

STATE AFFAIRS REPORT

Each year the Association embarks on the quest to monitor and mitigate state taxation issues that have the potential to negatively impact its members. The last year was no different. The Association directly engaged in six (6) states, while actively monitoring developments in five (5) others all while reviewing the activities of the majority of legislative bodies who convened in session.

As is the case each year, the issues the Association tackles change and yet remain the same. Composite return and withholding provisions remain the primary focus of the Association's activities. However, this year a number of "firsts" occurred. It was the first year a non-member PTP actually opposed legislative language that would have enacted language consistent with the Association's and the MTC's long-standing position relating to composite returns and withholding. It was also the first year we were approached to intervene in a local taxation issue as well as the first repeal of composite return and withholding requirements by a state – Michigan.

Overall, state budgets remain fairly stable. A number of states are facing deficits due to the downturn in oil and gas activity or continuing spending initiatives. Alaska, Louisiana, North Dakota, Texas, and West Virginia fall into the first category while Illinois remains a prime example of the latter. Also noteworthy is California; for the first time that we can recall, California is actually running a surplus. Montana is another state we will be watching carefully as it is projecting a shortfall of nearly \$2 billion, or nearly 20 percent of the budget.

There are a number of issues we will be monitoring going forward. Potentially the greatest issue, and one that is difficult to quantify at this point, is the adoption of the new partnership audit rules by the states. The impact of the elections on the make-up of legislatures is still undetermined. Voter apathy and general turnout will likely have dramatic impacts this year and have the ability to result in unexpected outcomes. Fewer states are discussing tax overhauls and merely focusing on competitiveness, attracting new business and ensuring "loopholes" are closed.

We continue to thank the membership for their guidance on these issues. The successes of the Association are dependent on this important feedback and we are grateful to have their continued involvement as issues are identified.

Below is an overview of the issues that we tackled during the last year along with updates on the issue status and next steps, as appropriate.

California

We continue to follow up with the Franchise Tax Board (FTB) regarding the treatment of unitholders of master limited partnership structured as LLCs. This issue has been on-going for a number of years due several issues. These include notices issued by the FTB to certain owners of limited liability companies (LLCs) as well as litigation resulting from the treatment of non-resident owners LLC interests by the State of California. The issue at question is whether the non-resident interest owners of an LLC are responsible for the payment of the minimum franchise tax or whether just the LLC itself is liable for such tax.

Representatives of MLPA participated in a call in December with FTB personnel to discuss the ongoing issue with the treatment of non-resident LLCs who own units of a LLC MLP. The call was in an attempt to determine the next steps with respect to filing a request for opinion from the Board that would result in an exemption from the Board's current (and ever changing) position that all LLCs are subject to a minimum franchise tax.

Prior to the call, representatives of the FTB had indicated there was a process that could be potentially be utilized to appeal to the Board to resolve the issue. However, during the call, representatives appear to have changed their position once again. As a result, it may be nearly impossible for any MLP to satisfy the demands of the Board. Their current position is that an LLC must not only have a provision within their member agreement that a unitholder cannot manage or control, directly, or with the potential to in the future, but the agreement must prohibit that provision from being changed in the future.

The FTB requested, and was provided, a complete copy of a partnership agreement from an MLP for the FTB for their review to evaluate whether a provision explicitly states that unitholders do have the ability to control or direct the operations of the PTP.

After reviewing the document, the Board issued the following statement to MLPA and advised us that if formally approached for a private letter ruling on this issue it would be denied on the grounds outlined.

“Because this client is not taxed as a corporation, it is classified as a partnership for tax purposes. It is the position of the Franchise Tax Board that multiple-member LLCs that are classified as partnerships for tax purposes, are subject to the same legal principles applicable to any partnership. In this LLC's operating agreement, the members do not operate the business; instead, the management of the business has been delegated to a board of directors and corporate officers. This type of management structure is often referred to as a “manager-managed” LLC. However, the operating agreement provides a mechanism for the members to amend it. Under Delaware's Limited Liability Act, the default rule is that the members of an LLC have the power to manage the business; however, they have the right

to delegate this power to a manager as they have done here. This means that the members could vote to amend the operating agreement, which, in our view, constitutes the right to participate in the conduct of the business.

As outlined in FTB Legal Ruling 2014-01, the right to participate in the conduct of the business is the basis for the conclusion that partners of a partnership doing business in California are also doing business in California. Thus, because multiple-member LLCs are treated as partnerships for tax purposes, if a multiple-member LLC classified as a partnership for tax purposes is doing business in California under California Revenue and Taxation Code section 23101, the members of the LLC (who are treated as partners of for tax purposes) are themselves doing business in California.”

As a result of this email, MLPA has not taken further steps to clarify the issue. No further unitholders have come forward seeking assistance due to notices and the *Swart Enterprises, Inc. v. California Franchise Tax Board* is still pending.

MLPA has several additional options that it may chose to consider including seeking a legislative change and/or submitting an Amicus Brief in the Swart case. In short, we may get through this without legislation, but it will be a long, slow process.

Louisiana

Louisiana is one of several PTP heavy states that are experiencing significant budget shortfalls. The initial projection was just under \$1 billion for the current cycle and another \$2 billion (approximately) for the next biennium. A special session was held in March to address the situation prior to the normal regular session. Several proposals would have significantly impacted oil and gas operations, and pipelines. However, those all failed to pass or found to be non-germane.

Michigan

Michigan took an action to eliminate its long-standing composite return and withholding requirements. For tax years beginning after July 1, 2016, Michigan will no longer require flow-through entities to withhold at the prescribed rates on the distributive share of taxable income of their individual nonresident members or on the distributive share of business income of members that are corporations or other flow-through entities. For tax years beginning after July 1, 2016, the annual reconciliation return of a flow-through entity that has withheld taxes on distributive shares of business income will no longer be required.

Until July 1, 2016, a flow-through entity was required to withhold income at the prescribed tax rate. For individual nonresident members withholding is on the distributive share of taxable

income and for corporations or other flow-through entity members withholding is on the distributive share of business income.

The legislation also amended the personal income tax definitions of "tax" and "taxpayer" to align with in the flow-through entity withholding changes. Also the legislation now generally uses the phrase "person who receives income subject to withholding" rather than the previous phrase "person that receives a pension or annuity payment, employee, member, or person with winnings or a payoff on a winning ticket subject to withholding". Act 158 ([H.B. 5131](#)), Laws 2015, effective July 1, 2016.

Publicly traded partnerships have enjoyed an exemption from these requirements and remain exempt from the withholding requirements.

Missouri

Late last year, the Association was approached to join a coalition to support tax reform at the local level in St. Louis. The issue is the result of the Wynne case and a challenge to a local income tax on the following, which is currently applied on the following activities that could be interpreted to apply to MLPs:

- Net profits of associations, businesses or other activities conducted by residents;
- Net profits of associations, businesses or other activities conducted in the city by nonresidents;
- Net profits earned by all corporations as the result of work done or services performed or rendered and business or other activities;

The coalition specifically sought support from the Association by providing either testimony or finding a plaintiff to challenge the ordinance.

At this point, the Association has been reluctant to support the effort for two reasons: 1) Missouri is the next priority for seeking legislation to exempt PTPs from the composite return and withholding provision and we do not want to do anything to complicate the matter; and 2) the businessman who has supported these efforts has been somewhat controversial, and while PTPs and their unitholders are impacted, it may be best to let others push the effort.

We would appreciate any feedback the Board or members have with respect to how the Association should approach the issue in the future.

Montana

The Association's activities continued in the great State of Montana over the course of the last year. As you may recall, the Association worked cooperatively with the Department of Revenue to develop an informal waiver process that was established last year to address reporting issues relating to lower-tier partnerships. Legislation was passed during the 2015 legislative session which included provisions to address the concerns of the Association and ultimately codify the informal waiver process.

The DOR proposed pass-through rules to further outline the process and requirements necessary for entities to secure an exemption from the lower tier reporting requirements that were consistent with the discussion with the DOR in late 2015. The Association submitted comments that were supportive of the rule. The Department has since issued the final rules, adopted with one minor change.

Nevada

The State of Nevada passed a new tax, the Commerce Tax, a gross receipts based tax modeled after the Texas Franchise and Ohio Commercial Activities Taxes in 2015. The tax will be imposed annually on any "business entity" whose Nevada gross revenues for the fiscal year exceed \$4 million at a rate ranging from 0.052 to 0.331 percent.

Over the course of the last year, the Department of Taxation held a series of public workshops to discuss the draft rules necessary to implement the tax. The rules were adopted in June of 2016, with the first filing due by taxpayers August 15 of this year.

Those stakeholders objecting to the new tax, including several major industrial groups, trade associations and legislators, sought relief from the tax through a voter-backed petition that would have placed the initiative on the November ballot. Despite an initial court decision approving the measure, the Nevada Supreme Court ruled the initial signatures invalid. Those opposing the tax have dropped efforts – for now – to legally challenge the provisions given the significant hurdle required to re-secure the signatures needed to challenge the provision through voting in November.

North Dakota

The North Dakota Department of Revenue issued reminder notices to at least one MLP that provided information regarding composite return and withholding requirements in early 2016. The notice was unexpected, as PTPs are exempted from the requirement under state law. We believe the notices were sent to a broad range of companies and are not indicative of a larger issue, as no further issues or compliance activity resulted from the notices that we are aware of.

Ohio

The Association was contacted in June of this year regarding legislation in Ohio relating to composite returns and withholding. Ohio was one of the first states to adopt such requirements and currently provides an exemption from composite return and withholding provisions for PTPs. Under the initial proposed draft of S.B. 288, the requirements to file a composite return and withholding would be simplified for most partnerships. However, the proposal would have eliminated the exemption for PTPs.

The Association has been engaged with the Department of Revenue as well as the Senate sponsor and the respective working group on these issues. The Association worked to develop language that would exempt PTPs, and those lower-tier limited liability companies or limited partnerships that are 50 percent owned, directly or indirectly, by the PTP. The language has been accepted by the Department and the Senator's office and has been included in the most current draft of the legislation being reviewed by the working group.

The next meeting of the working group is September 20th. We will continue to work cooperatively with the group as the proposal moves through the process.

Oklahoma

Last fall the Association was contacted regarding an issue involving the withholding of income taxes on royalty payments made to MLPs in Oklahoma. The State has had a statutory provision of this nature for some time. However, the Tax Commission has previously refunded the tax without incident. That has recently changed due to an auditor's position that the funds can only be refunded to the partners and not to the MLP.

In November, the Association met with representatives from the Department on the issue. The meeting was productive and resulted in the impression that the Department would help resolve the issue- whether informally or formally through a rulemaking or legislation.

Legislation was introduced on behalf of the Association in January that sought a short clarifying amendment to exempt producers from withholding on the royalty payments made to PTPs. While the proposal was determined to be insignificant by the Department and many legislators, one key chairman, who had a background in investments, was convinced that a much more significant impact would be incurred to the state budget. This was a deal breaker for any piece of legislation due to the state's financial situation.

The Association held a series of meetings with members to successfully overcome the concerns raised. However, by the time all objections to the legislation were resolved, there was little time and only a few vehicles that could be used to pass the provision. In the end, the bill that would

have been used for our provision had to be used for another, more critical issue. Legislators have committed to resolving the Association's issue during the 2017 session.

Texas

The Texas budget situation continues to be in flux due to the significant impact the downturn in oil and gas activity has had on severance and sales tax collections. The fiscal year closed on August 31, with an official surplus of \$600 million. Sales tax collections were \$1 billion below projections. The only way for the state to now meet FY2017 budget projections is for sales tax collections to grow by 9 percent. This requires a significant uptick in oil and gas activity as it equates to more than 40 percent of the sales tax revenue. If this does not occur, a \$2 billion deficit is projected.

There are several remaining major legal issues that will further impact the state budget that will likely be resolved prior to the next legislative session, including sales tax exemptions and franchise tax calculation issues. These cases could result in significant taxpayer refunds and additional reductions to the state's bottom line, even with the recent Supreme Court rulings in favor of the State on school finance and manufacturing tax exemptions.

The Senate Finance committee held a hearing on several issues relating to the margin tax this spring. The universal opinion is that no one likes the margin (franchise) tax and would prefer something different. At this point, the only tax liked less than the margin tax is the property tax. While everyone would like reform, there will not be money do anything unless there is a known alternative, which there is not. If anything, a phase out may be looked at if certain financial/revenue goals are met.

The House Ways and Means and Appropriations Committees are scheduled to meet on September 15th to discuss a variety of issues relating to property and franchise taxes.

We will monitor the hearing and provide updates as appropriate.

Vermont

The Association has continued to work with members and the Vermont Department of Taxation to resolve changes to the composite return and withholding policy. In late 2014 the Association became aware of a new, informal position being taken by the Department that interpreted a change in statute to provide flexibility so that the existing exemption for PTPs from the requirement could be eliminated. Despite our working with the Department and the legislature to reconfirm the exemption, PTPs continued to receive notices regarding the issue well into last year.

We are pleased to report that we believe the issues have all been resolved in favor of the PTPs.