MULTISTATE TAX COMMISSION

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

FROM: MTC Staff

SUBJECT: Staff Report

DATE: October 25, 2017

[WITH MINOR CORRECTIONS – AS OF NOVEMBER 7, 2017]

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

Commission staff and partnership work group participants are reviewing the most recent version of the proposed draft model received from the Interested Parties—paying special attention to the partnership provisions, including Section C. This report sets out three categories of issues identified thus far: General or Structural Issues, Important Substantive Issues, and Other Issues (including stylistic issues). In addition, the final section of this report includes Additional Issues to Consider.

This report has three attachments —

- The most recently submitted version of the model ("the model") – Attachment A
- The model showing changes from our review ("changes") – Attachment B
- The model as it would read if the changes were made ("changed version") – Attachment C

Our review is comprehensive in that it reflects changes ranging from major to minor, but it *is not exhaustive*. The purpose of this report is to summarize the most critical issues that have been raised and provide a basis for further discussion.

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GENERAL OR STRUCTURAL ISSUES

The most common concern expressed about the model is that it is too complex. In large part, the complexity appears to stem from three sources:

- Inclusion in the model of substantive tax or other related procedural rules that already exist in state law, rather than simply referencing those existing provisions. In some cases, this was likely done to make the model more understandable. States will, however, need to be careful to compare any provisions that overlap existing substantive tax or other procedural rules even if they agree with the provisions in the model, since any potential conflicts will cause problems.

- Duplication of or overlap in the model's provisions. This also can create conflicts or unintended consequences where duplicated or overlapping provisions within the draft are slightly different, and in any case, it makes the draft longer and harder to understand.

- An attempt to do by statute what may only be possible to do by regulation or instruction. There are places in the model where the rule set out is more detailed but not detailed enough to cover every scenario or flexible enough to adapt to changing circumstances. This can create questions for administrators as to whether and how they can address the scenarios that are not covered or changing circumstances (more likely in this area than in others). In these places, it would be better omit certain details.

In part for these reasons, Section C of the model was rewritten completely, as shown in the changes (Attachment B). (Other, substantive changes to that Section are discussed below.) Some provisions of the model's Section C were purposefully omitted. If there is no compelling reason to include them, whether because existing state law suffices or because regulations could address the issues, then this will simplify the model considerably. If, based on further review and discussion, some of the omitted provisions are determined to be necessary, then they can be re-included in some form.

There are a number of examples of these kinds of issues, but a few will serve to illustrate the point. The model requires all partnerships to make one of three elections in subsection C(3). The details of the elections are then repeated in other subsections. Also, in paragraphs C(3)(b) and (c), the model discusses what to do if the partnership fails to make an election or is dissolved or insolvent. The need for C(3)(b)—what to do if the partnership fails to make an election—can be eliminated by making the deemed election of that provision the default rule—so that it applies unless the partnership makes some other election. But it is harder to see the benefit of including subsection (c) or to have the partnership be deemed to make an election if it is found to be dissolved or insolvent (which are two different scenarios) at the time it must act. Instead, the state agency should simply retain all authority to assess the partners for taxes determined to be due, and take other necessary actions.

The other common concern expressed was the complexity of the timelines, especially for tiered partners. The timelines include:

- 180 days from FDD (final determination date) for filing an FAR (federal adjustments report) in Section B (non-partnership related)
- 60 days from FDD for filing an FAR in Section C(2) and making an election by partnership subject to a partnership audit
- 90 days from FDD for filing amended state schedule K-1s
- 180 days from FDD for complying with the requirements of 1 of three elections by partnership subject to partnership audit
- 150 days from FDD or 60 days from time amended state schedule K-1 was mailed for tiered partners to file FDD and make elections
    - o But "a Tiered Partner shall be ineligible . . . and must pay the state imputed underpayment . . . if the tiered partner received its amended state schedule K-1 on or after the extended due date of the audited Partnership's federal tax return for the year that includes the Final Determination Date." (Subparagraph C(7)(b)(ii))
    - o And "in the event the Tiered Partner makes an election or is deemed to have made an election pursuant to subsection C(3)(a)(i), the Tiered Partner shall file . . . and pay . . . within 90 days from the date the amended State Schedule K-1 was mailed to the Tiered Partner."
    - o See other exceptions or special rules set out in Subsection C(7)—including provisions for when the taxable partners of tiered partnerships must file – which is 90 days after the receipt of an amended state schedule K-1.
- 1 year from the date the Federal Adjustment Report was filed or was due for the tax agency to assess the partners if the partnership fails to file or pay as required.

NOTE: This last period, in particular, is more than just confusing—it is unreasonable. Given how the deadlines work, the state would have very little time between when it knows that the partnership has not complied (180 days after the FDD) and before it has to assess – 455 days (90 days plus 365 days) after the FDD – or about nine months.

And regardless of the timelines, tiered partners may request a 60-day extension which must be granted unless the state has grounds (alleged tax evasion or insolvency).

The changes would simplify these deadlines and fix other issues. It should be noted that these same entities and partners, despite the complexity of their structures and reporting information, must file *original* returns and pay tax each year within certain definitive time constraints (with possible extensions)—and they must do so despite the fact that they both receive (from lower tiers) and must provide (to upper tiers) information which is essential to tax reporting for the tax year at issue. Also, the model itself, by imposing a hard deadline on all tiered partnerships ("no later than the extended due date of the audited Partnership's federal tax return for the year that includes the Final Determination Date"), recognizes that there can be a hard deadline that all tiers must comply with.

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IMPORTANT SUBSTANTIVE ISSUES

We recognize two guiding principles in reviewing the major substantive issues embodied in the draft. First, we have reviewed the model to determine if it might have the unintended consequence of creating a system that allows state tax liabilities to be significantly reduced or avoided, even assuming partnerships and partners otherwise comply. If the tax due under the model is significantly less than would have been owed, had the amounts been reported correctly, this will tend to encourage, rather than discourage, underreporting—especially if the unintended "loophole" is something that can easily be exploited.

We have also reviewed it for workability. States will need new systems and forms, as well as regulations and instructions, for implementing the partnership changes in particular. Therefore, the states will need a model that is as clear and simple as possible and can be evaluated for exactly how it will work so that these administrative tasks can be carried out efficiently.

The important substantive issues noted in this section may represent intended or unintended elements of the model and will therefore require further discussion. But, given the importance of these issues, the comments received, and the past discussions in the work group, the changes in Attachment B and the changed version in Attachment C reflect the recommended approach to these issues.

AMENDED FEDERAL RETURNS FILED DURING A MODIFICATION PERIOD

The model does not specifically address how states will handle amended federal returns filed during a partnership's modification period—which may lead to modification of the final federal adjustments. Those amended federal returns would likely trigger a requirement to file under existing law and it would appear that there is no reason for the partners not to file amended state returns at that time as well. But the treatment of such amended returns under the model is ambiguous. Section B appears to require that all adjustments arising from a federal partnership audit be handled under Section C; however, Section C does not address the filing of amended federal returns in the modification period specifically. To resolve this, the changes specify that amended returns filed in the modification period are treated as any other amended return and presumably the partners will need to include information on the federal adjustments as part of their reporting to the state, along with a copy of the amended federal return.

ADMINISTRATIVE ADJUSTMENT REQUESTS

The model appears to intend that administrative adjustment requests by partnerships be treated the same as adjustments arising from partnership audits. The one exception is that the final determination date is the same as for amended federal returns or refund claims, the date the administrative adjustment request is filed. (See further discussion of the definition of Final Determination Date below.)

But although the model appears to intend to treat administrative adjustment requests in the same way as partnership audits, this is not clear in various places in Section C. Therefore, changes were made throughout to clarify.

REFUNDS

The model in some places referred to refunds "due" which may not be proper to the extent that a refund must be reviewed and approved before it is granted, and therefore "due." But, in any case, the provisions of the model would appear to apply to a situation involving overpaid tax as well as underpaid tax—and would use the same approach to calculating the tax. This appears to be a reasonable approach and we attempt to take the same approach with the changes noted below.

SUBSEQUENT AFFECTED YEARS

An IRS adjustment in a reviewed year may well have implications for subsequent years. In some cases, those effects may be greater than in the reviewed year. For example, assume in 2020 the IRS audits a taxpayer for the year 2017 and makes changes reducing the taxpayer's substantial NOL in that year to zero. Assume that adjustment is final in 2022. The taxpayer will presumably have used the NOL to offset income in the years 2018-2020, at least, and perhaps through 2022. The states should be able to require reporting and payment of related state taxes for those years as well.

Not only is this circumstance not anticipated by the proposed draft, the use of the term "Reviewed Year" in some contexts indicates that there would be no requirement for making state-level changes to subsequent affected years. The attached changes attempt to address this.

NEED TO ADDRESS S CORPORATIONS AND TRUSTS (OTHER PASS-THROUGHS)

The model needs clarification as to how S corporations and certain trusts will be treated when it comes to a partnership audit or an administrative adjustment request where they are tiered partnerships. We believe that the intention of the model is to allow these other pass-throughs to be subject to the same rules and have the same elections as partnerships, but it is not clear whether this is the case, or even if that is entirely workable. In any case, the changes attempt to address this, mainly through revised definitions.

ELECTIONS – GENERALLY

As noted in the prior section on General and Structural Issues, the elections in Section C can be simplified by consolidating different sections that refer to those elections and making any "deemed" election the default rule.

But the changes in Section C also reflect more substantive changes. Rather than the three elections proposed in the model, the rewritten Section C would essentially require partnerships, tiered partners, and taxable partners to amend all related returns and pay taxes owed under the substantive tax provisions of existing state law. Composite and withholding rules in place would also apply. But partnerships and tiered partners would be able to elect to pay an amount in lieu of doing all this. In addition, the rewritten Section C would allow the tax agency, by regulation, to provide for partnerships and tiered partners to apply to use some combination of both methods.

In addition to simplifying Section C in this way, the changes also affect how subsection C(8) would apply and issues with that subsection, discussed further below.

SUBSECTION C(8)

Subsection C(8) is critical in that it determines the amount of tax or refunds due. In general, it appears that the calculation of the tax would follow the majority rule for the general calculation of tax under existing state law, with two exceptions. The first is the absolute rule of apportionment at the partnership level. The second is netting of adjustments prior to allocation and apportionment. Each is discussed below.

APPORTIONMENT AT THE PARTNERSHIP LEVEL

Strict apportionment at the partnership level might lead to distortion—where a partnership tier is interposed for the purpose of stripping factors. Current state law may or may not address such situations, but in states that do have rules for when factors flow up to a higher tier, those rules should not be supplanted—especially where those rules would have applied, and would presumably have been followed, in the reviewed year on original returns. Even where the partnership elects to pay a state imputed underpayment, such rules might need to be applied to prevent distortion. Therefore, we recommend simply referring to the state's existing rules.

NETTING OF ADJUSTMENTS

Paragraphs C(8)(i) and (ii) provide that all adjustments are first netted, and then allocated or apportioned at the partnership level. However, this may not be possible constitutionally. Assume that one adjustment is to an item of business income and another adjustment is to an item of nonbusiness income. Those items cannot be allocated and apportioned on a net basis. And states may also provide for allocation of certain items that are not constitutionally required to be allocated. Again, if these items are first netted with apportionable items, it will not be possible to allocate or apportion them according to the state's rules.

Moreover, there does not seem to be any real simplification accomplished by netting the adjustments since paragraph C(8)(iii) requires determining each partners "share of the adjustments" (plural) in accordance with the partnership agreement, which may very well allocate different items to the partners in different ways—and would therefore require disaggregating the items previously netted in order to allocate them. Therefore, we would recommend that the adjustments be allocated and apportioned separately, rather than netting them.

However, netting *is* necessary to determine whether the net effect will be positive or negative—that is—resulting in underpaid or overpaid tax. But that is a somewhat different issue and can be handled differently.

In addition, netting of all adjustments would include netting of reallocation adjustments which causes a different issue, covered in the following section.

REALLOCATION ADJUSTMENTS

Perhaps the biggest concern with the model is the treatment of reallocation adjustments which are not only excluded from the computation of the state imputed underpayment (see the definition of that term in the model) and amounts to be paid/withheld for partners, but also from the determination of the tax owed.

Here is a simplified example, for the purpose of illustration:

- Partnership P has two partners - A and B.
- A and B are residents in State X – with a 10% tax.
- P allocates all partnership items to A and B equally, except that it allocates all capital gains to B so that B can take advantage of $2 million in capital losses.
- IRS audits P's 2018 tax year and determines that gains were improperly allocated 100% to B (because the allocation lacked substantial economic effect) and reallocates the gains 50/50.
- Assume the applicable federal rate is 15%.

<u>Federal</u>

The amount of federal tax that should have been paid by A and B is calculated as follows:

A's taxable gains (determined by IRS audit)	$1 million
A's reported gains	$0
A's under-reported taxable gains	$1 million
A's tax due	$150,000
B's taxable gains (determined by IRS audit)	$1 million
B's reported gains	($2 million)
B's over-reported gains	$1 million
B's capital losses	($2 million)
B's under-reported taxable gains	$0
B's tax due	$0

The amount of the federal imputed underpayment owed by P as a result of the audit will be computed as follows:

Under-allocated capital gains to A	$1 million
	X 15%
Imputed underpayment	$150,000

State

The amount of state tax that should have been paid by A and B is calculated the same as the federal tax that should have been paid, except with the substitution of a 10% rate for both A and B.

A's tax due	$100,000
B's tax due	$0

Because the amount of tax owed under the model's requirement for netting all adjustments in subsection C(8), and the exclusion of reallocation adjustments from the definition of "state imputed underpayment", however, the result will be:

Under-allocated capital gains to A	$1 million
Less over-allocated capital gains to B	($1 million)
Net adjustment (or adjustment excluding reallocations)	$0
State imputed underpayment or composite/withholding	$0
State tax due	$0

So, under the model subsection C(8), P will not have to pay any state imputed underpayment or composite return amount, or remit any withholding. In addition, the requirements of subsection C(3) would not apply to adjustments that are reallocation adjustments, except the specific requirement in (i) to file amended state schedule K-1s, because subsection C(3) specifically applies only to adjustments that "result in a State Imputed Underpayment." Partners would still owe tax under Section C(8)(c).

But this is not the end of the problem. There has also been some discussion of whether, under the federal rules, if the partnership pays the federal imputed underpayment, it will then be allowed to net the over-allocated amounts from any reallocation adjustments against a certain class of income in the adjustment year. Assume that this will be the case. Then, going back to the example above, this means that while the P will have a federal imputed underpayment of $150,000 for the reviewed year, it will be able to use the $1 million over-allocated to B to offset income and reduce related taxes. For state purposes, however, the state had no imputed underpayment because the over-and under-allocated amounts were already netted or eliminated. So they will need to have an add-back of the $1 million offset taken in the adjustment year. This is not addressed by the model.

We believe the best approach is to modify the computation of the amount the partnership must pay, if it elects to do so, and also the amount that would be paid if the partnership files amended composite returns or withholds tax.

"ON BEHALF OF"

The model uses the term "on behalf of" in various places to describe payments that are made by the partnership—whether it is the state imputed underpayment or other payments for composite returns or withholding. We understand that the nature of the payment is likely to have implications for how it is treated not only for tax purposes and determining tax attributes, but also for purposes of applying accounting rules and partnership agreements.

The states must also be concerned about the ability to assess and collect the amounts to be paid by the partnership and the ability to take any actions under other provisions of state law to do so. We expect partners will also want protection from any legal liability for taxes if the partnership properly pays the amount owed.

We believe the intention of allowing a partnership-level payment is to relieve partners of the tax they would otherwise owe. Technically, it is not the tax owed by the partners (and it is computed differently than that tax would be computed under existing state law). Therefore, we describe the payment in the changes as "in lieu of" the taxes owed by the partners. The changes also prohibit the partners from taking a credit or deduction for the amount or claiming a refund. We understand that some states may nevertheless wish to provide partners with the ability to claim a credit or deduction.

OTHER ISSUES

In general, changes were made throughout with the intention of simplifying the provisions and avoiding duplication, or clarifying, conforming with the ULC style guide, or making minor changes that are reflected mostly with annotated comments.

CHANGES TO DEFINITIONS

The commission uses the ULC style guide (a copy of which is linked on our partnership project page). The guide has useful instructions for definitions. Definitions are needed when a term could otherwise be ambiguous or when it is necessary to encapsulate a larger concept so as to simplify the drafting of substantive provisions. But definitions, themselves, should not include what are essentially substantive provisions. With a properly crafted definition, it will be possible to substitute the definition for the term in the text of the substantive provisions, and still have those provisions read properly. Care has to be taken when a defined term is part of the definition of another defined term. (See Rule 301.)

Normally definitions are put in the first section of a model act, or a subsection in which they are used, and are listed in alphabetical order. But because some terms are necessary for other terms, reviewing the definitions can be difficult. Changes to the model would alleviate this problem somewhat. Additional terms were defined, which can also simplify other definitions or provisions. Some definitions were altered in the substance. Some specific changes in the draft are annotated with comments explaining those changes. Other changes are summarized below:

- **"Partnership" etc.** The definitions of partnerships, partners, tiered partners, etc., were confusing, ambiguous, and incomplete in some respects, in large part because they are related and use overlapping terms, and in part because a term like "Partner" (which is a component of other terms) has different meanings in the context in which we are using it here (e.g. an owner of an S corporation that owns a partnership might be referred to as an "indirect partner"). So the recommended changes also include creation of a separate section at the beginning of the definition section for all those related terms, adding definitions for necessary terms and simplifying the definitions.

- **"Federal Adjustment" and "Final Federal Adjustment"** – There was a need for these terms, separately, to avoid having to describe federal adjustments or use other language through-out the document and to make sure that the definition was broad enough to act as a comprehensive term. First, it appears there is already a dispute over the scope of a federal partnership level audit and will likely be litigation on this topic. States should not have to separately litigate this issue at the state level based on their own similar statutory language, but instead should to be able to depend on the federal determination. Second, the language used in the model describes the adjustments in terms of the effect on federal taxable income, but there may be amounts determined under the IRC that affect state taxes but not federal taxable income. Finally, there is a need to distinguish "final federal adjustments" in certain contexts and to explain what is meant by a "positive" federal adjustment (that is, one that leads to additional tax owed).

- **"Final Determination Date"** – The definition of final determination date was substantially rewritten to simplify and clarify.

  NOTE: While the term final determination date included one type of "voluntary" adjustments (those made by the taxpayer)—an administrative adjustment request by a partnership—it did not address the final determination date for others—amended federal returns and refund claims—but instead, these were noted separately in Subsection B(1). So the rewritten definition includes them with administrative adjustment requests but the effective date, which is the triggering event for other deadlines, was not changed, so that it is still the date on which the return or claim is filed.

- **"Reallocation Adjustment"** – This term was defined for use in place of a lengthier description used throughout the draft.

- **"State Imputed Underpayment"** – This is an example of a term that has a specific use in Section C and is better defined in that context, especially since it contains inherently substantive rules. Therefore, the definition was deleted from this section and moved to Section C.

- **"State Partnership Representative"** – This is another example of a term that has a specific use in Section C and is better defined in that context—especially since it also contains inherently substantive rules.

SPECIAL NOTE ON "TAXPAYER"

It is not clear that the term "Taxpayer" can be defined to include partnerships and tiered partners and can be used appropriately throughout, if so. Therefore, a condition was added as part of the changes, mainly as a *placeholder* pending further review, that the definition applies “unless the context clearly indicates otherwise.”

CONFORMING EDITS – WITHOUT ANNOTATED COMMENTS

The changes contain non-substantive edits to conform to ULC style guide. Note that some things were not changed in the interest of ensuring reviewability—including leaving defined terms capitalized (contrary to rule 301 (i)), retaining subsection headings (contrary to 303 (i)), and retaining the numbering of sections and subsections.

Changes made throughout with no specific annotated comments –

- Rule 103 – in general, use singular (number) and present tense
- Rule 109 – use Arabic numbers for any number above nine
- Rule 201(e) – be careful in using possessives
- Rule 201(g) – don’t use “any” or “each” or “every” or “all” unless necessary
- Rule 201(i) – don’t use “deem” except to mean that something is treated as true while contrary to fact
- Rule 201(j) – don’t use the term “the provisions of” when referencing another section
- Rule 201(q) – don’t use “within” when designating a deadline – use “no later than” or “at least”
- Rule 202(i) – don’t use “provided that” (use if)
- Rule 203(a)-(e) –use “shall” to impose a specific obligation (and use “must” instead when the verb modified is passive), but otherwise avoid use of “shall”
- Rule 301(b) and 301(c) – “means” (exclusive) versus “includes” (nonexclusive) when used in definitions
- Rule 208 – don’t use “such”

OTHER CHANGES WITHOUT ANNOTATED COMMENTS

- Minor simplifications
- Substitution of defined terms in the text (see section on Definitions above)

FINAL NOTE: In a few places provisions were modified and retained, even though they may no longer be necessary. In others, comments were made to sections of the draft that were deleted and then supplemented with an entirely rewritten provision. This was done in recognition that the changes may not be accepted by the work group and, instead, these provisions and comments may become relevant.

OTHER ISSUES TO CONSIDER

Other issues that have been raised but not sufficiently analyzed or discussed to cover in this report include:

- Treatment of corporate partners generally and especially where the corporate partner is unitary with the partnership
- Treatment of situations where the partnership has resident partners in the state but has no nexus in the state—whether physical presence or economic nexus. Can the partnership be required to file any reports in that event? If not, how might this be handled?