tax on the adjustment at the partnership level, the apportionment factors of Partnerships 1 and 2 will not have any application in determining the state portion of that adjustment.

Mismatch of Traditional Apportionment Formula and Investment Partnerships

As alluded to in the April 5th report, the general UDITPA formula may not fit investment partnerships. (And as the report points out, a significant portion of the large, complex partnerships subject to the new audit rules will likely be investment partnerships.) The following is just a sampling of the issues that may arise in attempting to use the standard apportionment formula as applied to investment partnerships:

- Partners who participate in the partnership business may do so only sporadically and, in any case, will not be treated as employees receiving compensation, so calculating the payroll factor may be difficult.
- The assets of investment partnerships will be intangible property and under the standard formula, such assets are not included in the property factor—and if they are included—there would be sourcing questions.
- The receipts of investment partnerships will be from dividends, interest, gains, etc. which are difficult to source. (The MTC currently has a work group addressing how such receipts might be sourced in special circumstances where they will need to be included in the receipts factor.)

Whether Residency of Partners is Better Method of Apportionment in Some Cases

When assessing certain investment partnerships at the entity level, it may be preferable to apportion partnership income not based on the "source" of the income (that is, based on factors) but based on the residency of the partners. Assume, for example, that an investment partnership is managed by a third-party investment manager and all of the owners of the partnership are limited/passive investors. Rather than attempting to allocate or apportion the income of that partnership based on the location of the manager (or the location of the intangible investments), it might be preferable to apportion the income to where the partner/investors are domiciled (pro-rata by ownership share). This would more closely track the treatment in some states under the existing pass-through system, which sources such passive income to the state of domicile of the partner. There are questions, however, about whether the partnership itself can be made liable for entity-level tax where the only connection to the state is that a limited partner is resident there.

Apportionment Issues with Respect to Special Allocations

Partnerships have the ability to make special allocation of particular partnership items and those allocations will be respected for tax purposes if they have substantial economic effect. Often, the reason for the special allocation is that it is a separate item of income or gain which the partners have agreed should be allocated in a particular manner. If an IRS audit makes an adjustment to a specially allocated item, apportionment of the adjustment, as necessary for determining the state tax liability, might be made using specific factors related to that particular item, rather than the partnership's factors generally.

For example, assume that a real estate partnership has numerous partners and rental properties generating income in multiple states. Assume it also has gain from the sale of a particular property in one state, which it specially allocates to a small number of particular partners. Upon audit, the IRS determines the gain was under-reported and the partnership pays the liability rather than pushing it out to the affected partners. Rather than apportioning the gain using the partnership's factors generally, it might arguably be preferable to use factors related to the real property sold, given that it is allocated separately from other partnership income.