Pass-Through Entities

Federation of Tax Administrators
2005 Annual Meeting

San Antonio, Texas
June 13, 2005

New York State Department of Taxation and Finance


New York State Capitol Building
Albany, New York

The Audit of
Pass-Through Entities

Nonie Manion
Director of Tax Audits

Audit Evolution

- Prior to current technology audit selection consisted of physically pulling and reviewing returns.
- As the program evolved specific issues were identified enabling Audit to adjust the audit selection criteria.
- Due to new technology and better data identifying non-compliant returns is easier.

Data Warehouse

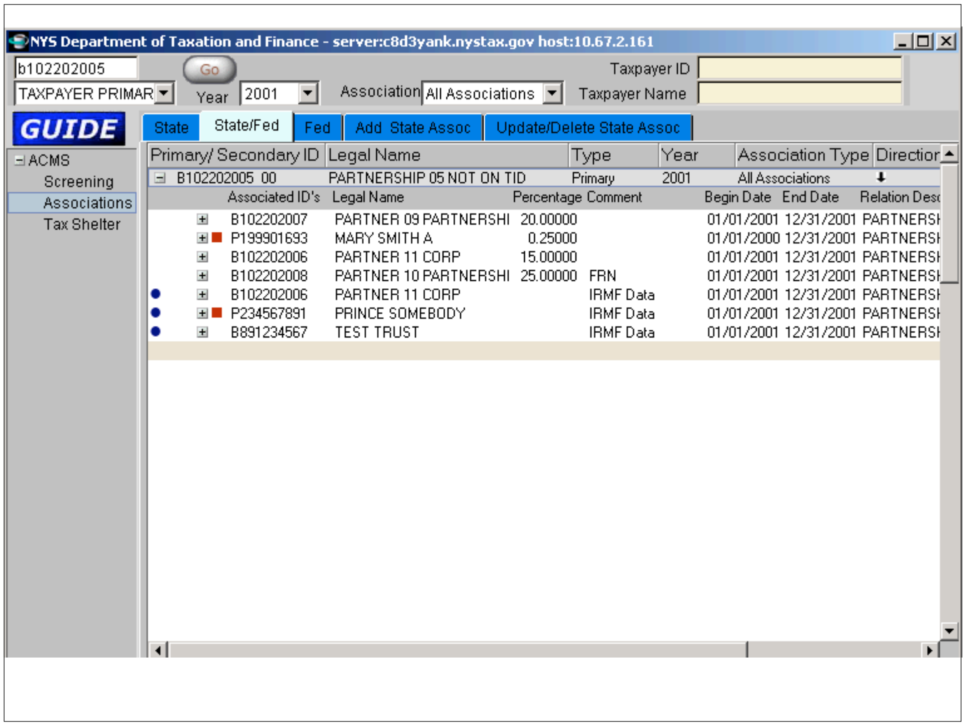
- State Data
- Federal Data
- Third Party Data
- Query Tools

ACMS Screening Application

- Taxpayer Profile
- Audit History
- Assessment History
- Filing History

ACMS Association Application

- Illustrates the relationships between entities and their owners.
- Identifies the responsible parties who should be reporting the income from these flow through entities.
- Includes state and federal association information.



Imaging System

- Most returns filed with the Tax Department are now Imaged and available online.

Multi-State Tax Shelters

Id Number: **123456789 EIN** Name: **ABC Partnership**

Add/Modify Other State Profile

Primary Profile

Primary Data

Type of Entity	**Partnership**	Begin Tax Year Involved	**2004**
Originating Taxing Agency	**NYS**	End Tax Year Involved	**2004**
Promoter Name	**WTEN Corporation**	Contact Name	**Emily Peters**
Promoter State	**NYS**	Contact Phone	**518-457-8765**
Create Date	**4/19/2004**	Last Updated Date	**4/19/2004**

Address Data

Original Address		Current Address	
Street	**12 Main Street**	Street	**450 South Park Avenue**
City	**Latham**	City	**Watervliet**
State/Province	**New York** Zip **12110**	State/Province	**New York** Zip **12189**
Country	**United States**	Country	**United States**

Other State Profiles

State	Address	Contact Name	Contact Phone
NJ	52 South Street, Wildwood, NJ 12345	John Jacobs	518-546-7896

Add

Schemes

Type of Scheme	State Entered By	Created Date
Son of Boss	NYS	4/15/2004

Modify

Impacted States

State	State Entered By	Created By
NYS	NYS	Emily Peters
NJ	NJ	John Jacobs

Modify

Comments

Comments	State	Created By
Taxpayer is moving state to state.	CA	Emily Peters

Add

Multi-State Tax Shelters

View Associations

ID Number 333333333 EIN Association Year 2003 Go Clear

Name The LLC

Associated ↓

Associated ID's	Name	Entity Type	Begin	End	Orig State
999999999	John Jones	Individual	2003	2004	NY
133333333	Taffy Duck	Individual	2003	2004	NY

Associated ↑

Associated ID's	Name	Entity Type	Begin	End	Orig State
123456789	ABC Partnership	Partnership	1999	2004	NY

Multi-State Pass-Through Entity Database (MSPD)

- Modeled after the MSTS and ACMS Association applications.
- Allow states to share data relating to flow through entities.

Chainbridge, Inc.

Use of IRC Section 482
to Combat
Corporate Tax Shelters

Eric Cook
Executive Vice President

The Problem

- Interstate and international companies can manipulate internal pricing (transfer pricing) to minimize state corporate taxes
- Transfer prices should be the same as if unrelated taxpayers had engaged in the same transaction under similar circumstances
- Variety of tax structures are used including both traditional pass-throughs and new forms of pass-throughs

Source of Problem

- Evolution of transfer pricing in accounting firms
- Tax minimization schemes are heavily marketed to major corporations
- Accounting/consulting firms employ over 2,500 transfer pricing professionals
- Consulting revenue for transfer pricing likely over $500 million annually

Nature of Problem

- Delaware/Bermuda/Nevada holding companies
- REITs
- Partnerships and Sub-S
- New forms of pass-throughs – C corporations
- Other methods

Scope of Problem

- Corporate income taxes supplied 10.2 percent of state tax revenue in the states levying them in 1979, but just 6.3 percent in 2000
- Total US loss of state corporate income tax revenue attributable to tax planning was $10.353 billion for FY2001 (MTC estimate)
- Our research – state case study results 3 to 4 times larger than MTC estimate

Tax Policy Issues
Level Playing Field

- Large businesses must remain competitive
- Unequal reduction of tax payments by large businesses versus small businesses
- Small businesses cannot compete by eliminating corporate income taxes through multi-state tax planning
- Policy issues – eliminate corporate income tax or level the playing field

State Responses to Problem

- Legislation – unitary taxation
- Legislation – royalty add-backs
- Legislation – alternative taxation methods
- Litigation – involuntary combined filing
- Litigation – "economic nexus"
- Legislation and litigation – application of IRC Section 482

What is IRC Section 482?

- Allows the Secretary (of the Treasury) to adjust income, deductions, credits, etc. between or among two or more related parties in order to either prevent tax evasion or clearly reflect the income between related parties
- IRC regulations provide explicit methodologies for evaluating the arm's length nature of intercompany prices
- Transfer prices must be the same as if unrelated taxpayers had engaged in the same transaction under similar circumstances
- If not, using 482 states have authority to adjust income, deductions, credits, etc. between or among two or more related parties in order to either prevent tax evasion or clearly reflect the income between related parties

Why Use IRC Section 482?

- Economic approach, not pure accounting approach – not a forced combination
- State case law indicates that involuntary combination or add-back approach is a 50/50 chance in the face of Due Process and Commerce Clause
- Has been used successfully at the federal level for decades
- Technically clean and economic principles are easy to understand

State Issues

- Authority – explicit, language and broad
- Case law
- Combined, consolidated, separate and unitary filing matters
- Probabilities of payment and litigation

How States Are Using IRC Section 482

- As part of the system that includes both monitoring and report generation functions for a state corporate auditing team
- As a tool for generating analyses for specific state tax court cases for a state legal team
- As part of a system that is contemplated for delivery to a state

JOBS for Kentucky
Tax Modernization

Mark Treesh, CPA, CMA – Commissioner
Kentucky Department of Revenue
Finance and Administration Cabinet

JOBS for Kentucky
Tax Modernization

Signed by Governor Fletcher on March 18, 2005
Effective for Corporation Income Tax Periods Beginning On or After January 1, 2005

Goals of JOBS for Kentucky

- Encourage rather than impede the success of business;
- Make changes that are revenue neutral with elements that will spur economic growth in the future; and
- Export some of the tax burden to nonresidents.

Conclusion

- The scope of state corporate tax sheltering is substantial
- If the tax is on the books, as a matter of tax equity large corporations should pay their share
- The states have a great potential revenue gain by collecting tax owed them

Key Components of the JOBS Plan

Corporation Tax Changes

Key Components of the JOBS Plan

- Repeals Corporation License Tax
- Reduces Corporation Income Tax Rate and Expands Brackets
- Updates Internal Revenue Code Reference Date with Some Exceptions

Key Components of the JOBS Plan

- Closes Corporation Tax Loopholes
  - Eliminates Carry Back Provisions of NOLs
  - Requires Nexus Consolidated Filing
  - Limits Yearly NOL Deduction to 50% on Nexus Consolidated Return
  - Requires Disclosure and Establishes Criteria for allowance of "Delaware Holding Company" Deduction
- Requires Three-Factor Apportionment for LLCs and Partnerships

Key Components of the JOBS Plan

- Creates an Alternative Minimum Calculation with taxpayer paying the maximum of;
  - Regular Tax; or
  - AMC Calculation (Lesser of A or B); or
    - A. $0.095 per $100 of gross receipts; or
    - B. $0.75 per $100 of Kentucky gross profits.
  - $175.00 Minimum Tax

AMC Calculation - Example 1

Taxable Net Income Calculation

Taxable Net Income - $10,000,000	$50,000 X 4%	=	$2,000
	50,000 X 5%	=	2,500
	9,900,000 X 7%	=	693,000
			$ **697,500**

Gross Receipts Calculation

Ky. Sales	$100,000,000
X	.00095
	$ 95,000

Gross Profits Calculation

Ky. Sales	$100,000,000
Less Ky. Return & Allowances	- 5,000,000
Less Ky. COGS	- 25,000,000
Ky. Gross Profits	**$70,000,000**
X	.0075
	$ 525,000

AMC is the lesser of $95,000 and $525,000 = $95,000. Total Tax Due is the greater of the tax on net income ($697,500), the AMC ($95,000), or minimum of $175. Tax Due = $697,500.

AMC Calculation - Example 2

Taxable Net Income Calculation

Taxable Net Income = loss of ($120,000)

Gross Receipts Calculation

Ky. Sales	$25,000,000
X	.00095
	$23,750

Gross Profits Calculation

Ky. Sales	$25,000,000
Less Ky. Return & Allowances	- 3,000,000
Less Ky. COGS	- 21,120,000
Ky. Gross Profits	**$ 880,000**
X	.0075
	$ 6,600

AMC is the lesser of $23,750 and $6,600 = $6,600.
Total Tax Due is the greater of the tax on net income ($0), the AMC ($6,600), or minimum of $175. Tax Due = $6,600.

AMC Calculation - Example 3

Taxable Net Income Calculation
Taxable Net Income = loss of ($10,000)

Gross Receipts Calculation

Ky. Sales	$150,000
X	.00095
	$ 143

Gross Profits Calculation

Ky. Sales	$ 150,000
Less Ky. Return & Allowances	- 10,000
Less Ky. COGS	- 40,000
Ky. Gross Profits	**$ 100,000**
X	.0075
	$ 750

AMC is the lesser of $143 and $750 = $143.
Total Tax Due is the greater of the tax on net income ($0), the AMC ($143), or minimum of $175. Tax Due = $175.

Key Components of the JOBS Plan

- Entities that Now Must Pay Corporation Income Tax
  - Multi-Member Limited Liability Companies
  - Single Member Limited Liability Companies
  - Limited Partnerships
  - Limited Liability Partnerships
  - S Corporations
  - Others (REMICs, REITs, and FASITs)

Key Components of the JOBS Plan

Treatment of Individual Owners

- Individual partners, members or shareholders of pass through entities will receive a credit for the tax paid on net income at the entity level based on their distributive share ratio.
- In addition, a refundable credit is provided for individual owners for tax periods ending after January 1, 2005 and before January 1, 2007. The credit is based on the 1% difference between the top corporate rate and the top individual rate.

Issues

- Forms – Partnership or Corporation Rules on Forms?
- Credit For Tax Paid to Kentucky - How Will Others States Treat Kentucky's Entity Taxation on Partners, Shareholders and Members Individual Income Tax Returns?
- Non-Refundable Credit – How Many Individual Taxpayers Will Not Be Able To Fully Utilize the Entity Tax Credit on Their Kentucky Individual Income Tax Returns?

Contacts

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