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IMPROVING PERSONAL INCOME AND PASS-THROUGH TAX COMPLIANCE AFTER FEDERAL AUDIT CHANGES

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Revenue Stabilization and Tax Policy Committee

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MULTISTATE TAX COMMISSION

The Multistate Tax Commission (MTC) is an intergovernmental state tax agency formed in 1967. New Mexico is a founding member of the MTC, enacting the Multistate Tax Compact in June of that year. In addition to compact members, states can participate in the Commission as "sovereignty" or "associate" members. The overarching goal of the MTC is to facilitate states working together. The MTC's uniformity committee drafts model state tax regulations and statutes. The joint audit and nexus programs provide services to participating states. (New Mexico participates in the joint audit program.) The MTC also provides training, research, litigation support, and other services, as requested. See the MTC's website at www.MTC.gov.

Unless indicated, the views in this testimony are my own and not the official positions of the Multistate Tax Commission or any of its member states.

GROWTH OF PASS-THROUGH ENTITIES

Traditionally, if you wanted to grow a business, you had two choices—taking out loans from financial institutions or selling ownership shares. To get big, you generally had to be a C corporation. Today, partnership structures (including LLCs, etc.) are being used to create large investment vehicles that can provide much more flexibility to investors and the businesses they invest in.

PARTNERSHIP TAXATION

There are two main income tax systems for business income—C corporation taxation and pass-through taxation. Pass-throughs include S corporations, partnerships, and LLCs. S corporations have their own distinct system. Other pass-through businesses are generally taxed under the partnership system. In recent years, according to IRS data, the total business income generated in this country that is reported by entities taxed on a pass-through basis (including partnerships and S corporations) surpassed the income reported by entities taxed as C corporations. While S corporation taxation is fairly straight-forward, partnership taxation (which applies to partnerships and LLCs) is much more complex. And the growth of partnerships combined with the complexity of the income tax rules for partnerships created a tax-administration crisis.

Corporate income is taxed twice—once to the entity when it is earned, and once to the owner when it is distributed. But the income of partnerships is taxed only once, in a hybrid manner, so that it is taxed when earned, but the tax is determined at the owner (partner) level. Partnerships have flexibility under the tax rules to structure deals in any number of different ways, including multi-tiered structures (partnerships that own other partnerships that own other partnerships). Partnerships can also allocate items of income and expense to the partners in different proportions, and this can change over time.

I can boil down the complexity of this pass-through tax system by telling you this: A few years ago, the U.S. Treasury Department attempted to take all the income reported to the IRS on the partnership returns and trace that income through to the taxable owners to see if it was properly reported on the tax returns of those owners. And it also tried the reverse—tracing all the income on the returns of the owners back to the ultimate partnership returns. The result was that it found that 15-20% of the income could not clearly be traced one direction or the other, in part because the structures involved were so complex.[1]

[1] Richard Prisinzano, U.S. Treasury Dep't., and others, "Business in the United States: Who Owns It and How Much Tax do They Pay?", p. 3, available here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/NYU-2016-Business-in-US-Analysis-of-tax-paid.pdf.aspx

Suffice it to say, the IRS has long recognized that it is unable to audit the income of partnerships effectively. And even if it audits the partnership and finds a problem, it is not feasible to assess the taxpayer-partners if there are more than a few dozen. And today, it is not unusual for a large partnership to have thousands of partners.

So in 2015, Congress passed the Bipartisan Budget Act which gave the IRS new authority to audit large partnerships (having more than 100 partners, or multiple tiers) and assess tax on audit adjustments at the entity level.[2] Partners may decide, during the audit, to file amended federal returns and pay any additional tax. But, at the end of the audit, if there is any remaining tax liability, the IRS will assess the partnership. If the partnership decides it doesn't want to pay the tax on the audit adjustments at the entity level, then it will have to "push-out" that liability to the partners to be reported on their returns in the year that the adjustments are final (rather than having the partners file amended returns). This is a whole new system for assessing audit adjustments related to partnership income.

EFFECT ON THE STATES – NEED FOR LEGISLATION

States, like New Mexico, that have income taxes and base those taxes on federal tax amounts, have a mechanism to handle changes in the state tax due as a result of a federal audit adjustment. But states typically do not assess tax against partnerships, although they may have partnership withholding or composite returns. So the new federal partnership audit regime means states must make changes in their laws in order to pick up the state tax due on these partnership adjustments. From the standpoint of the partnerships and partners, the issue is reducing the compliance burden and making it easier to report state adjustments. This is especially important because, when a partnership operates in multiple states and has hundreds or thousands of partners, the tax owed by any particular partner in any state may be very small, even though the total tax owed is substantial.

The MTC worked with several taxpayer and practitioner groups—including the America Bar Association, the American Institute of Certified Public Accountants, the Council on State Taxation, the Tax Executives Institute, and the Institute for Professionals in Taxation—to create a process so that states can assess the state tax due on federal partnership audit adjustments and also provide for the partnership to pay the tax on behalf of its partners. That process is part of model legislation that was adopted by the MTC this year.

Attached is the Hearing Officer's Report on this model legislation along with the legislation itself and letters supporting it.

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[2] See a copy of the legislation here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/Bipartisan-Budget-Act-of-2015.pdf.aspx.