Multistate Tax Commission

Hearing Officer's Report
On Second Hearing

Recommendation Concerning Enactment of a Uniformity Provision on Reporting Options For Non-resident Members of Pass-through Entities

January 10, 2003

I. Introduction.

This report concerns a second public hearing directed by the Executive Committee to gather public comment on the revision to the MTC proposed recommendation for enactment by the states of a uniformity provision on reporting options for non-resident members of pass-through entities. See the initial Hearing Officer's Report dated April 15, 2002 for the background of the initial proposal.

II. Background.

Acting on the April 15, 2002 Hearing Officer's Report, the Executive Committee on April 25, 2002 referred the matter back to the Income and Franchise Tax Subcommittee to modify the provision establishing liability of the pass-through entity for delinquent taxes owed by non-resident members. The Executive Committee recommended a provision requiring withholding of tax on income actually distributed to non-resident members. The subcommittee developed a withholding provision as a new Section 3 to replace the previous Section 3.

The full Uniformity Committee approved the revised proposal and the Executive Committee on August 2, 2002 authorized a second public hearing for public comment on the revised proposal.

The revised proposal authorized for public hearing by the Executive Committee reads as follows:

Proposed Statutory Language on Reporting Options for Non-resident Members of Pass-through Entities with Withholding Requirement

Section 1. Definitions.

A. "Pass-through entity" means a corporation that for the applicable tax year is treated as an S Corporation under [IRC §1362(a), or State Tax Code §], and a general partnership, limited partnership, limited liability partnership, trust, 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; a member of a limited liability company; or a beneficiary of a trust;

C. "Nonresident" means an individual who is not a resident of or domiciled in the state, a business entity that does not have its commercial domicile in the state, and a trust not organized in the state.

Section 2. Composite Return Authorized.

A. 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 members' pro rata or distributive shares of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

B. A nonresident member whose only source of income within a state is from one or more pass-through entities may elect to be included in a composite return filed pursuant to this section.

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

Section 3. Withholding Required.

A. A pass-through entity shall withhold income tax at the highest tax rate provided in [section x for individuals or section y for corporations or section z for other entities] on the share of income of the entity distributed to each nonresident member and pay the withheld amount in the manner prescribed by the [tax agency]. The pass-through entity shall be liable to the [state] for the payment of the tax required to be withheld under this section and shall not be liable to such member for the amount withheld and paid over in compliance with this section. A member of a pass-through entity that is itself a pass-through entity (a "lower-tier pass-through entity") shall be subject to this same requirement to withhold and pay over income tax on the share of income distributed by the lower-tier pass-through entity to each of its nonresident members. The [tax agency] shall apply tax withheld and paid over by a pass-through entity on distributions to a lower-tier pass-through entity to the withholding required of that lower-tier pass-through entity.

B. A pass-through entity shall, at the time of payment made pursuant to this section, deliver to the department a return upon a form prescribed by the department showing the total amounts paid or credited to its nonresident members, the amount withheld in accordance with this section, and any other information the department may require. A pass-through entity shall furnish to its nonresident member annually, but not later than the fifteenth day of the third month after the end of its taxable year, a record of the amount of tax withheld on behalf of such member on a form prescribed by the department.

C. Notwithstanding subsection A, a pass-through entity is not required to withhold tax for a nonresident member if

(1) the member has a pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State of less than $1,000;

(2) the [tax agency] has determined by regulation, ruling or instruction that the member's income is not subject to withholding; or

(3) the member elects to have the tax due paid as part of the pass-through entity's composite return under Section 2.

III. Public Comment at Hearings

1. The public hearing was held on December 17, 2002 at 8:30 a.m. at the Hall of the States, Washington, D.C. Frank D. Katz, General Counsel of the Multistate Tax Commission, was appointed hearing officer for the second hearing. Exhibit A is the appointment. Notice of the Hearing was duly given. Exhibit B is the Notice. Exhibit C is the Certification of Loretta King affirming proper dissemination of the Notice. The following comments were received at the hearing.

   - John Chandler of Williams Energy Partners and Mary Lyman of the Coalition of Publicly Traded Partnerships ("Coalition") requested that the Commission exclude publicly traded partnerships (PTPs) from the provisions of the proposal requiring the partnerships to report or pay tax for their members. They also submitted written comments, attached as Exhibit D.

     PTPs are partnerships the interests in which—known as units—are traded on public exchanges. There are about 60 such PTPs at present, half of which are in the energy business. The roughly 27,000 unit holders are scattered among the 50 states. Most of the PTPs do business in multiple states, some operating in over 40 states. The Coalition is confident that the great majority of the unit holders report and pay state tax. They acknowledged, however, that it is likely that most report and pay the tax only to their state of residence rather than to the state where the income was earned. The Coalition gave several reasons why PTPs should not be subject to the provisions of the proposal.

     First, paying taxes for nonresident unit holders destroys the fungibility of units necessary for trading securities on a public market. Every unit must be identical in all attributes, they claim, including tax attributes. That fungibility is destroyed if units carry different tax consequences depending upon whether they are owned by residents or non-residents of a state.

     Second, income that is attributable to a unit does not necessarily match distributions to that unit holder. Income is attributed to a unit holder at a different time than when distributions are made. Distributions may also be return of capital, not income.

     Third, withholding is administratively burdensome; accurate withholding is not possible, largely because of the high trading volume in the thousands of units each day and because many of

the units are held in street name with the PTP knowing only the broker's name, not the real owners. Although they find out the names and addresses of the owners once a year for the annual return, that list would become increasingly out of date as the units trade through the year.

Finally, the state tax dollars are small. The 15 largest PTP's have $30 billion is assets, but only $210-200 million in taxable income, some of which is earned in states with no income tax. So the total tax would be about $8 million. Moreover, there are a large number of smaller investors who may fall below the $1000 exemption for withholding.

IV. Summary of Written Responses.

1. The American Institute of Certified Public Accountants (AICPA) submitted additional written comments supplementing the written comments they had submitted on April 5, 2002. The additional comments are attached as Exhibit E. Specifically, the AICPA suggests:

   - The proposal should not apply to non-individual members
   - An exemption from withholding should exist for non-cash or "phantom" income,
   - Use of highest tax rate should be optional to taxpayer.
   - Exemptions to withholding should be permitted for PTPs, entities with over 1000 members, family investment entities, investment entities, entities with less than $10,000 of income attributable to a state and corporate owners agreeing to be subject to tax.
   - The Proposal should use the MoSCITA composite provisions.

   The AICPA again raises issues of the constitutionality of taxing nonresident members, and of this just being a matter of where the tax is being paid—to the state of residence rather than the income source state—not the overall amount of tax being paid. They further suggest that the states make use of the information they already have to pursue non-filers rather than impose these heavy administrative burdens on pass-through entities. If the proposal were adopted, they want pass-through entities compensated for the administrative burden.

2. Malcolm Day of Houston Texas sent email, attached as Exhibit F, requesting that the Commission exempt publicly traded partnerships from the provisions of the proposal.

V. Hearing Officer Recommendations

The Hearing Officer recommends that the proposal be submitted to the States in a Bylaw 7 survey in anticipation of adoption by the Commission.

The request to remove PTPs from the purview of the proposal appears to be inconsistent with the intent to have nonresident members pay tax where their income is earned. The Coalition acknowledges that most nonresident members probably pay tax only in their state of residence. One can both understand and sympathize with that practice. The task of having to file returns in some 40 states reporting and paying tax on income earned through a PTP cannot be a happy one. Indeed, that is the whole purpose of the composite return, to relieve the nonresident member of that burden. The pass-through entity has the records of the owners of its shares and the knowledge of its distributions. If it can send money to unit holders, it can get and record their name. It is vastly easier for the PTP to file 40 returns reporting and paying the tax for the thousands of nonresident members in each state where that income is earned. Finally, one suspects the market is quite capable of determining any valuation difficulty of units. Stocks are routinely sold before and after the declaration and later distribution of dividends. Ultimately, if PTPs cannot ensure that their members pay tax where the income is earned, perhaps states should rethink the idea of allowing PTPs to escape taxation at the entity level. The Coalition did assure the hearing officer that there are not many PTPs, so such a move would not have wide ramifications for other pass-through entities.

A number of the Coalition's suggested problems seem illusory. There is no different tax consequence for the resident or nonresident member. Both owe income tax on their income to each state in which that income was earned. Their units are fungible. When either a resident or a nonresident sells a unit, they do not also sell the obligation to pay tax on income already distributed. That remains the obligation of the original unit holder. To the extent that the Coalition suggests that there is a separation between unit holders to whom income is actually distributed and to whom the income is attributed for tax purposes, it is that disjunction that causes any lack of fungibility, not a withholding requirement. Finally, the withholding is required only of income distributed, not capital. Ultimately, the PTP reports each year to the unit holders just what income was distributed to them, allocated among the states in which it did business. If it can make that report, it can withhold the tax.

There does not seem to be any good reason to exclude PTPs from the withholding and composite return provisions.

A number of the comments by the AICPA also lack support. Why should corporate members be excluded? Is there anything in last year's corporate tax scandals that makes one believe corporations are more responsible in paying their taxes than individuals? Withholding *is* only on actual distributions, not "phantom" income. Members *do* have the option of taking every deduction and exemption and tax rate advantage available by filing an individual return. The only difference between the current proposal and the MoSCITA provision is that MoSCITA lacks withholding. That is a crucial part of the proposal.

Perhaps the Commission's purpose is misunderstood. The Proposal's requirement for withholding if the members do not agree to join a composite return is not intended to "punish" anyone. It is not intended, to impose any tax that is not already due. Nor is it intended to make compliance harder. Quite the opposite is true. The Proposal will enable the filing of returns and payment of tax already owed in the overall most convenient way while at the same time ensuring compliance. While it does impose some burden on the entity to file 40 separate tax returns listing the income distributed to each of its nonresident members and multiply that number by the maximum tax rate, that method is hugely more convenient than having *each* taxpayer file a *separate* return in 40 states. The more members the entity has, the greater the convenience of the composite return. Unless the AICPA can persuade the Commission that nonresident members are constitutionally or statutorily not subject to tax, (*International Harvester v. Wisconsin*, 322 U.S. 435 (1944), makes that a tough sell), how can they object to the *most convenient* filing method?

In furtherance of this main purpose of the Compact to promote taxpayer convenience, thresholds to eliminate tax on *de minimis* activity are always a good idea. The AICPA has suggested some that the Commission might consider. The proposal already has one, $1000 in income to a member. Perhaps AICPA's suggestion of a $10,000 entity threshold is also appropriate.

Excluding investment partnerships may be unnecessary. A number of states have ruled that investment partnerships that only buy and sell securities are not "doing business" in the state and therefore the nonresident partners owe income tax in their state of resident. See the recent North Carolina PD-02-1; New Mexico Administrative Code § 3.3.11.14.

The AICPA's question about the constitutionality of imposing tax on nonresident members and the Coalitions acknowledgment that most non-

resident members likely pay tax on their income from pass-through entities to their home state rather than the state in which the income was earned as required by statute only confirm the suspicion that there is currently wholesale noncompliance with state income tax laws by nonresident members of pass-through entities. These arguments hardly persuade your hearing officer that a compliance element in the proposal is unnecessary. Because the compliance measure is also the most convenient and efficient method of filing and paying the tax for the numerous nonresident members to diverse states, your hearing officer recommends proceeding to a Bylaw 7 Survey.

Respectfully submitted January 10, 2003,

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Frank D. Katz

Exhibits Attached to the Report of the Hearing Officer
Regarding the Proposed Recommendation to States
for Enactment of a Uniform Provision Concerning Reporting
Options For Non-Resident Members Of Pass-Through Entities

Exhibit A: Memorandum of Appointment of Hearing Officer

Exhibit B: Notice of Public Hearing.

Exhibit C: Certificate of Loretta King attesting to proper notice of hearing.

Exhibit D. Written Response of the Coalition of Public Traded Partnerships

Exhibit E: Written Response of the American Institute of Certified Public Accountants (AICPA).

Exhibit F: Email from Malcolm Day

Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

Memorandum of Appointment of Hearing Officer

To: Record of the Hearing on Uniformity Provision Concerning Reporting Options For Non-Resident Members Of Pass-Through Entities

From: Dan R. Bucks, Executive Director

Date: October 30, 2002

Re: Appointment of Hearing Officer for Proposal on Uniformity Provision Concerning Reporting Options For Non-Resident Members Of Pass-Through Entities

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The Executive Committee of the Multistate Tax Commission approved at its meeting held October 18, 2002, the conduct of a public hearing on the Uniformity Provision Concerning Reporting Options For Non-Resident Members Of Pass-Through Entities. Pursuant to that action and the Multistate Tax Compact, I hereby appoint Frank D. Katz, Deputy General Counsel, as Hearing Officer for this proposal. I further request that he proceed with the conduct of this hearing.

Dan R. Bucks, Executive Director

EXHIBIT A

NOTICE OF PUBLIC HEARING

Regarding a

UNIFORMITY PROPOSAL CONCERNING REPORTING OPTIONS FOR NON-RESIDENT MEMBERS OF PASS-THROUGH ENTITIES

The MULTISTATE TAX COMMISSION ("MTC") has scheduled a public hearing to obtain comments from interested parties on a proposed recommendation to States for enactment of a uniform provision concerning reporting options for non-resident members of pass-through entities.

The proposal permits pass-through entities to file composite returns reporting and paying tax for electing non-resident members on their distributive share of income from the pass-through entity from in-state sources. Only non-resident members whose entire in-state income will be reported on composite returns may join a composite return. Eligible non-resident members may choose to file an individual return or may join a composite return. If they do join a composite return, they may subsequently file an individual income tax return, if required or desired, and get credit for any tax paid with the composite return. Pass-through entities must withhold tax on income distributed to non-resident members who do not elect to join a composite return, whose distributive income exceeds $1000 and who have not received a ruling from the tax agency exempting them from withholding.

The hearing on this proposal will be held at the time, date and location specified below:

TUESDAY, DECEMBER 17, 2002 AT 8:30 A.M. (EST)

Suite 231
Hall of the States
444 North Capitol Street, N.W.
Washington, D.C.

Public comment is sought on whether the MTC should recommend adoption of the proposal. The full text of the proposal has been provided with this notice. (The proposal and this notice are available on the MTC's website at www.mtc.gov). General comments about the proposal as well as comments regarding the specific language of the provisions are encouraged.

All comments received as part of the hearing process will be set forth in a hearing officer's report that will be submitted to the MTC Executive Committee. The MTC Executive Committee will read what you say and then will consider the proposal for appropriate action. *See* The MTC's Uniformity Recommendation Development Process at step seven, available at www.mtc.gov/uniform/9steps.htm

EXHIBIT B

The hearing officer in this matter is Frank D. Katz. Please submit all questions, comments and correspondence regarding this hearing matter to: Hearing Officer Frank D. Katz, Multistate Tax Commission, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (505) 982 4351, Fax: (505) 982 4379, E-mail: fkatz@mtc.gov

All interested parties are invited to participate in this public hearing. Parties wishing to make formal oral presentations are requested to notify the hearing officers in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged. They may be submitted at any time prior to or on the hearing date or by such later date as may be announced at the closing of the public hearing. Interested parties may participate by telephone. Please contact the hearing officer for specific instructions on how to connect by telephone.

Proposed Statutory Language on Reporting Options for Non-resident Members of Pass-through Entities with Withholding Requirement
(Approved for Public Hearing October 17, 2002)

Section 1. Definitions.

A. "Pass-through entity" means a corporation that for the applicable tax year is treated as an S Corporation under [IRC §1362(a), or State Tax Code §], and a general partnership, limited partnership, limited liability partnership, trust, 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; a member of a limited liability company; or a beneficiary of a trust;

C. "Nonresident" means an individual who is not a resident of or domiciled in the state, a business entity that does not have its commercial domicile in the state, and a trust not organized in the state.

Section 2. Composite Return Authorized.

A. 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 members' pro rata or distributive shares of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

B. A nonresident member whose only source of income within a state is from one or more pass-through entities may elect to be included in a composite return filed pursuant to this section.

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

Section 3. Withholding Required.

A. A pass-through entity shall withhold income tax at the highest tax rate provided in [section x for individuals or section y for corporations or section z for other entities] on the share of income of the entity distributed to each nonresident member and pay the withheld amount in the manner prescribed by the [tax agency]. The pass-through entity shall be liable to the [state] for the payment of the tax required to be withheld under this section and shall not be liable to such member for the amount withheld and paid over in compliance with this section. A member of a pass-through entity that is itself a pass-through entity (a "lower-tier pass-through entity") shall be subject to this same requirement to withhold and pay over income tax on the share of income distributed by the lower-tier pass-through entity to each of its nonresident members. The [tax agency] shall apply tax withheld and paid over by a pass-through entity on distributions to a lower-tier pass-through entity to the withholding required of that lower-tier pass-through entity.

B. A pass-through entity shall, at the time of payment made pursuant to this section, deliver to the department a return upon a form prescribed by the department showing the total amounts paid or credited to its nonresident members, the amount withheld in accordance with this section, and any other information the department may require. A pass-through entity shall furnish to its nonresident member annually, but not later than the fifteenth day of the third month after the end of its taxable year, a record of the amount of tax withheld on behalf of such member on a form prescribed by the department.

C. Notwithstanding subsection A, a pass-through entity is not required to withhold tax for a nonresident member if

(1) the member has a pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State of less than $1,000;

(2) the [tax agency] has determined by regulation, ruling or instruction that the member's income is not subject to withholding; or

(3) the member elects to have the tax due paid as part of the pass-through entity's composite return under Section 2.

Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Frank D. Katz, General Counsel and Hearing Officer for MTC Uniformity Proposal Concerning Reporting Options for Non-resident Members of Pass-through Entities

From: Loretta King, Administrative Assistant

Date: January 6, 2003

Subject: Certification of mailing of "Notice of Public Hearing Regarding a Uniformity Proposal Concerning Reporting Options for Non-resident Members of Pass-through Entities."

In compliance with the Multistate Tax Commission Bylaw 7, the "Notice of Public Hearing Regarding a Uniformity Proposal Concerning Reporting Options for Non-resident Members of Pass-through Entities" was mailed on November 15, 2002, to the names on the mailing lists maintained by the MTC.

EXHIBIT C

Coalition of
Publicly
Traded
Partnerships

Suite 500
805 15th Street, N.W.
Washington, D.C. 20005
(202)-371-9770
Fax (202)-371-6601
www.ptpcoalition.org

COMMENTS ON THE MULTISTATE TAX COMMISSION'S UNIFORMITY PROPOSAL CONCERNING REPORTING OPTIONS FOR NON-RESIDENT MEMBERS OF PASSTHROUGH ENTITIES

December 17, 2002

The Coalition of Publicly Traded Partnerships ("the Coalition") is a trade association representing the interests of publicly traded partnerships ("PTPs"), often known as master limited partnerships or MLPs. PTPs are, quite simply, partnerships the interests in which, known as units, are traded on public exchanges. A typical PTP has millions of units outstanding held by tens of thousands of individual investors. Among all partnerships in the Coalition, there are an average 33 million units outstanding held by an average of roughly 27,000 unitholders. The unitholders of each PTP are scattered among the 50 states and the District of Columbia, and sometimes territories or foreign countries as well.

The Coalition is currently aware of about sixty PTPs, roughly half of which are in the energy industry (petroleum products and coal). The rest are in other natural resources, real estate, mortgage securities, timber, and a sprinkle of other businesses. While some smaller PTPs are limited to one or a few states, the majority are multistate businesses, and some operate in over 40 states.

While PTPs are a relatively small component of the capital markets (their aggregate market capital was around $24 billion at the beginning of 2002), they are an important one, particularly in the energy industry. For energy companies, PTPs are a means of fully realizing the value of cash generating assets such as pipelines and storage terminals, and of raising equity capital to build, acquire, and maintain these facilities and other types of energy infrastructure. They own close to $30 billion in energy-related assets. For investors, they are a liquid, affordable investment that provides a safe and reliable income stream through quarterly cash distributions.

The Coalition has strong concerns with the MTC's recommended provision requiring passthrough entities to report and pay state income tax for their non-resident members. Our message to you today is simple: **Publicly traded partnerships must be exempted from any such provisions.**

This does not mean that the Coalition or its members favor or condone noncompliance with state tax laws. Publicly traded partnerships take seriously their obligation to comply with state and federal tax laws, and to see to it that their investors do the same. Prospectuses for

EXHIBIT D

issues of PTP units advise investors of the state tax consequences, and the tax package that we send to our unitholders every year informs our investors of their tax obligations, if any, in each state in which we operate. Special K-1 Support and investor relations departments are available to assist any investor who does not understand these obligations.

We feel that this effort to inform our partners of their tax obligations and encourage and assist with their compliance should be the full extent of our obligation to the taxing authorities with regard to this matter. Beyond that, and of course, the proper filing of our own returns, the responsibility lies with the individual investor.

Beyond this general objection, there are serious practical reasons and policy grounds for excluding PTPs from the proposed regime:

Paying Taxes for Partners Destroys Fungibility of Units

Our first and most basic objection is that both withholding and composite tax payments are incompatible with a basic necessity for trading a security on the public market: that our publicly traded units be "fungible." Fungibility means that every unit in a class of securities, be it a share of common stock or a common partnership unit, is identical to, and interchangeable with, every other unit in all respects (including tax attributes), so that it makes no difference to any purchaser which particular units are bought. If one imagines the alternative, it is easy to understand why national trading of equity securities would not be practical or possible without this feature.

If a partnership pays the state tax of some partners—those who live outside a particular state—but not others, the units held by the out-of-staters will have different attributes than those held by the state residents. Fungibility will be lost and trading of partnership units will grind to a halt. Nonresident withholding requirements thus would force PTPs to give up their liquidity, and thus their value to investors.

Mismatch of Tax to Income

The second problem with the provision's withholding requirement is that it does not match the withholding to the income being taxed. In fact, the provision's reference to the "share of income distributed to each nonresident member" does not accurately characterize partnership distributions.

While PTP unitholders typically receive a quarterly cash distribution, this is not the same as a corporate dividend and should not be confused with those dividends for tax purposes. A PTP's status as a passthrough entity means that there is no entity-level tax. Income, gain, deductions, losses, and credits are flowed through to the partners, each of whom is allocated a predetermined share of these items and pays tax (after subtracting his share of any credits) on the resulting taxable income. The partner never actually receives this income; it is merely allocated on paper.

The cash distribution actually represents a return of capital, not income. The partner's basis in his partnership interest is reduced by the amount of each distribution, and distributions

are not taxable until the partner's basis reaches zero. While a partnership's income situation may affect the level of cash distributions, they are entirely different items and there is no direct correlation between them. A partner will be liable for tax on his share of partnership income even if he has received no cash distribution; conversely, no matter how large his distribution, if his allocated share of partnership income is a net loss, he will owe no tax. And in fact, many PTPs in any given year will pass through a net loss to their partners, either nationwide or within particular states, at the same time that they are paying substantial distributions.

When the Coalition surveyed several members on the average income earned per unitholder in one particular state last summer, we found that even without taking into account section 743(b) adjustments, which reduce unitholders' taxable income, the amounts were small and in some cases negative.

Withholding tax from partnership distributions is therefore mixing apples with oranges, and would often result in collecting tax from partners who owe none whatsoever. This is true not only because of the mismatch of tax to income, but also because in most cases, even if the partnership passes through net income, by the time partnership income is allocated among all the states in which it operates, and then allocated among all its partners, the per partner amount will be quite small, usually less than the state's personal exemption or standard deduction.

The exemption for partners whose pro rata share of partnership income in the state is less than $1,000 does not really address this situation. For reasons explained below, there is no practical way for a PTP to apply this exemption.

Withholding from distributions is administratively burdensome, and accurate withholding is not possible

Withholding on partnership distributions is at best an enormous administrative burden, and in fact is a requirement that is virtually impossible for PTPs to comply with. This is because, as noted above:

1. PTP units are publicly traded, which means that millions of units will change hands during the reporting period for which withholding is required, and

2. Most PTP units are held in "street name," and the only information that the PTP has on ownership during the course of the year is the name of the broker that is holding them.

Federal law does require brokers to report to publicly traded partnerships specific ownership information on units held in street name, including name and address. However, this information is provided only once a year for the purpose of providing partnerships with the information needed to send K-1s out to their unitholders so that the unitholders can include it in their federal tax returns. As any partnership tax manager can attest, it is an enormous job for the partnerships to process the information sent by brokers and report to partners within the time allotted by law.

The problem this poses for quarterly withholding is evident: By the time the first quarter distribution is paid, the list of unitholders will have changed from the one provided for federal tax reporting purposes, and by each succeeding quarter it will have changed still more. Due to the daily trading of units, the information is somewhat outdated even at the time the partnership receives it. A PTP faced with implementing quarterly distributions therefore has no way of knowing with any degree of accuracy which or even how many units are held by partners to whom the withholding applies. Moreover, because income tax is calculated based on income and loss for an entire year, and withholding is quarterly, the partnership has no real way of knowing at the time it must withhold what will be the amount of income (or loss) attributable to the state for which tax is being withheld.

For the same reason, it will be impossible to know with any accuracy which partners will have a distributive share of income in any particular state that is under the $1,000 threshold, although we believe that the vast majority would. In addition, some of our unitholders are tax-exempt entities which will owe no tax at all. Moreover, even if there were some way to separate out those partners who are below the threshold, withholding for the other unitholders and not for them would raise the same fungibility issue.

The composite return provisions are not a workable alternative

The composite return alternative is not a solution to the many problems posed by a withholding requirement. First and foremost, it poses the same fungibility issues as withholding, as the partnership will have paid tax on behalf of some partners—the electing nonresidents—and not others. Moreover, the partnership will still have to undertake withholding for those partners who do not make the election, not only continuing the problems of withholding, but creating an impossibly complex tangle of electing and non-electing partners for each state. While the partnership is required to report to its partners on tax payments made on their behalf, there is no requirement that individual partners, or the nominees who hold their interests in street name, make a report to the partnership on composite return elections they have filed in any particular state. It is unlikely in the extreme that a partnership with tens of thousands of partners could possibly know this information by the filing deadline set forth in the recommendations.

The cost outweighs the benefits

Even without the concern that these requirements could, if implemented, threaten PTPs and their unitholders with a sudden loss of liquidity, it is difficult to justify imposing this type of burden on PTPs. The costs and burden of compliance with such provisions far outweigh any possible gain in revenue to the states. As discussed earlier, the amount paid by any unitholder once net taxable income has been divided up among all unitholders and apportioned among all the states in which the PTP does business will rarely be a large amount, and in many cases will be under the state threshold for paying tax. Moreover, the state may well be receiving overpayments from residents with PTP income earned in other states who simply pay the state level tax on the entire amount of income in the state of residence rather than apportioning it among states. It could well be that this produces a wash, and that each state in fact gets the revenue it ought to, albeit from different partners than the law technically says it should.

Against all this must be weighed the enormous expense and burden of attempting to comply with a distribution withholding regime, the potential reduction in market value from diminishing the quality—high cash distributions—that make PTPs attractive in the first place, the enormous inaccuracies in withholding that will result, and the fact that withholding from distributions to pay tax on partners' pro rata share of partnership income is mixing apples with oranges. This is an incredibly large imposition in order to address what we believe is a very minimal—and perhaps even nonexistent—revenue loss.

Conclusion

The Coalition and its members understand the fiscal problems that states are facing at a time when the gap between spending needs and revenue sources is looming large for many. PTPs have always made every effort to comply with all federal and state tax provisions with which they are subject, and to give their unitholders the knowledge with which to do the same.

In this case, however, we firmly believe that the burden that would be imposed by these recommended provisions—a burden so serious as to threaten our existence as publicly traded entities—far outweighs any small contribution that our investors could be making to states' revenue problems. Inclusion of PTPs in these provisions would harm a number of companies and tens of thousands of investors without producing any noticeable increase in state revenues—both because we literally do not know how we would be able to comply, and because there is little revenue to be gained from this source in any case.

In short, the uniformity proposal concerning reporting options for non-resident members of pass-through entities should not apply to publicly traded partnerships. Such partnerships can be defined with reference to the federal Internal Revenue Code (section 7704), or simply as any partnership traded on a national exchange.

AICPA

DEC 1

Direct Dial (202) 434-9235
Email: cferguson@aicpa.org

December 11, 2002

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

Dear Mr. Katz:

Attached please find the American Institute of Certified Public Accountant's comments regarding the MTC's uniformity proposal on Reporting Options for Non-Resident Members of Pass-Through Entities which will be considered at your December 17, 2002 hearing. As noted in our comments, the AICPA is in the process of finalizing additional comments on some of the most recent revisions to the proposal. We anticipate the comments will be ready for submission shortly after the hearing date. Meanwhile, we respectfully request that the MTC revisit and consider the issues raised in our submission dated December 11, 2002 which are discussed in greater detail in the AICPA position dated July 22, 2002 (a copy of which is also attached for your reference). We welcome the opportunity to discuss or clarify any of our comments.

Sincerely,

Carol B. Ferguson, CPA
Technical Manager - Tax

EXHIBIT E

AICPA

AICPA Position on the Multistate Tax Commission's Revised Proposed Statutory Language Regarding "Reporting Options for Non-Resident Members of Pass-Through Entities" December 11, 2002

As previously communicated to the Multistate Tax Commission (MTC)[1], the American Institute of Certified Public Accountants (AICPA) supports voluntary, uniform composite return filings for pass-through entities; however, we remain concerned that the MTC's most recent proposal does not appropriately achieve this goal.

We appreciate the MTC modifying its earlier proposal to take into consideration a few of our suggestions, but we note that the MTC disregarded the most important of our suggestions including the following:

- The proposal should not apply to non-individual members;
- An exemption from withholding should exist for non-cash or "phantom" income;
- Net operating losses must be considered in computing composite taxable income;
- When preparing the composite return, use of the highest tax rate without allowance for exemptions, deductions, and NOLs should be optional to the taxpayer, rather than mandatory;
- Exemptions to the withholding requirements should be provided for the various pass-through entities such as: (1) publicly traded-partnerships; (2) entities with more than 1,000 owners; (3) family investment entities; (4) investment entities; (5) entities with less than $10,000 of income attributable to the state; and (6) corporate owners that either currently file state returns or file an agreement to be subject to state income on the income distributed from the pass-through entity[2]; and
- The MTC should develop the composite filing process by starting with the Model S Corporation Income Tax Act (MoSCITA), to which the AICPA and other interested parties have previously provided input and the MTC has endorsed. To do otherwise would provide an inconsistent treatment for the S-Corps when compared to other pass through entities.

We strongly believe that, as proposed, mandatory withholding at the entity level will create undue administrative complexity and result in unfair and unconstitutional taxation of non-residents. As previously communicated, we believe that the MTC's anecdotal information indicating that states are suffering a revenue loss by non-residents who do not file state returns ignores the impact on the revenue of the non-residents' home states.

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[1] See, AICPA Position on the Multistate Tax Commission's Revised Proposed Statutory Language Regarding "Reporting Options for Non-Resident Members of Pass-Through Entities" dated July 22, 2002.

[2] Applies only if the MTC does not adopt the AICPA's suggestion to exempt non-individual members from withholding.

One of the more significant impacts being the home state's credit for taxes paid to another state. Accordingly, if the non-resident member pays the tax in a state other than its home state, the home state's tax revenue from that individual decreases. On an overall net basis, the revenue pick up under this scenario is neutral. We believe that further study of the revenue impact is needed before the MTC advocates the creation of complex administrative burdens on pass-through entities.

The MTC Proposal, which began as a filing options effort, quickly shifted to a withholding requirement in an effort to shift the tax collection burden to pass-through entities. States already have the information needed to pursue non-filers in their taxing jurisdiction, and should make greater use of this information, rather than impose a heavy administrative burden on pass-through entities that would require financial system changes and complex tax payments. If the Proposal is adopted, pass-through entities should be compensated for this new burden in a manner similar to the discounts and allowances currently provided by a few states for administering sales and use taxes. Fixed credit amounts could be established to compensate the entity based on the number of non-resident owners. Alternatively, a credit equal to the direct cost charged to the pass-through entity for the preparation of the composite and withholding-related returns and reports (e.g., the amount of the return preparer's invoice) could be established to compensate the entity. The AICPA would be pleased to assist the MTC in determining the average costs charged for the preparation of such returns.

The AICPA is in the process of finalizing additional comments that will be ready for submission shortly after the hearing on December 17, 2002. Meanwhile, we respectfully request that the Multistate Tax Commission revisit and consider the issues raised here and discussed in detail in the AICPA Position on the Multistate Tax Commission's Revised Proposed Statutory Language Regarding "Reporting Options for Non-Resident Members of Pass-Through Entities," dated July 22, 2002.

AICPA Position on the Multistate Tax Commission's Revised Proposed Statutory Language Regarding "Reporting Options for Non-Resident Members of Pass-Through Entities" July 22, 2002

The American Institute of Certified Public Accountants (AICPA) submits the following comments on the Multistate Tax Commission's (MTC) proposed revised statutory language regarding "Reporting Options for Non-Resident Members of Pass-Through Entities" (the Proposal).

MTC'S OBJECTIVES

According to our understanding, the MTC intends this Proposal to:

- Reduce the cost of collecting tax on non-resident individuals by relieving the related administrative burden for both taxpayers and state tax authorities through a composite filing process;
- Respond to tax practitioner requests to pursue composite filing uniformity among the states; and
- Eliminate a perceived loss of state revenues – based on anecdotal information that taxpayers are engaging in one-time transactions using flow-through entities that allow non-residents to escape state taxation on the transaction's profits or distributions.

After reviewing comments on the first draft of its Proposal, the MTC concluded that mandatory withholding on cash distributions would address these three concerns and issued the current proposal. It is our understanding that the MTC will consider adopting this proposal at its July 28, 2002, meeting in Madison, Wisconsin.

KEY ISSUES

1. The MTC has already reviewed and developed model statutory language related to voluntary, uniform filing requirements in its Model S Corporation Income Tax Act (MoSCITA), to which the AICPA and other interested parties have previously provided input. If the Proposal's objective is administrative ease and uniformity, then it makes sense to begin with the MoSCITA and develop the composite filing process from there.
2. Withholding at the entity level will impose taxes on many non-resident members who either do not have nexus with the state or do not have a net tax liability with the state due to the non-resident member's credits, deductions, or losses from other sources.
3. The Proposal began as a filing options effort and has become more of an entity level tax proposal with withholding requirements. These are distinct issues that deserve to be considered separately.

4. States already have the information needed to pursue non-filers in their taxing jurisdiction, and should make greater use of this information, rather than impose a heavy administrative burden on pass-through entities that would require financial system changes and complex tax payments.
5. The MTC's anecdotal information indicating that states are suffering a revenue loss by non-residents who do not file state returns ignores the impact on the revenue of the non-residents' home states. One of the more significant impacts being the home state's credit for taxes paid to another state. Accordingly, if the non-resident member pays the tax in a state other than its home state, the home state's tax revenue from that individual decreases. On an overall net basis, the revenue pick up under this scenario is neutral. Further study of the revenue impact is needed.

AICPA'S POSITION

The AICPA supports voluntary, uniform composite return filings for pass-through entities, which would benefit taxpayers, tax practitioners, and tax administrators. However, we are concerned that the MTC's current Proposal does not appropriately achieve this goal.

Based on our members' extensive experience in the practical and logistical aspects of flow-through entity compliance with multiple state tax jurisdictions, we believe that composite filing options for pass-through entities must have the following characteristics:

- Composite filing must be elective and voluntary.
- The pass-through entity should not be liable for any taxes as a result of member/owner non-payment of their individual liabilities, and should not be treated as the taxpayer through this type of administrative process.
- The eligibility requirements for taking advantage of composite return filing must emphasize administrative ease and uniformity.
- There must be an exemption from payment of tax attributable to non-cash or "phantom" income.
- Net operating losses must be considered in computing composite taxable income.

The following logistical issues related to composite filing not addressed by this Proposal – should be considered.

- The Proposal shifts a large part of the state's administrative burden to the pass-through entity. If the Proposal is adopted, pass-through entities should be compensated for this new burden in a manner similar to the discounts and allowances currently provided for administering sales and use taxes. Fixed credit amounts could be established to compensate the entity based on the number of non-resident owners included in the composite return. Alternatively, a credit equal to the direct cost charged to the pass-through entity for the preparation of the composite return (e.g., the amount of the return preparer's invoice) could be established to compensate the entity. The AICPA would be pleased to assist the MTC in determining the average costs charged for the preparation of such returns.

- Because non-residents may have other business interests in the state that could offset any income received from the flow-through entity, tax computations on the composite return would result in overpayments. It is unrealistic to expect entities to track each individual's activities within the state and adjust for offsets from other ventures. Other sources of potential overpayment include using the highest marginal rate, lack of uniformity in the tax base, etc.
- The Proposal contains provisions that cannot be adopted through regulation and would require legislative action.

SPECIFIC SECTION COMMENTS AND QUESTIONS

Section 1(B) – We recommend adding optional language clarifying who is a "member." An alternative would be "non-resident individual member." The Proposal should not apply to non-individual members.

Section 1(C) –As currently drafted, the Proposal allows corporations and other business entities to be included in a composite return. As stated above, we believe the proposal should not apply to non-individual members. If left unchanged, we suggest eliminating the phrase "and a business entity that does not have its commercial domicile in the state."

Section 2(A) – Requiring the composite tax to be determined using the highest individual rate without allowance for exemptions, deductions, and NOLs is inappropriate. However, states could allow this method as an option for pass-through entities preferring to compute the tax using a simplified, but more costly method.

Section 2(B) We suggest amending this section to read: "A non-resident member of a pass-through entity whose only source of income within a state is from one or more pass-through entities may elect to have one or more of the pass-through entities on composite returns..."

Section 2(C) – We strongly recommend striking this section because it would allow each state to establish rules and procedures to carry out these provisions. This is counterproductive to the goal of uniformity.

Section 2(D) – Allowing nonresidents to later file individual returns and receive credit for taxes paid on their behalf by the pass-through entity creates administrative difficulties for the entity. There should be at least a requirement that individuals opting out of returns for which they had elected composite treatment must notify the pass-through entity of their change in status.

Section 3 – This section creates enforcement provisions to ensure that all non-participating individuals are actually filing and paying tax. This diminishes the elective nature of the provisions in Sections 1 and 2; is contrary to the overall voluntary nature of this proposal; and, is administratively complex.

Section 3(A) – We recommend that this section be removed, because it has the effect of making the pass-through entity a taxpayer. This section also imposes an unrealistic administrative burden on the pass-through entity, because the entity cannot know whether individuals have losses from other,

unrelated business activities in a particular state and, thus owe no tax to that state. The entity should not be liable for taxes owed by an individual who does not elect to participate in a composite return.

Section 3(General) – At a minimum, exceptions to the consent agreement requirements should be made for:

- Publicly-trade partnerships;
- Pass-through entities with more than 1,000 owners (the proposal is too difficult to administer in such situations);
- Family investment flow-through entities;
- Investment pass-through entities; and
- Pass-through entities with less than $10,000 of income attributable to the state.

SUMMARY

Although the AICPA favors the voluntary, uniform composite filing options as outlined in the Proposal, we believe that mandatory withholding at the entity level will create undue administrative complexity and result in unfair and unconstitutional taxation of non-residents. Instead, we believe that a thorough analysis of the Model S Corporation Income Tax Act aimed at updating and refining that model act would be the most appropriate process to address voluntary, uniform, composite filing options.

From: Malcom Day [malcom@houston.rr.com]
Sent: Thursday, December 12, 2002 3:04 PM
To: fkatz@mtc.gov
Subject: Reporting Options for Non-resident Members of Pass Through Entities

Dear Sir or Madam,
I respectfully request that the Multistate Tax Commission specifically exempt publicly traded partnerships in the proposed language relating to "Reporting Options for Non-resident Members of Pass Through Entities".

Publicly traded partnerships may have hundreds of thousands or even millions of investors who may buy or sell their ownership interests in the partnership daily. It seems to me that it is impractical and maybe impossible for a publicly traded partnership to determine the residency status of each partnership unit owner at every distribution date.

Sincerely,
Malcom Day
Houston, Texas

EXHIBIT F