COMMENTS CONCERNING Multistate Tax Commission's Proposed Statutory Language On Reporting Options for Non-Resident Members of Pass-Through Entities

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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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Comments On Multistate Tax Commission's Proposed Statutory Language On Reporting Options for Non-Resident Members of Pass-Through 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 courts\(^1\) and administrative 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 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,\(^1\) See e.g. Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E. 2d 73 (App. Ct. 1st Dist. 2000).

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.  

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.

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3 See e.g. Maryland Administrative Release No. 6 (Rev. 8/31/01).
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 Statue does not appear to have been intended to raise.