Taxation of Income from Pass-Through Entities

Presentation to the New Mexico Legislature
Revenue Stabilization and Tax Policy Committee
By Helen Hecht, Uniformity Counsel, Multistate Tax Commission
November 3, 2022

Helen Hecht
Uniformity Counsel
Multistate Tax Commission

Bio

<u>Work</u>:

- 2020 – Current - Uniformity Counsel for the Multistate Tax Commission
- 2014 – 2020 - General Counsel for the Multistate Tax Commission (Washington, D.C.)
- 2009 – 2014 - Tax Counsel for the Federation of Tax Administrators (Albuquerque, NM)
- 2003 – 2009 - Of Counsel – Sutin, Thayer & Browne law firm (Albuquerque, NM)
- 1995 - 2003 - Senior Manager (and various) - KPMG accounting firm (Albuquerque, NM)
- 1984 – 1995 – Bureau Chief (and various) - New Mexico Taxation and Revenue Department (Las Cruces, Santa Fe, and Albuquerque, NM)

<u>Education</u>:

- Juris Doctor, University of New Mexico
- Masters in Accountancy, New Mexico State University
- Bachelors in Accountancy, New Mexico State University

<u>Other</u>:

- Member of the New Mexico and U.S. Supreme Court Bar
- New Mexico Licensed CPA
- Founding member of the New Mexico Tax Research Institute

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 also 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 these programs.) 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 expressed in this testimony are my own and not the official positions of the Multistate Tax Commission or any of its member states.

What is a pass-through entity?

- Refers to an entity whose income is taxed only once, to the owners.
- Two possible approaches – tax when the income is earned or tax when it is distributed.
- Taxing only at distribution means the tax is deferred—potentially forever.
- So taxing authorities typically tax the income when earned, whether or not it is distributed.
- But how does the owner know what income was earned by the entity?
- The tax system requires the entity to do the tax reporting of entity items – income, expense, gain, loss, etc.
- Then the owners take their share of the items into account when computing their own taxes..

What pass-through taxation accomplishes.

- General preservation of the substantive tax rules that would otherwise apply – including those that apply at the owner level

- Example:

  - Partnership incurs a loss which, based on the related transaction and the property involved is properly characterized as a capital loss under the substantive rules.

  - That loss passes through to the partner as a capital loss. Whether the partner can offset that loss against income from other sources depends on the various loss-limitation rules, applied at the partner level.

  - The ultimate tax owed by the partner on income and loss from the partnership will be based on the tax rates as applied to that partner.

  - So a high-income partner will pay more tax on the share of partnership income than a lower-income partner will pay on that partner's share.

- Preservation of the effect of progress tax rates makes a substantial difference at the federal level where rates can range from around 10% to over 35%.

Two main types of pass-through taxation.

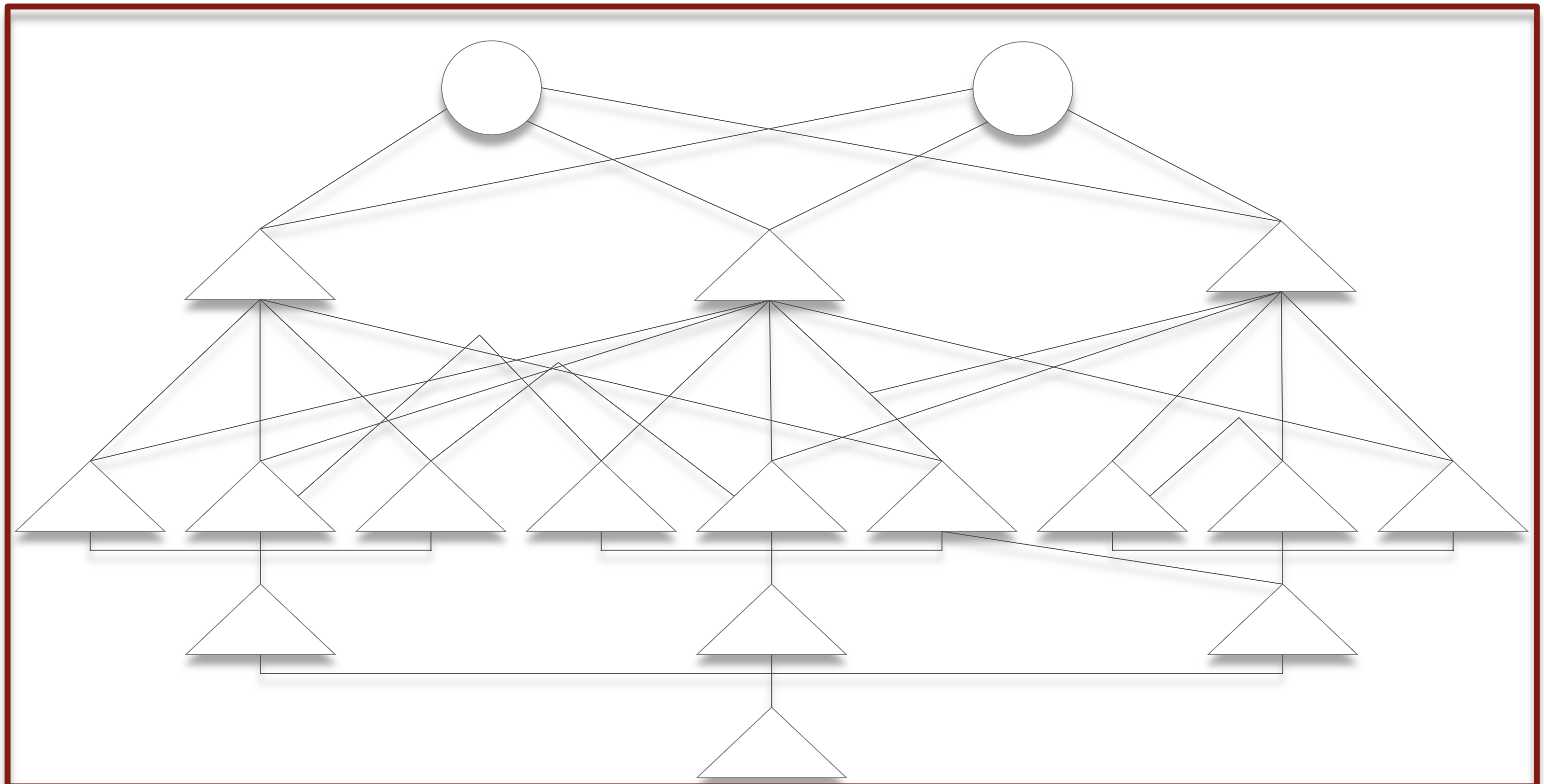
- S Corporation – IRC Subchapter S
  - Corporations or LLCs electing to be treated as corporations
  - There are federal tax restrictions:
    - Number of owners
    - Type of owners
    - Only one class of stock
  - This means the S corporations are fairly simple.
- Partnerships – IRC Subchapter K
  - Entities may be general or limited partners or limited liability companies.
  - No federal restrictions on number of owners, type of owners, or ownership interests
  - This means that partnerships may be large, complex, multi-tiered entities with owners who agree to share items of income, expense, gain, or loss in different proportions.

Partnership Taxation is Complicated

"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.")).

This is **NOT** a complex partnership structure.



Complex partnership structures can have thousands of taxpaying partners and dozens of "tiers" (partnership partners) and can even have circular ownership structures.

Partnerships are not all alike

Investment Partnerships

- Slightly more than half of the profit earned by partnership entities is investment income earned in the finance sector.
    - Private equity funds
    - Hedge funds
    - Real estate investment funds
    - Family partnerships
- Most of this profit ultimately flows to high-wealth investors
- Investment partnership income is often sourced to the partner's state of residence.

Operating Partnerships

- Most pass-through entities – in terms of numbers – are small businesses and professional firms.
- A small business might choose the partnership form over the S corporation form (which is often more beneficial for individual partners) because it needs the flexibility that partnerships allow, including –
    - Ability to have corporations and trusts as partners
    - Ability to vary the allocations of items of income and expense made to partners
    - Tax basis-related differences

Developments

- Federal Level –
  - 1982 – Congress enacted TEFRA –
    - Created hybrid-partner/ partnership audit rules to try to make it somewhat easier for the IRS to audit partnership income and make adjustments.
  - 1986 – Federal tax reform –
    - Imposed withholding on domestic income of foreign partners and also increased the limits on the use of partnership losses to offset income from other sources.
  - 1995 – IRS Partnership Anti-Abuse Regulation –
    - Addressed aggressive tax shelters using complex partnership structures and transactions by limiting the use of losses.
  - 2014 – the federal Governmental Accountability Office –
    - Reported that the IRS was unable to conduct audits of large complex partnerships.
  - 2015 – Congress passed the Bipartisan Budget Act –
    - Provided the IRS with the ability, for tax years beginning 2018, to audit "large" partnerships entirely at the partnership level and to assess tax to the partnership—unless the partnership and partners do the work of reporting the audit adjustments.
  - 2017 – Congress passed the Tax Cuts and Jobs Act (TCJA) –
    - In part, the Act capped the state and local tax deduction.

Developments

- State Level –
  - Last 40 years - There have been challenges as to whether states in which partnerships operate can tax non-resident partners.
  - 1990's – MTC and the states began working on withholding rules for non-resident partners and also providing an election for a "composite" return – which is very similar to an entity level tax but generally applies only to non-residents with no other income from the state. These efforts were widely opposed.
  - 2016 – In response to the Bipartisan Budget Act centralized partnership audit regime, the states had to amend their laws in order to require reporting of state tax on federal partnership adjustments. The MTC began developing a model statute and a number of states, including New Mexico, have adopted a version of that model which allows the partnership to elect to pay the tax.
  - 2017 – State tax agency representatives asked the MTC to also consider how states might shift to an entity-level tax instead of a tax on the partners. But practitioner and taxpayer groups strongly opposed this idea and the MTC did not address it.
  - 2019 – States began adopting a "work around" to the federal TCJA cap on the deduction for state taxes which involves letting pass-through entities pay the tax (and deduct it) instead.
  - 2021 – MTC began a comprehensive project on state taxation of partnerships.

Today

- Thirty states have some form of elective PTE taxes (and others may still have composite filing for non-residents).

- One state has made the PTE tax mandatory in lieu of the tax on the owners.

- One complaint by practitioners is that the pass-through entity taxes (or PTEs) are not completely thought out. California, and other states, have had to amend the initial laws to address issues not anticipated.

- Another complaint is that there is little uniformity among the state PTEs—but this is largely the result of a long history of practitioner and taxpayer opposition to the idea.

- To be fair – when a PTE tax is made mandatory, it may result in the need for certain businesses to restructure.

- The "uptake" on PTE election has surprised most states (and people at the MTC who witnessed the backlash against the idea only a few years ago). Revenue from these taxes is routinely much higher than expected.

- The MTC project on the state taxation of partnerships has issued a comprehensive outline, a white paper on investment partnerships, a model for treatment of investment partnership income, and is continuing to work on other issues.

New Mexico

- Has a withholding requirement and a composite return election – See NMSA Sec. 7-3A-1, et seq.
- 2021 – adopted statutory changes to enable the state to assess tax related to adjustments from federal partnership audits – including an option for the partnership to pay the tax.
- 2022 – Adopted an elective entity level tax as a work-around to the federal cap on the deduction for state taxes.
- Issues are being raised by experts and practitioners – including:
  - What is the proper tax rate to be applied – will some taxpayers inevitably pay more or less
  - Whether individual partners forego the state deduction for capital gains
  - How NOLs and credits, which may be used at the entity level but not fully used up, should be tracked
- Frankly, in all states, these PTE taxes have also raised issues that states have not fully addressed in general, including the proper sourcing of multistate pass-through income.

What's next?

- States will continue to tweak the elective PTE taxes.
- If the federal state and local tax deduction cap sunsets when it's expected to (2026), then some states PTE taxes will also sunset.
- But whether the federal government will let the cap sunset—and whether states will also get rid of the elective PTE tax is unknown.
- States may begin to question whether the pass-through system makes sense from a state tax standpoint. Reasons:
  - The main reason for the pass-through system as opposed to a single level of tax at the entity level is the difference in tax rates—which is far less great at the state level.
  - The rate differential matters more for investment partnership income, which could continue to be taxed on a pass-through basis. Note – this income is generally sourced to the partner's state of residence.
  - States are waiting to see if the IRS can use their new authority to effectively do partnership audits.
  - Most states do not have the ability to audit complex partnerships.
  - The complexity poses risks for small businesses—especially as states begin to explore enforcement efforts.

Resources

- See the MTC Project Web Page for the State Taxation of Partnerships Project which contains information about the project, including the comprehensive issue outline, the white paper on investment partnerships, the draft model on the treatment of investment partnership income, and a lot of additional information and resources, including links to the IRS website and to state information on PTE taxes, here: https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax

Questions

Helen Hecht
hhecht@mtc.gov