State Taxation of Partnerships Work Group Status Report

To the Uniformity Committee

July 28, 2021

Work Group Chair, Laurie McElhatton, CA and Staff, Helen Hecht

MTC

MULTISTATE TAX COMMISSION

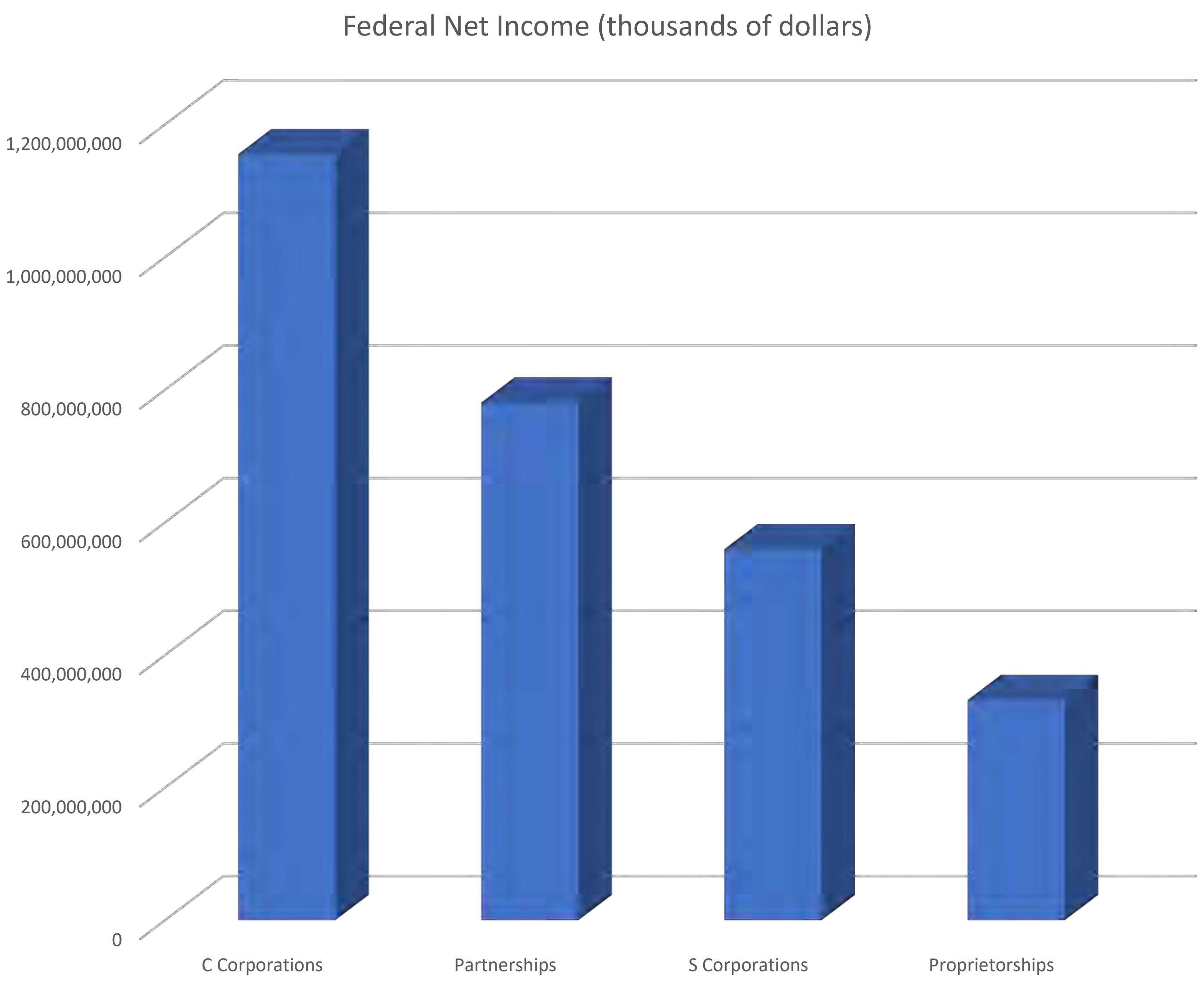
Growth of Partnerships

The trend in business growth is a shift from C corporations to pass-throughs and especially partnerships.

2018
Business Income

Partnership income continues to grow relative to the income of C corporations. As this graph shows, the income reported by all types of pass-throughs combined would now far exceed the income reported by C corporations.

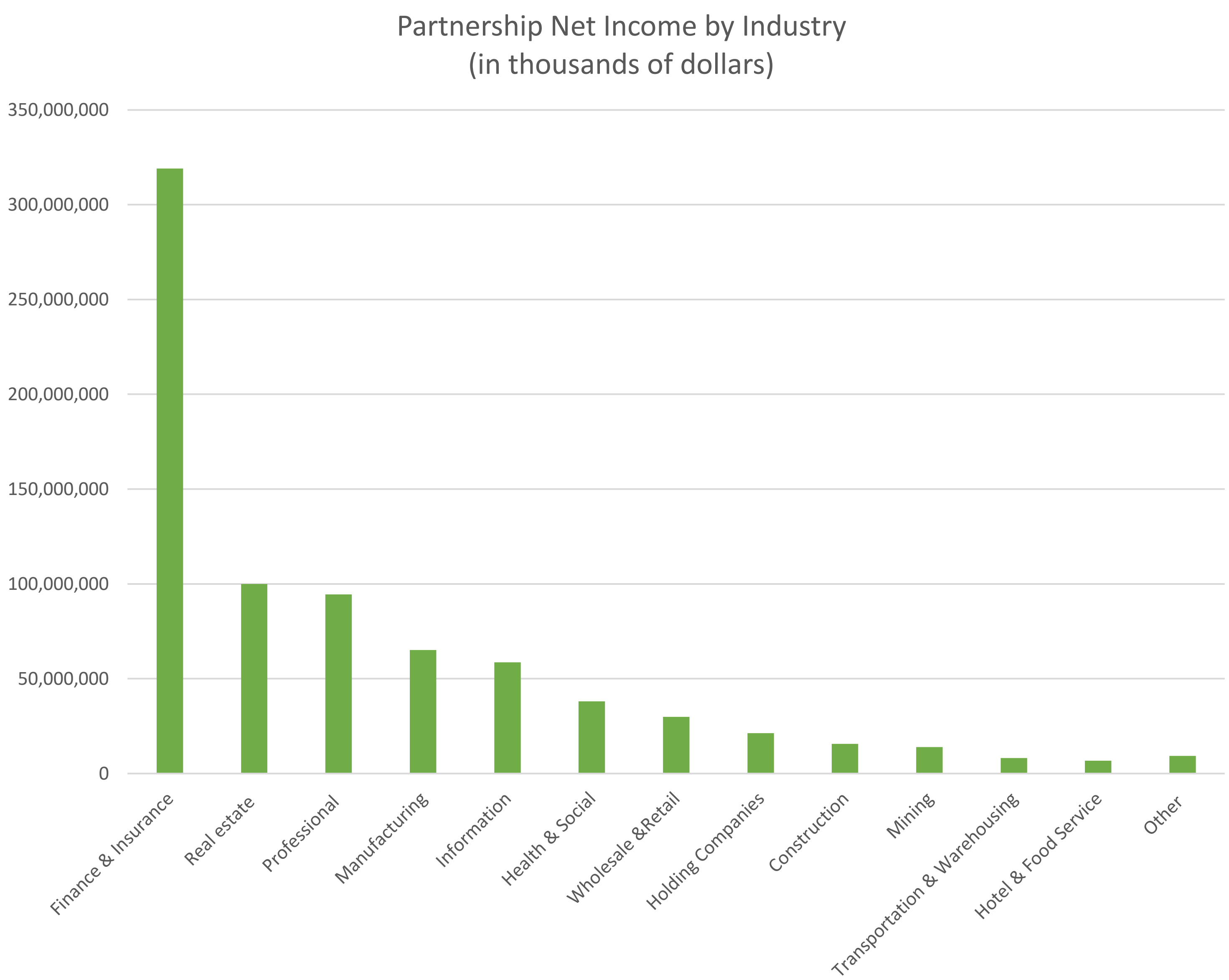
Source – IRS



Industry Data

Often people think of partnerships as small family businesses. The majority of the income from partnerships, however, comes from a few very large, complex partnerships and is derived mainly from a few industries—primarily finance, real estate, and professional businesses and firms.

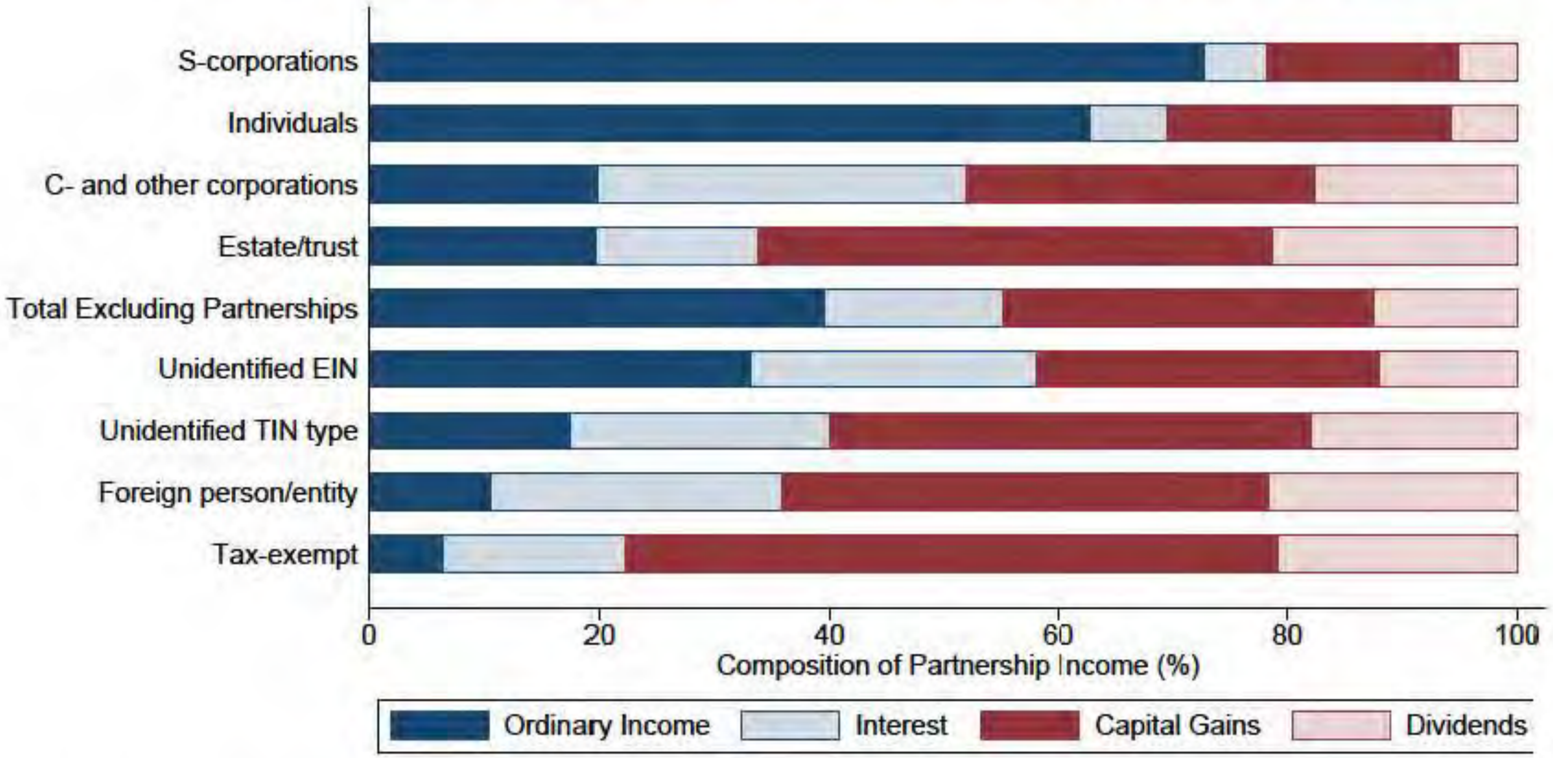
Source - IRS



Composition of Partnership Income

Just as it would be incorrect to view partnership income as coming mainly from small partnerships, it would also be wrong to think of partnership income as composed entirely or even mainly of operating (ordinary) income. A substantial portion is made up of capital gains and dividends.

Income by Type of Partner



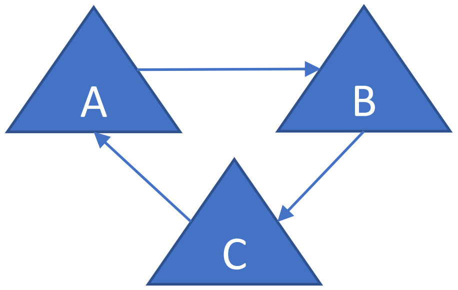
Source - Business in the United States: Who Owns It and How Much Tax Do They Pay? U.S. Dept. of Treasury, Office of Tax Analysis, Working Paper 104, Oct. 2015. [Hereafter – OTA Report]

Large Partnership – Growth in Size and Complexity

" . . .less than 1% of partnerships issue nearly 40% of K-1s. Some of these partnerships issue more than 100,000 K-1s."

OTA Report

Example - “Circular Partnerships”



The OTA report also found that there were some partnership ownership structures that could not be resolved which it called “circular” partnerships (that is Partnership A is a partner in Partnership B which is a partner in Partnership C which is a partner in Partnership A) making income difficult to trace to the ultimate taxpayer:

> “After our recursive algorithm reaches a fixed point, there remain 22,417 ‘circular’ partnerships for which we cannot uniquely link all income to non-partnership owners. These partnerships issue 9.6 million K-1s. . . . $100 billion [in income] remains within the nexus of the 22,417 circular partnerships.”

Complexity of Sub-Chapter K

The federal partnership tax rules have also grown in complexity—while at the same time—have not kept up with difficult issues.

Goals of pass-through taxation:

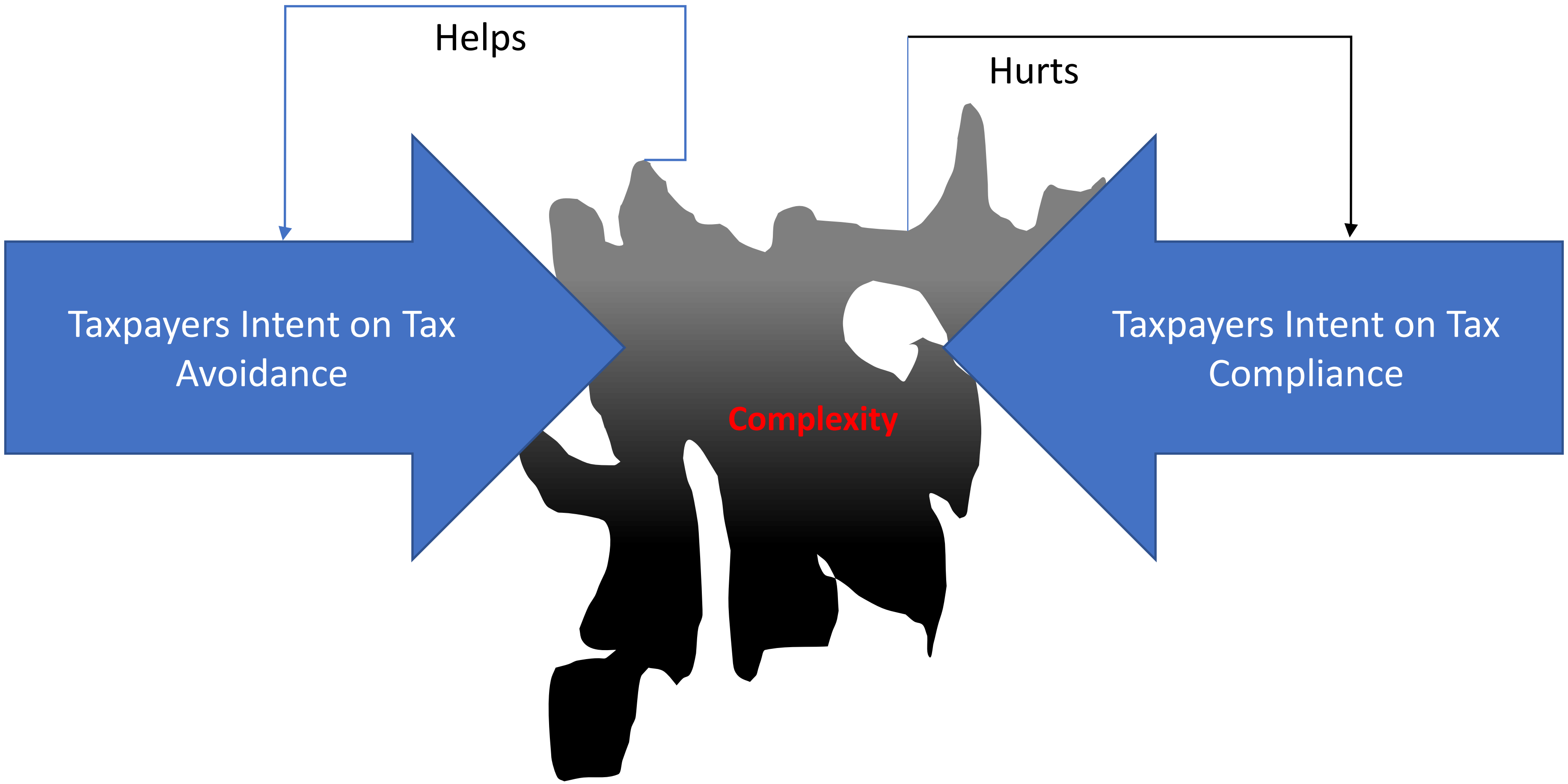
- Single level of tax –
  - Pass-through taxation allows tracking of tax basis (both “inside” and “outside”) over time so that operating income and other appreciation is only taxed once—to the taxpayer partner.
- Partners’ attributes are taken into account –
  - A high-income taxpayer will pay tax on the distributive share at a higher rate.
  - Partners can offset gains and losses from various sources.
- Tax items are characterized as if earned directly
- Respect for economic arrangements between partners

“Subchapter K has a well-earned reputation as one of the most complex areas of the tax law; while a flow-through regime sounds simple enough in concept, implementing that regime is another matter.”

The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 6th, Laura E. Cunningham and Noël B. Cunningham, p. 1.

“Subchapter K needs to be fixed. In its present condition, the statute and regulations promulgated thereunder are simply too complicated for taxpayers to apply or for the IRS to administer. . .. Yet, despite their complexity, the rules do not prevent taxpayers from inappropriately deferring [or avoiding] income and gain. The net result is that well-meaning taxpayers struggle to comply, usually incurring substantial time and expense, while less scrupulous taxpayers can flout the rules with little or no fear of detection of their aggressive position[s].

Monte A. Jackel, “Is It (Finally) Time? Reforming Subchapter K,” Tax Notes Federal, Mar. 29, 2021, P. 2031 (citing Stuart L. Rosow and Rachel A. Hughes, “Reforming Subchapter K: The Partnership Simplification Act of 20___,” 94 Taxes 361 (2016)).


Helps
Hurts
Taxpayers Intent on Tax Avoidance
Complexity
Taxpayers Intent on Tax Compliance

"It is a self-perpetuating cycle—as the law is tweaked to address the needs of elite partnerships who can afford advisors to guide them through complex rules, it further pushes out to sea the forgotten partnerships who do not have those good partnership tax lawyers."

Weekly SSRN Tax Article Review And Roundup: Hayes Holderness Reviews Monroe's Improvisation And Forgotten Taxpayers In Partnership Tax, Hayes Holderness, May 7, 2021 (TaxProf blog).

According to the IRS the single biggest source of the tax gap is under-reporting of business income in the individual income tax area.

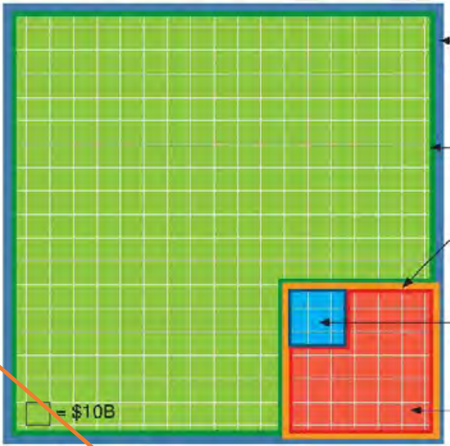
This is 4 times higher than under-reported tax by large corporations.

This likely due to complexity, which also makes tax reporting less transparent.

Tax Gap Estimates for Tax Years 2011–2013

(Money amounts are in billions of dollars; estimates are annual average amounts.)

IRS Research, Applied Analytics & Statistics



Estimated Total True Tax Liability*
$2,683B

Tax Paid Voluntarily & Timely
$2,242B 83.6% Voluntary Compliance Rate (VCR)

Gross Tax Gap
$441B

Enforced & Other Late Payments
$60B

Net Tax Gap (Tax Not Collected)
$381B 85.8% Net Compliance Rate (NCR)

Calculating the Net Tax Gap

Nonfiling
Underreporting
\+ Underpayment
Gross Tax Gap
− **Enforced & Other Late Payments**
Net Tax Gap

Total True Tax Liability	Tax Paid Voluntarily & Timely	Gross Tax Gap: Nonfiling	Underreporting	Under-payment	Gross Tax Gap	Enforced & Other Late Payments	Net Tax Gap (Tax Not Collected)
$2,683	$2,242	$39	+$352	+$50	=$441	− $60	= $381
By Type of Tax							
Individual Income Tax $1,398	Individual Income Tax $1,084	Individual Income Tax $31	Individual Income Tax + $245	Individual Income Tax + $38	Individual Income Tax = $314	Individual Income Tax − $43 (14%)	Individual Income Tax = $271
Corporation Income Tax $294	Corporation Income Tax $251	Corporation Income Tax #	Corporation Income Tax + $37	Corporation Income Tax + $5	Corporation Income Tax = $42	Corporation Income Tax − $10 (24%)	Corporation Income Tax = $32
Employment Tax $920	Employment Tax $839	Employment Tax [4] $6	Employment Tax + $69	Employment Tax + $6	Employment Tax = $81	Employment Tax − $5 (6%)	Employment Tax = $77
$16	Estate Tax $13	Estate Tax $2	Estate Tax + $1	Estate Tax + $<0.5	Estate Tax = $3	Estate Tax − $2 (55%)	Estate Tax = $1

Individual Income Tax underreporting:

Business Income	Non-Business Income	Credits	Income Offsets [1]	Filing Status	Other Taxes [2]	Unallocated Marginal Effects [3]
$110	$57	$42	$20	$5	$1	$10

Corporation Income Tax underreporting:

Large Corpo-rations	Small Corpo-rations
$26	$11

Employment Tax underreporting:

Self-Employ-ment Tax	FICA & Uncollected FICA TAX	Unem-ployment
$45	$24	$1

NOTES:

* Totals include Excise Tax.

\# – No estimate.

Detail may not add to totals due to rounding.

[1] Includes adjustments, deductions, and exemptions.

[2] Includes the Alternative Minimum Tax and taxes reported in the "Other Taxes" section of the Form 1040 except for self-employment tax and unreported social security and Medicare tax (which are included in the employment tax gap estimates).

[3] Is the difference between (1) the estimate of the individual income tax underreporting tax gap where underreported tax is calculated based on all misreporting combined and (2) the estimate of the individual income tax underreporting tax gap based on the sum of the tax gaps associated with each line item where the line item tax gap is calculated based on the misreporting of that item only. There may be differences if the marginal tax rates are different in these two situations.

[4] Self-employment tax only.

Revised 09/2019

Publication 5365 (Rev. 9–2019) Catalog Number 73349K Department of the Treasury Internal Revenue Service www.irs.gov

“Partnership taxation has been described as a mess, a disaster, and a magic circle of tax abuse. Simply stated, it is a deeply flawed system.”

Andrea Monroe, Integrity in Taxation: Rethinking Partnership Tax, 64:2:289, 295 Ala. Law Rev. (2012)(citing Lawrence Lokken, Taxation of Private Business Firms: Imagining a Future Without Subchapter K, 4 FLA. TAX REV. 249 (1999) (“Subchapter K is a mess.”); Andrea R. Monroe, What’s in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse, 60 CASE W. RES. L. REV. 401, 402 (2010) (“Partnership taxation is a disaster.”); Lee A. Sheppard, Partnerships, Consolidated Returns and Cognitive Dissonance, 63 TAX NOTES 936, 936 (1994) (“A partnership is a magic circle. Anything that is dropped into it becomes exempt from taxation. Forever. . . . Adherents to this view of subchapter K understand the word ‘flexible’ to mean that you can do absolutely anything you want without incurring tax.”)).

“The substantive and procedural rules applicable to the income taxation of partners and partnerships are ‘distressingly complex and confusing’ . . .. That complexity has proven to be easily exploited, and consequently, entities classified as partnerships have become the vehicles of choice in creating and operating abusive tax shelters. . . .

“Abusive tax shelters are complex financial artifices which exploit two fundamental weaknesses in the federal tax system: (1) the complexity of the internal revenue laws and (2) the government's inability by conventional means to identify quickly and challenge abusive tax schemes. By exploiting these weaknesses, tax shelter promoters precipitated a proliferation of abusive tax shelters and huge revenue losses to the federal government.”

Tigers Eye Trading, LLC v. Commissioner, 138 T.C. 67, 93 (2012)

This is a problem for the states since they generally conform to Subchapter K.

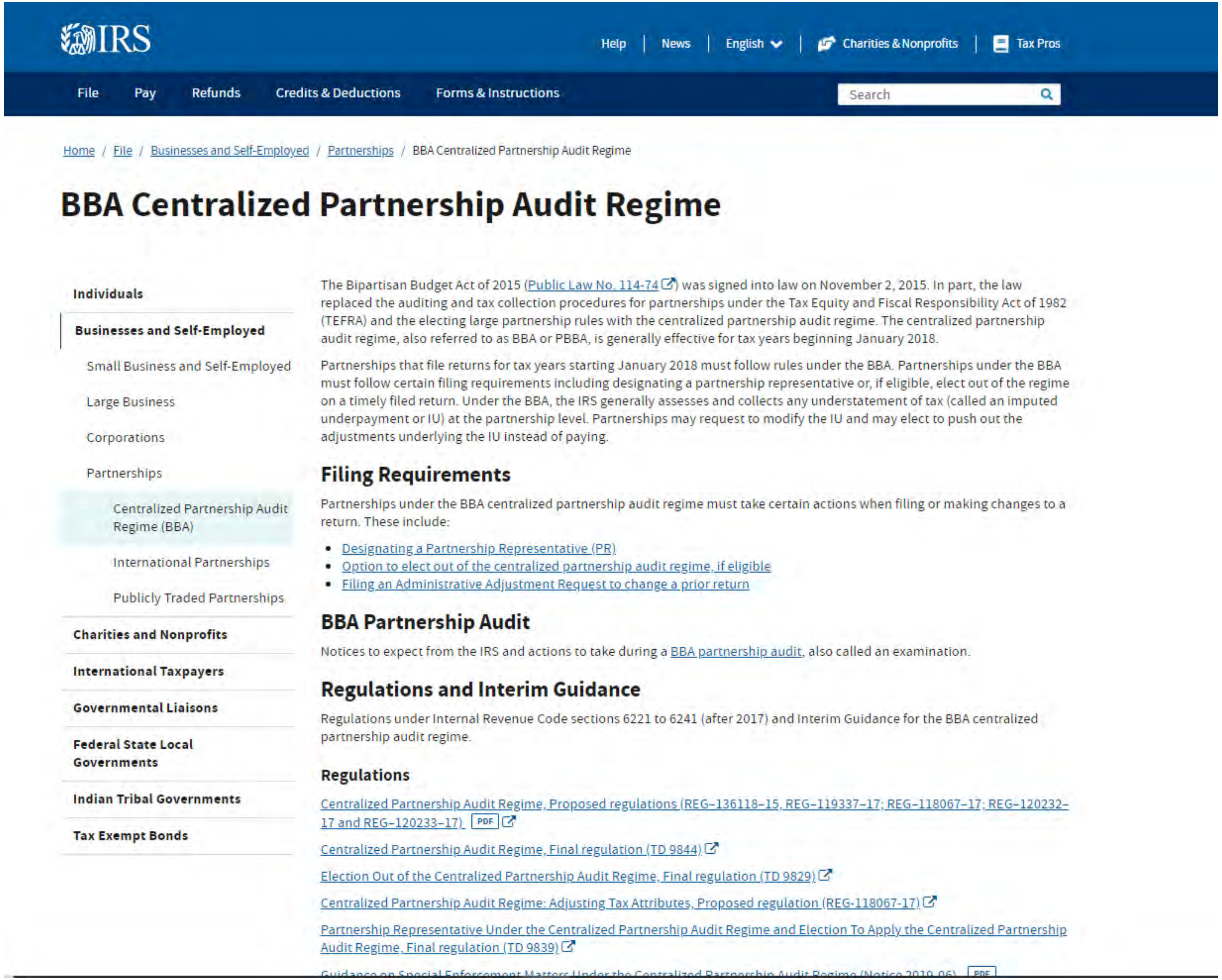
Just One of Many Examples –
Partnership reorganization versus sales of partnership interests.

"Distinguishing routine [nontaxable] partnership contribution and distribution transactions from disguised sales of partnership interests [taxable] is challenging — so challenging that the government has been unable to craft workable rules nearly four decades after Congress enacted section 707(a)(2)(B) and tasked Treasury with issuing regulations on the issue. . . .

Bradley T. Borden, Douglas L. Longhofer, Martin E. Connter Jr., Nastassia Shcherbatsevicha, "Financial Analysis of Disguised Sales of Partnership Interests," State Tax Notes, July 19, 2021.

The Federal Solution

But it remains to be seen whether these federal partnership audits will be sufficient to address complexity in both partnership structures and the law itself—or whether the IRS will have sufficient resources to carry out these audits in the coming years.



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BBA Centralized Partnership Audit Regime

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The Bipartisan Budget Act of 2015 (Public Law No. 114-74) was signed into law on November 2, 2015. In part, the law replaced the auditing and tax collection procedures for partnerships under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the electing large partnership rules with the centralized partnership audit regime. The centralized partnership audit regime, also referred to as BBA or PBBA, is generally effective for tax years beginning January 2018.

Partnerships that file returns for tax years starting January 2018 must follow rules under the BBA. Partnerships under the BBA must follow certain filing requirements including designating a partnership representative or, if eligible, elect out of the regime on a timely filed return. Under the BBA, the IRS generally assesses and collects any understatement of tax (called an imputed underpayment or IU) at the partnership level. Partnerships may request to modify the IU and may elect to push out the adjustments underlying the IU instead of paying.

Filing Requirements

Partnerships under the BBA centralized partnership audit regime must take certain actions when filing or making changes to a return. These include:

- Designating a Partnership Representative (PR)
- Option to elect out of the centralized partnership audit regime, if eligible
- Filing an Administrative Adjustment Request to change a prior return

BBA Partnership Audit

Notices to expect from the IRS and actions to take during a BBA partnership audit, also called an examination.

Regulations and Interim Guidance

Regulations under Internal Revenue Code sections 6221 to 6241 (after 2017) and Interim Guidance for the BBA centralized partnership audit regime.

Regulations

Centralized Partnership Audit Regime, Proposed regulations (REG-136118-15, REG-119337-17; REG-118067-17; REG-120232-17 and REG-120233-17) PDF

Centralized Partnership Audit Regime, Final regulation (TD 9844)

Election Out of the Centralized Partnership Audit Regime, Final regulation (TD 9829)

Centralized Partnership Audit Regime: Adjusting Tax Attributes, Proposed regulation (REG-118067-17)

Partnership Representative Under the Centralized Partnership Audit Regime and Election To Apply the Centralized Partnership Audit Regime, Final regulation (TD 9839)

Guidance on Special Enforcement Matters Under the Centralized Partnership Audit Regime (Notice 2019-06) PDF

State-Level Issues

The work group focus will be mainly on issues involving nexus and sourcing—but also on the administrative issues and problems created by the combination of pass-through taxation and traditional state sourcing principles.

The kinds of questions raised:

Do states have nexus over limited, minority, indirect partners of a partnership doing business in the state?

Should sourcing differ for corporate and individual partners and do tiered partners affect the sourcing of lower-tier partnership income?

Should guaranteed payments to a partner for services as a partner be apportioned in the same manner as the distributive share of partnership income? What about the built-in gain on contributed assets?

Do transfer-pricing rules apply to related partnerships that are engaging in inter-company transactions?

Partnership Work Group

Bi-weekly meetings – Tuesday afternoons at 2 P.M. Eastern starting August 17, 2021

Some meetings may be devoted to covering background on the issue (and may be recorded)

Information from the meetings will be posted on the project web page

Regular participants in the work group are encouraged to submit information and questions

The Project – A High Level Description

ISSUES GENERALLY

(From Standing Subcommittee Recommendation as more fully outlined in the draft discussion paper):

- Partnership – Operating Income – Generally – Pass-Through Treatment
  - Jurisdiction or Nexus over Out-of-State Partnerships & Nonresident Partners and Related Issues
  - Sourcing of Income and Related Issues
  - Investment Partnerships
  - International Issues
- Sale of a Partnership Interest – Generally
  - Nexus over Nonresident Partners
  - Sourcing of Gain/Loss
  - Investment Partnerships
  - International Issues (if any)
- Administrative and Other Issues
  - Credits for Taxes Paid
  - Information Reporting (Including and Composite Returns and Withholding), Audits, Etc.
  - Partnership Level Taxes – Generally (Including SALT Cap Workarounds)

General Approach to the Project

Identify	Identify and generally describe a comprehensive list of potential issues. (Status – started.)
Connect	Connect – note the important relationships between those issues. (Status – started.)
Select	Select a particular issue and develop a set of generally recommended practices or positions for addressing that issue.
Repeat	Repeat step 3 until all major issues have a set of recommended practices/positions, revising earlier issues if necessary to reconcile any differences.
Agree	Agree on the overall set of recommended practices/positions for all issues—the detailed work plan.
Draft	Draft models, etc., to carry out the recommended practices/positions—putting forward those that are ready for adoption.