

MINUTES
SENATE LOCAL GOVERNMENT & TAXATION COMMITTEE

DATE: Wednesday, January 18, 2012
TIME: 3:00 P.M.
PLACE: Room WW53
MEMBERS PRESENT: Chairman Corder, Vice Chairman Johnson, Senators Hill, McKenzie, McGee, Siddoway, Werk, and Bilyeu
ABSENT/ EXCUSED: Senator Hammond

NOTE: The sign-in sheet, testimonies, and other related materials will be retained with the minutes in the committee's office until the end of the session and will then be located on file with the minutes in the Legislative Services Library.

Chairman Corder called the meeting to order at 3:10 pm.

DOCKET NUMBER: 35-0101-1102
Rule 263. Dealing with Guaranteed Payments to Partners. **Chairman Corder** turned the gavel over to **Vice Chairman Johnson**. **Vice Chairman Johnson** introduced **Dan John** of the Idaho State Tax Commission. **Mr. John** said the purpose of the rule was to capture Idaho source income. The rule treats guaranteed payments the way the Tax Commission has handled them in the past. **Mr. John** introduced **Cynthia Adrian** of the Idaho Tax Commission. See Attachments #1-#4.

Ms. Adrian said there are very limited uses for guaranteed payments. There are times when a guaranteed payment is treated as the partner's distribution of ordinary income.

Senator Werk asked if the rule were to be followed, would that change the treatment of the guaranteed payments. **Ms. Adrian** said the rule is the current practice.

Chairman Corder asked if the rule is in compliance with Idaho Statute and IRS code. **Ms. Adrian** replied yes. **Chairman Corder** said if other people have the belief the rule is not in compliance, what should be done. **Ms. Adrian** said the guaranteed payments are Idaho source income, so the taxes should be paid to Idaho. There is a difference of opinion as to whether these are Idaho source income. **Chairman Corder** asked if the Tax Commission more often favors the taxpayer or the Tax Commission. **Ms. Adrian** said she did not know.

Vice Chairman Johnson introduced **Steve Young**, of Holland and Hart. **Mr. Young** spoke in opposition to the rule. See Attachment #5. **Mr. Young** said this may be a clarification in the minds of the Tax Commission, but not in the minds of the taxpayer. The 2005 decision was not precedent; it was related to a company that operated 100% in the state of Idaho. **Mr. Young** said if there is an oil partnership that drills wells and one of the partners is hired to drill the well; he is not paid in his capacity as a partner, but rather as a well-driller. That should be considered a guaranteed payment and only taxed in the state where the work was performed, not split among the states where the company has facilities.

Chairman Corder asked if a person worked in another state doing work for the benefit of Idaho; would that be taxed in Idaho. **Mr. Young** said as a partner, the partnership work is taxed in every state where the company is doing business.

Senator Werk asked in the case of a managing partner, would any additional fee received for managing the partnership be considered a guaranteed payment. **Mr. Young** said it could be. In a prior law firm, there was a set salary for the managing partner as well as a distribution through the partnership. The set salary should be considered a guaranteed payment because the amount is not based on the income of the partnership. The income of the partnership should be used for taxes and not the income of the partner, unless the work was done in Idaho.

Mr. Young said there was a client who was a member of a C Corporation for 35 years. The client was the president of the C Corporation. The business was converted from a C Corporation to an LLC; at that time, the company stayed the same with the exception of the corporate structure and Idaho then taxed the president's salary as a guarantee payment.

Senator Bilyeu said if the Tax Commission has treated guaranteed payments this way in the past, what will be different with the new rule. **Chairman Corder** said people have appealed this treatment in the past.

Vice Chairman Johnson introduced **Mike Lindstrom** of Eide Bailey, LLP, who spoke in opposition of the rule. Mr. Lindstrom said currently, 100% of income for work that is performed in Idaho is taxed in Idaho. This change would cause the taxes to be distributed among all states where the company does business; and Idaho would lose money. There is a very narrow group of people this rule applies to; this rule only applies to non-residents of Idaho.

Vice Chairman Johnson introduced **John McGown** of Hawley Troxell who spoke in opposition to the rule. **Mr. McGown** said there are two systems of taxation in Idaho, one for individuals and one for entities. Under the individual tax structure, if you are a resident, you pay tax on all of the income; but receive a credit for taxes paid to other states for work done in those states. All of the income is reported to Idaho. Entities have apportioned taxes. This case is a mix between guaranteed payments, which are taxed as an individual and partnership income which is a different tax system.

Senator Hill asked if the rule would be contrary to IRS code. **Mr. McGown** said it would be contrary. The rule as proposed says guaranteed payments are not going to be treated as individual income, it will all be treated as entity income.

Vice Chairman Johnson introduced **Chelsea Kidney** of the Idaho Tax Commission. **Ms. Kidney** said federal tax rules are complex. The position of the Tax Commission is that guaranteed payments are not salary. At the federal level, they are treated as ordinary income. The Tax Commission's treatment of guaranteed payments is consistent with the federal government's treatment. Recipients of guaranteed payments do not receive a W-2 or 1099 as they would with a salary.

Senator McKenzie asked if Internal Revenue Code 707(a) is used when the partner is acting in a capacity other than as a partner and IRC 707(c) is used when acting as a partner, then if guaranteed payments are analogous to a salary, should IRC 707(a) be used. The partner is providing service to the partnership when not acting as a partner. **Ms. Kidney** said work that is done by someone who does not need to be a partner in order to do it is covered in 707(a) and guaranteed payments are covered in 707(c).

Senator McKenzie asked what is the difference in policy between a C Corporation and an LLC. **Ms. Kidney** said when a partnership creates a structure, there is a choice of entities to be taxed by.

Senator Hill said guaranteed payments are on a separate line of the K-1 and are not listed as part of the overall partnership income because the IRS wants this source of income treated differently. Is this strictly a state issue or is it also a federal issue. **Ms. Kidney** said it is a federal issue. There are guaranteed payments given that are not for services. **Senator Hill** said we need to be fair and the rules that we make need to be fair. The majority are punished for the behavior of a few and that is done in laws all the time. Most guaranteed payments go out in different portions because one partner performs more services or provides more capital than someone else.

MOTION:

Senator Hill made a motion to reject rule 263-04 of Docket Number 35-0101-1102. **Senator Siddoway** seconded and the motion carried by Voice Vote.

**DOCKET
NUMBER:
35-0101-1102**

Rule 275 relating to Exempting Nonresident Income from a Qualified Investment Partnership. **Ms. Adrian** said that ninety percent (90%) of gross income from investments that produce income that would not be taxable by a non-resident individual if the investment were held by that individual, according to Idaho Statute 63-2036A 3(c).

Mr. Young spoke in opposition to the rule. See Attachment #6. **Mr. Young** said the concept of a Qualified Investment Partnership (QIP) is that a group invests in a stock together rather than individually. Under tax law, the partners of the partnership would only pay tax for the state in which they reside. This encourages people to invest in states other than the ones where they reside. However, according to this rule, if a partnership rather than an individual invests in an Idaho company stock, the members of the partnership need to pay tax in Idaho. Section 63-2036A of Idaho Statute says a QIP must derive at least 90% of its gross income from investments that produce income that would not be taxable to a nonresident individual if the investment were held by that individual.

Senator McKenzie asked what non-investment income is and how it would factor into the 90% rule. **Mr. Young** said non-resident individuals shall not be taxed on investment income from a qualified investment partnership. The tax commission rule introduces the concept of non-investment income of the qualified investment partnership. If you meet the 90% test, then all of your income should qualify. The distributive share of non-investment income of a QIP is included in Idaho Taxable income.

Senator Siddoway said he does not believe that people will not invest in Idaho because they had to file an income tax return. **Mr. Young** said for very wealthy investors, that would probably be the case, but for others who may want to invest, it would be a deterrent. If they did not care, there would be no reason for QIP's.

Mr. John said the rule was not intended to exempt income that was taxable to an individual had they engaged in the transaction on their own. If this rule is rejected, income would be transferred from taxable to nontaxable simply by the form of the entity. If the rule is considered problematic, then the law should be changed from 90% to 100%.

Senator McKenzie said the QIP was not intended for individuals to get together to exempt transactions. **Mr. John** said rejecting the rule doesn't necessarily do that, the statute would have to be changed. If there is a QIP with \$1million in income and \$900,000 of that was from equities, it is still not taxable to investors who are not residents. The \$100,000 invested in a farm would be subject to tax.

MOTION: **Chairman Corder** made a motion to approve rule 275 of Docket 35-0101-1102. **Senator Werk** seconded. **Senator McKenzie** said the policy behind the rule makes sense, but it is inconsistent in the statute with having a 90% standard. The policy question is whether it should be a 90% or 100% exemption. A more rational policy would be to put the statute at 100%; treat QIP's the same as an individual. The motion carried by Voice Vote.

DOCKET NUMBER: 35-0101-1102 Rule 171. Relating to Idaho Capital Gains Deduction-Qualified Property. **Mr. John** said the rule deals with holding periods of distributions of pass-thru entities. The rule makes a distinction between different types of distribution; partial or complete. When you look at the Tax Commission and the IRC sections, this rule is the result you will get. If that is not good policy, then the statute should be changed.

Vice Chairman Johnson introduced **Phil Skinner** of the Idaho Tax Commission. See attachment #7. **Mr. Skinner** said Section 1223 of the Internal Revenue Code should be used to determine holding periods. The holding period for the item that was exchanged for the stake in the partnership would inherit the holding period of the partnership. IRC 1223(1) and 732(b) discuss liquidating distributions and IRC 1223(2) and 732(c) discuss distributions of a regular (non-liquidating) distribution.

Senator Siddoway asked if the liquidation holding period is time or money based. **Mr. Skinner** said it is both; all Idaho statute concentrates on is the holding period. For an Idaho capital gains deduction you need a holding period of 12 months. A non-liquidating distribution is when the partnership remains, some assets are being distributed.

Mr. McGown spoke in opposition to the rule. See Attachment #8. **Mr. McGown** said as an example, there is a partnership with three parcels of land to be liquidated. Distribution of the third parcel taints the other two in the Idaho State tax deduction if the partnership is being liquidated. There is no logic to this. The implications of the rule have not been considered.

Chairman Corder stated the Tax Commission has represented that these changes more accurately reflect the statute, do you agree. **Mr. McGown** replied no, the Tax Commission has strained to make the interpretation they have come up with. There is a case pending before the Board of Tax Appeals with a similar issue.

Mr. Skinner said the Attorney General's office has no opinion regarding these rules. Exchange of property does not include the liquidation of the partnership. If this rule is not adopted, the same result will be implied through the existing rule.

MOTION: **Senator Siddoway** made a motion to accept Rule 171-06B of Docket No.35-0101-1102. **Senator Bilyeu** seconded and the motion carried by Voice Vote.

Vice Chairman Johnson turned the gavel back to **Chairman Corder**.

Chairman Corder said if the same rule that was rejected in the Senate is rejected in the House, the rule will be rejected. If the rule is not rejected in the House, the rule is then not rejected at all.

ADJOURNMENT: The meeting was adjourned at 5:25 pm.

Senator Corder
Chairman

Jo Ann Bujarski
Secretary