
Current and Quotable

Proposed Statutory Language on Reporting Options for Nonresident Members of Passthrough Entities

The Multistate Tax Commission has proposed new statutory language on reporting options for nonresident passthrough entities. Several members of the American Bar Association's Section on Taxation have written comments in response to the proposed change.

Section 1. Definitions

A. **Pass-through** entity means a corporation that for the applicable tax year is treated as an S Corporation under [IRC section 1362(a), or State Tax Code section], and a general partnership, limited partnership, limited liability partnership, or limited liability company that for the applicable tax year is not taxed as a corporation [for federal tax purposes] [under the state's check-the-box regulation];

B. **Member** means [optional additional language: an individual who is] a shareholder of an S corporation, a partner in a general partnership, a limited partnership, or a limited liability partnership, or a member of a limited liability company.

Section 2. Composite Return Authorized

A pass-through entity may file a composite income tax return on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the member's pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

A non-resident member of a pass-through entity whose only source of income within a state is from pass-through entities may elect to have the pass-through entities on composite returns filed pursuant to this section report and pay income tax due on the member's pro rata or distributive share of income passed through to the member by each entity from doing business in, or deriving income from sources within, this State.

C. The [tax agency] may establish procedures or promulgate rules and regulations necessary to carry out the provisions of this section.

D. A nonresident member that has been included in a composite return may subsequently file an individual income tax return and shall receive credit for tax paid on the member's behalf by the pass-through entity with the composite return.

Section 3. Member Agreements; Mandatory Payments

A. With respect to each of its non-resident members, a pass-through entity shall for each tax year (1) timely file with the [State taxing authority] an agreement as provided in subsection B, and (2) make a payment to the State as required in subsection C. A pass-through entity that timely files an agreement as provided in subsection B with respect to a non-resident member for a tax year shall be considered to have timely filed such an agreement for each subsequent tax year.

B. The agreement referred to in subsection A is an agreement of the non-resident member

- to be subject to the jurisdiction of the State for purposes of the collection of income taxes owed on the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State; and either
- to be included on a composite return that is filed by the pass-through entity accompanied by payment of tax due on the member's income from the pass-through entity, or
- to file a return in accordance with the provisions of [individual income tax return filing requirement] and to make timely payments of all taxes imposed on the member by this State with respect to the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State.

C. If no agreement is filed in which the non-resident member consents to be included in a composite return that the pass through entity does, in fact, file for any tax year and if the non-resident member fails to file a [state] individual income tax return reporting the member's pro rata or distributive share of the income of the pass-through entity from doing business in, or deriving income from sources within, this State or fails to pay any tax due thereon, the pass through entity shall be liable for tax on such income at the highest marginal rate applicable to individuals. The pass-through entity shall be entitled to recover the payment made pursuant to the previous sentence from the non-resident member on whose behalf it paid tax.

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March 28, 2002

Frank D. Katz
Multistate Tax Commission 444 North Capitol Street Suite 425
Washington, DC 20001

Re: Multistate Tax Commission's Proposed Statutory Language on Reporting Options for Non-Resident Members of Pass-Through Entities

Dear Mr. Katz:

I am enclosing comments on the proposed model statute referred to above, as prepared by members of the State and Local Tax Committee's Subcommittee on Income and Franchise Taxes. Substantive contributions to these comments were made by David A. Fruchtman, Winston & Strawn, Chicago, Illinois, Robert Joe Hull, Bracewell & Patterson, Houston, Texas, and Steven Soles, Dechert, Philadelphia, Pennsylvania. These comments were reviewed by a member of our Committee on Government Submissions. These comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

Sincerely,
Richard M. Lipton
Chair, Section of Taxation

Enclosure

Comments on Multistate Tax Commission's Proposed Statutory Language on Reporting Options For Nonresident Members of Passthrough Entities

I. Introduction

We appreciate this opportunity to comment on the Multistate Tax Commission's ("MTC") "Proposed Statutory Language on Reporting Options for Non-Resident Members of Pass-Through Entities" (the "Model Statute") (copy attached). Our review of the Model Statute is intended to assist the MTC by providing a perspective of attorneys whose practices focus on state and local tax issues; however, our comments should not be construed as endorsing a suggestion that partners, LLC members or S corporation shareholders are or, as a matter of policy, should be subject to income taxation in states in which they neither reside nor have physical presence.

We note that the Model Statute does not distinguish between general and limited partners (or between active participants and passive investors, or between board managed and member managed LLCs). Whether such distinctions are appropriate (or required) has been addressed with conflicting results by state courts¹ and admin-

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association, the Section of Taxation, or the individuals' law firms.

These comments were prepared by members of the Committee on State and Local Taxation's Subcommittee on Income and Franchise Taxes. Principal responsibility was exercised by David Fruchtman. Substantive contributions were made by Robert Joe Hull and Steven Soles. The Comments were reviewed by Arthur Rosen of the Section of Taxation's Committee on Government Submissions.

Although members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the tax principles addressed by these Comments or may have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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March 28, 2002

istrative tribunals.² Under those circumstances, our only observation is that the need for such distinctions must be determined on a state-by-state basis.

With that preface, we offer the following comments.

II. Comments

A. The Model Statute should not impose derivative liability on pass-through entities without providing the entities with the authority to withhold taxes from cash distributions. We do not believe that the imposition of derivative liability on an entity is justified unless the entity has the ability to avoid that liability by withholding income taxes from its members' distributive income. However, the Model Statute allows for derivative liability to be imposed in such circumstances.

The Model Statute, in Section 3.C., imposes liability on a pass-through entity if a non-resident member chooses not to participate in a composite return but then fails to pay income

¹ See e.g. *Appeal of Amman & Schmid Finanz AG*, California State Board of Equalization, No. 96-SBE-008 (April 11, 1996) and *Secretary of Revenue of North Carolina v. Perkins Restaurant Inc.*, North Carolina Tax Review Board, Administrative Decision 351 (January 28, 1999). (For the full text of the California Board of Equalization's decision in *Amman and Schmid*, see *Doc*

96-16081 (8 pages) or *96 STN 130-3*. For the full text of the North Carolina Tax Review Board's decision in *Perkins Restaurant*, see *Doc 1999-19249* (4 original pages) or *1999 STT 107-23*.)

² See e.g. *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E. 2d 73 (App. Ct. 1st Dist. 2000). (For the full text of the Illinois Appellate Court, 1st District's decision in *Borden Chemicals and Plastics*, see *Doc 2000-5242* (12 original pages) or *2000 STT 38-18*.)

(Footnote 1 continued in next column.)

taxes on his distributive share of the entity's income earned in the state. Of course, the entity has no ability to force a member to pay state income taxes. Nor, under the Model Statute, does the entity have the authority to withhold taxes from distributions to members. The imposition of derivative liability on the entity in such circumstances is unfair because the entity lacks the ability to control the payment of tax. For the same reason, no derivative liability should attach where a member has a distributive share of the entity's income but does not receive an actual cash distribution. Here again, the entity has no mechanism to avoid such derivative liability.

As additional practical considerations, many pass-through entities operate in several states and have hundreds if not thousands of members. The monitoring required by the statute imposes an unreasonable burden on such entities. Moreover, an entity may not learn of a member's alleged failure to pay income tax until years after the member has left the entity, at which time it may be difficult or impossible for the entity to obtain information or reimbursement from the member.

We suggest the following revisions: (1) We recommend the addition of a subsection authorizing entities to withhold state income taxes from a non-resident member's cash distributions unless the member provides a statement agreeing to be subject to the state's income tax jurisdiction. We also recommend that the subsection provide that the receipt of such a statement will excuse the entity from all liability for the member's taxes owed to the state. (2) We recommend the addition of a subsection stating that an entity's derivative liability is limited to the income tax imposed on the amount of cash distributed to the non-resident member whose taxes are at issue. Alternatively, the subsection could provide that the entity's liability is limited to the amount of cash distributed to the particular member.³

B. The Model Statute should apply only to non-entity members. We recommend that the Model Statute state that it applies to individuals only, rather than leaving to the states' discretion whether to include entities within its reach. The statute seems to have been drafted with non-entity members in mind. For example, under the derivative liability provision, the pass-through entity may be liable for its members' unpaid taxes determined at "the highest marginal rate applicable to individuals." However, no consideration seems to have been given to the different amount of derivative liability that might arise from distributions to members that are entities. There does not appear to be any justification for a mismatch that causes the amount of a pass-through entity's derivative liability to be different from the amount of the member's primary liability. As a second example, it is not clear what the Model Statute intends for pass-through entities that are members of another pass-through entity. What is the effect of such a member-entity agreeing to be "subject to the jurisdiction of the State for purposes of collecting income taxes owed on" its share of distributive income?

These may not be the only areas in which the Model Statute raises questions as to its application to entities. We therefore recommend further analysis before the reach of the statute is extended beyond individuals.

C. The Model Statute should include a provision crediting members with all taxes paid to the state. The Model Statute holds a member liable for income tax on his share of the

pass-through entity's income earned in the state, holds the entity liable for the member's unpaid taxes, and grants to the entity the ability to require reimbursement from members whose income taxes were paid by the entity. However, the Model Statute does not provide a dollar-for-dollar credit to members whose taxes were paid by the entity. To protect members from having to pay the same tax twice, we recommend that the Model Statute include a subsection stating that income taxes paid to a state in satisfaction of a member's liability shall be fully credited to the member. The availability of this credit should not be affected by whether the member or the entity made the payment to the state. Nor should the availability of the credit be dependent on the member reimbursing the entity for taxes the entity paid to the state on the member's behalf.

Further, in recognition of the fact that the member may no longer have access to the entity's tax information, the member should have the ability to require a state to provide a statement of the amount of taxes paid to the state in full or partial satisfaction of the member's income tax liability.

D. The Model Statute should be split into two Model Statutes. The Model Statute actually addresses two issues: (1) Imposition of direct and derivative liability for income taxes, and (2) Tax reporting options. There is no apparent advantage to the joining of these issues into a single statute. In addition, the provision imposing liability is much more likely to be controversial than is the reporting provision. Therefore, we recommend separating the statute into two proposals. In addition, consistent with the MTC's desire for simplified tax reporting (a desire with which we agree), we recommend the inclusion of a statement with the Model Statutes clearly stating the MTC's belief that the composite reporting Model Statute should be enacted if the tax liability Model Statute is enacted.

E. The caption to the Model Statute should be revised to describe more accurately its contents and effect. The current caption of the Model Statute, "Multistate Tax Commission's Proposed Statutory Language on Reporting Options for Non-Resident Members of Pass-Through Entities," indicates that the proposal addresses taxpayer reporting options. However, the proposal is far more significant for its imposition of tax liabilities on non-resident members and pass-through entities. State legislators, revenue departments and taxpayers who are being asked to consider the Model Statute should be provided with a caption that is descriptive of its most important aspects. If the Model Statute is not split into two Model Statutes, we recommend the revision of its caption to be: "Proposed Statutory Language Imposing Income Tax Payment Obligations on Non-Resident Members of Pass-Through Entities and Income Tax Collection/Derivative Liability on Pass-Through Entities."

III. Summary

The Model Statute raises a number of important legal and policy issues. The core issue is, of course, whether income earned by non-resident partners should be subject to income taxation in the states in which the partnership earns the income. We believe that issue must be addressed on a state-by-state basis. We believe that incorporation of the recommended revisions will focus discussion at the state level by avoiding issues that the Model Statute does not appear to have been intended to raise. ☆

³ See e.g. Maryland Administrative Release No. 6 (Rev. 8/31/01).