



MULTISTATE TAX COMMISSION

# State Partnership Tax Context & Issue Outline

Summarizing the Staff Memo Submitted to the Standing Subcommittee

February 18, 2021

# Consideration and Recommendation

## For Reporting Out to the Uniformity Committee Meeting in April

- Should the Uniformity Committee take up a project and form a work group?
- What should the scope of the project be – what issues to cover?
- What should the approach to the project be – what process makes sense?
- What should the deliverable(s) be?
  - Information/educational sessions of states
  - Detailed survey of existing rules
  - Research paper analyzing the effects of different types of rules
  - White paper summarizing pros and cons of different rules or recommending a best practice
  - General recommendations without a model statute or regulation
  - Model statutes or regulations

# Are there the makings of a uniformity project?



- Interest in the project
- Some existing uniformity
- Issues states have not entirely addressed
- General benefit to taxpayers and administrators



# To Date



## November Meeting

Took up consideration of the partnership project assigned by the Uniformity Committee.

Staff provided overview.

Instructed staff to work on an issue list and survey of the states.



## December Meeting

Staff reported that work on issue list and survey showed there was important background that needed to be summarized



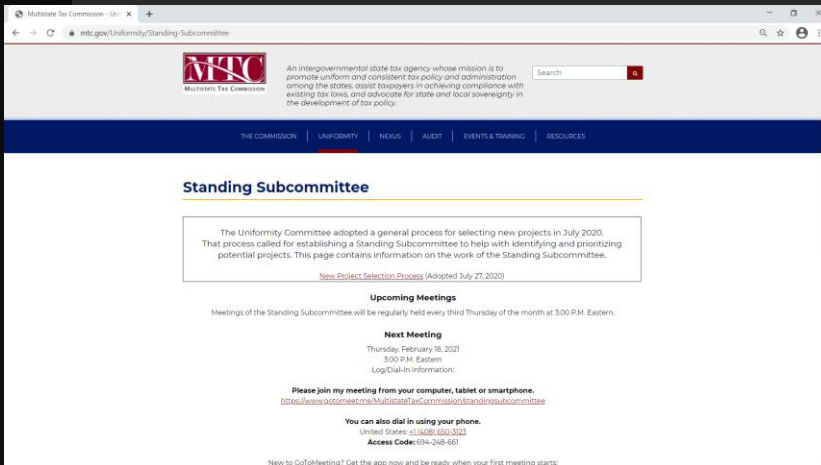
## January Meeting

Staff provided a working draft of a white paper/ issue list.

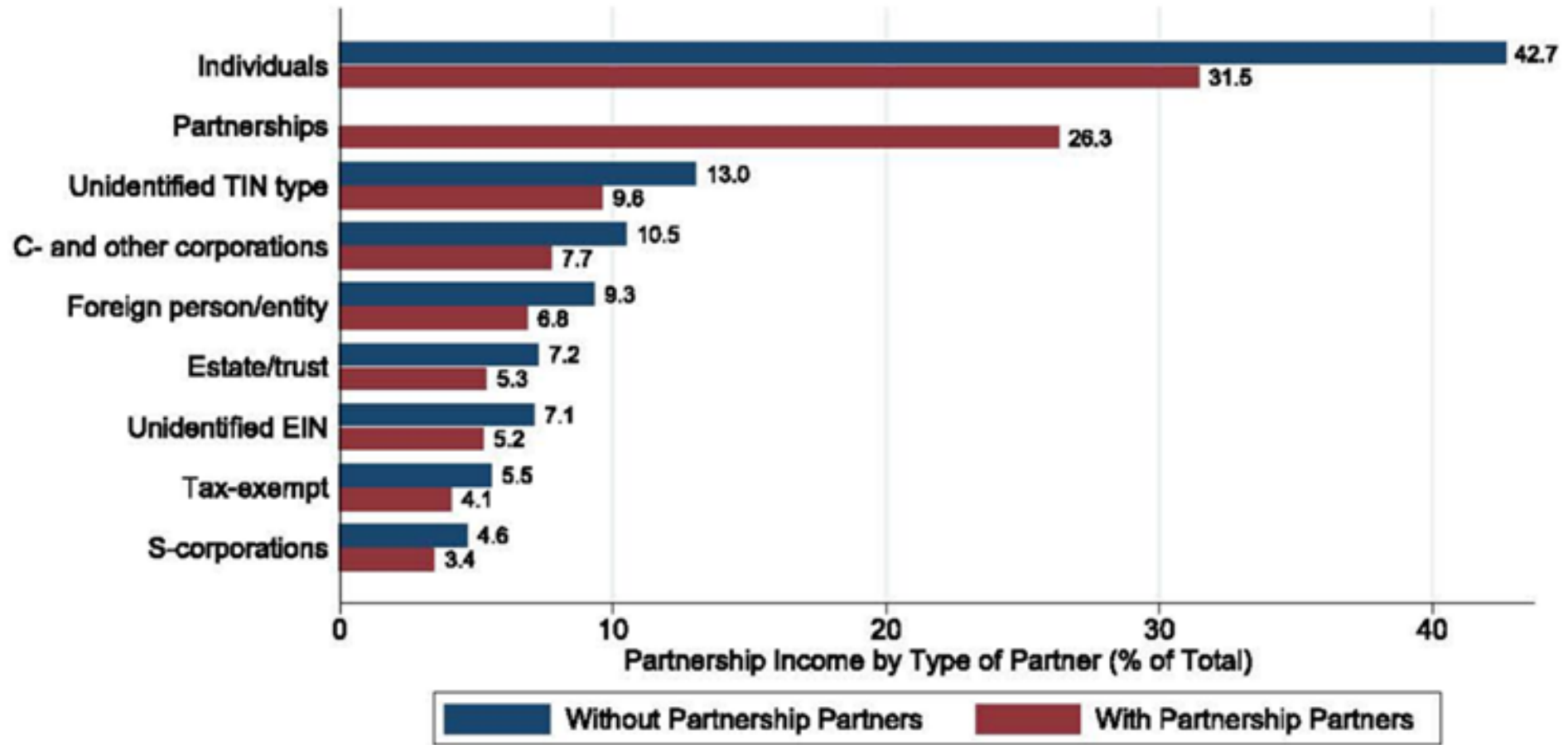
The Subcommittee asked staff to focus on nexus, business/nonbusiness and sourcing issues.



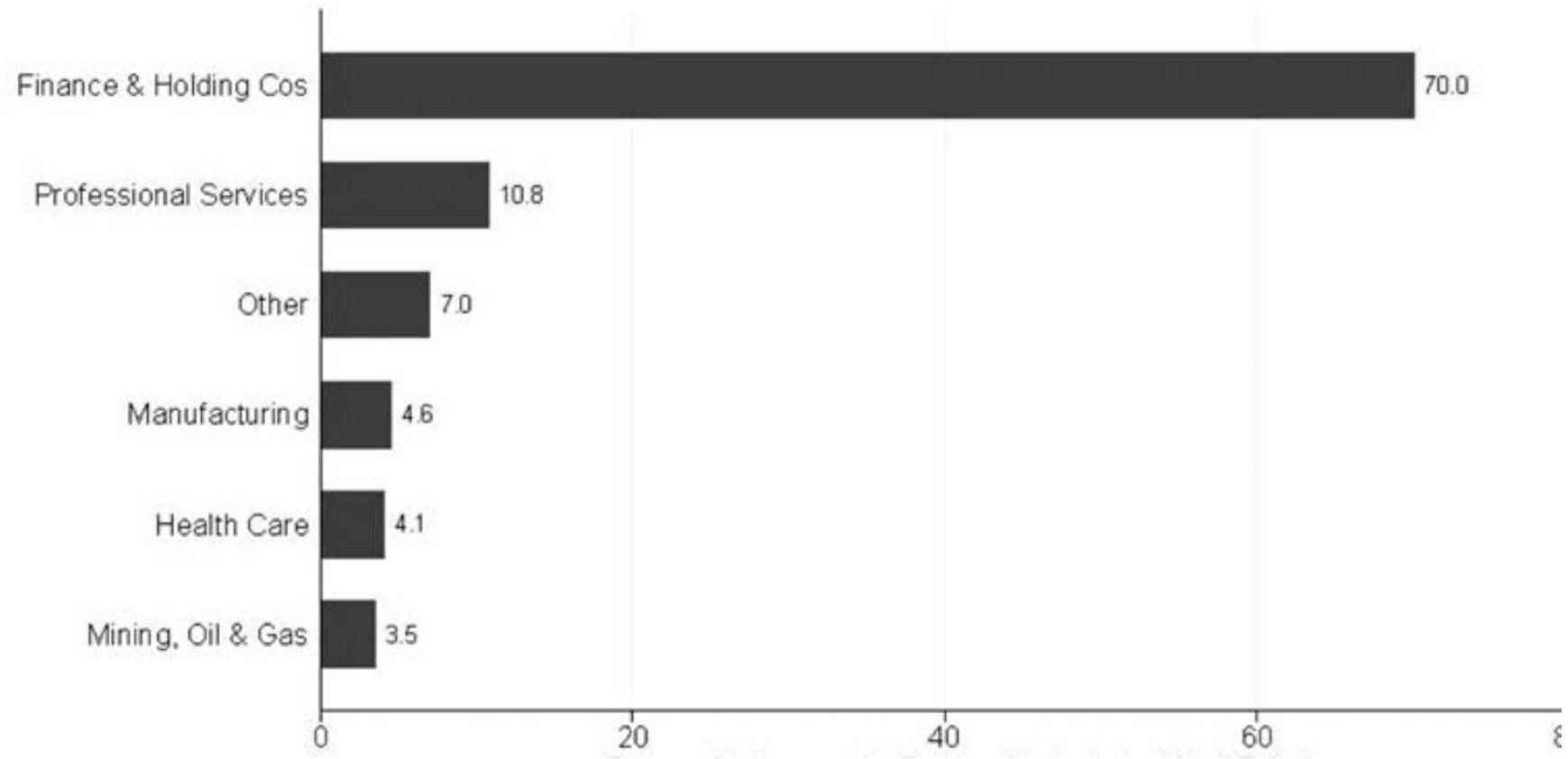
# Today's Staff Report



- A Working Document Update
- Added sections on:
  - Summary of important data on partnerships – p 16
  - Description of a partnership life-cycle – page 24
  - IRC provisions intended to prevent abuse – page 26
- Results from comparing state rules on the issue of taxing current partnership income – pages 29-36
  - Jurisdiction, Nexus, and Exceptions
  - Character of income – business versus nonbusiness or operational versus investment
  - Sourcing and apportionment issues



# Data - Partners



# Data - Sector

- Where states generally agree:
  - States have jurisdiction over partnerships doing business in the state or having other minimum connections with the state.
  - States have nexus to tax partnership income, wherever derived, of resident partners.
  - States have nexus to tax the partnership income of a nonresident or corporate general partner or any direct partner that is active in a partnership that conducts business in the state.

## Jurisdiction, Nexus, and Related Exceptions



# Jurisdiction, Nexus, and Related Exceptions

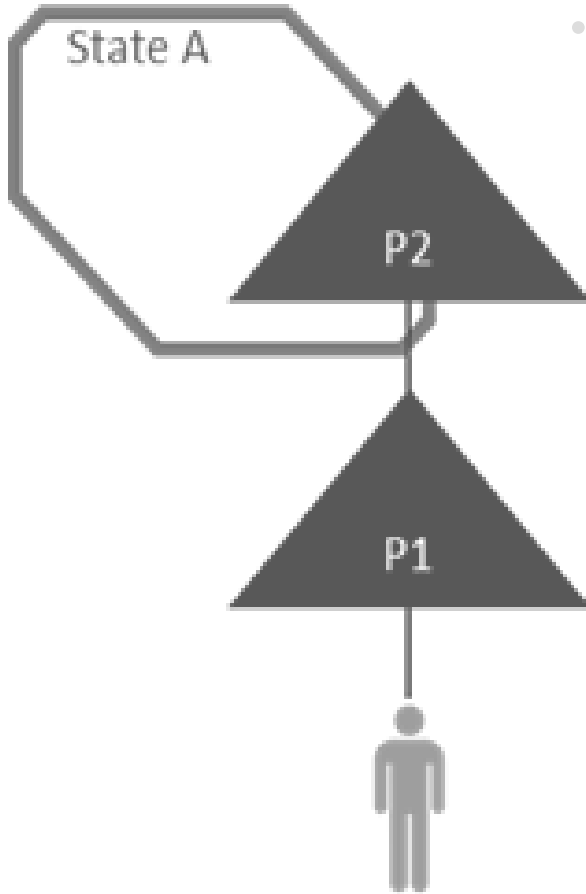
- QUESTION: Do states generally assert jurisdiction to impose reporting requirements on a partnership that does not do business in the state but has a **direct resident partner**?
  - ANSWER: Yes. Most states do this explicitly.
- QUESTION: Do states generally assert jurisdiction to impose reporting requirements on a partnership which does not do business in the state or have any direct partners in the state, but which has an **indirect resident partner** in the state?
  - ANSWER: Yes—it appears so, although a number of states do not do so explicitly.



# Jurisdiction, Nexus, and Related Exceptions

- QUESTION: Do states generally assert nexus to tax a nonresident/nondomiciliary **direct partner** on the partner's share of partnership income derived from the state, assuming this is the partner's only connection to that state, and assuming the partner **is not a general partner or active** in the partnership business?
  - ANSWER: The majority rule appears to be Yes, but the authorities on this question are somewhat split.
  - ANALYSIS: The authorities above appear to focus on limited versus general partners—but it is not necessarily the fact that limited partners have protection from partnership liabilities that matters. Rather, what matters is that limited partners often do not take an active role in the business. See Cal. Franch. Tax Bd., Legal Ruling No. 2014-01 (July 22, 2014).

# Jurisdiction, Nexus, and Related Exceptions



- QUESTION: Do states generally assert nexus to tax a nonresident/nondomiciliary **indirect partner** on the partner's share of partnership income ultimately derived from the state, assuming this is the partner's only connection to that state?
- ANSWER: In general, yes, to the same extent they would assert nexus on direct partners—although the facts and circumstances may matter and the answer in some states may be unclear.

# Jurisdiction, Nexus, and Related Exceptions

- QUESTION: Can states apply factor-presence nexus standards in the context of partnership taxation?
  - ANSWER: Yes – such standards are typically applied at the partnership level. The MTC adopted a model factor presence nexus standard that is applicable to partnerships.

# Jurisdiction, Nexus, and Related Exceptions

- QUESTION: Might states' "doing business" statutes exclude certain partners from tax?
  - ANSWER: This may be the case in some states. See *Swart Enterprises Inc. v. California Franch. Tax Bd.*, 7 Cal. App. 5th 497 (Cal. Ct. App. 2017) – holding that a purely passive corporate member of an LLC do-ing business in the states was not, itself, doing business.

# Jurisdiction, Nexus, and Related Exceptions

- QUESTION: Do states provide specific exceptions for certain partnerships, particularly those engaged in **passive investment activity**?
- ANSWER: A substantial number do for investment-type partnerships, either more broadly or narrowly. The general focus is on identifying partnerships whose activities are investment activities and whose partners are mostly passive.
- NOTE: The effect of these investment-type exceptions is that partnership income is generally sourced to residence/domicile.

# Sourcing of Partnership Income

- QUESTION: Do states look to UDITPA generally to provide sourcing rules for partnership income or tax items?
  - ANSWER: Yes. UDITPA provides that its rules apply to “any taxpayer” and a number of states have adopted UDITPA in some form, including this provision. Others have explicit guidance saying that UDITPA (or that state’s own apportionment and allocation rules which may be based on UDITPA) applies to partnership income generally—or may apply to certain kinds of partnership income.

# Sourcing of Partnership Income

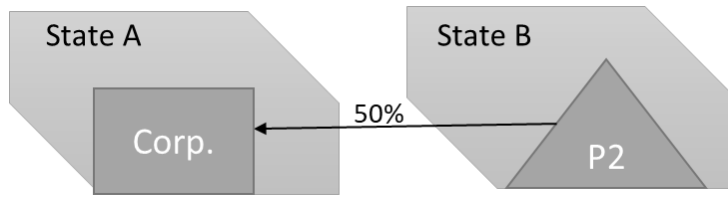
- QUESTION: Do states characterize items of partnership income generally as business/nonbusiness or operational/investment income?
  - ANSWER: Yes, with limited exceptions.
- QUESTION: Do states use the traditional criteria, including UDITPA or other rules adopted for C Corporations, in determining whether items of partnership income are business/nonbusiness or operational/investment income?
  - ANSWER: Yes, although some states may have special rules designating what is investment partnership income (and sourced to residence/domicile) or other partnership-specific rules.



# Sourcing of Partnership Income

- QUESTION: Do states distinguish **guaranteed payments** for different criteria or treatment?
  - ANSWER: Some states provide that guaranteed payments are treated like wages when paid to individual partners, particularly if the partnership is a service partnership and the partners are active in that business. Other states either have not addressed the issue or have addressed it only informally.

# Sourcing of Partnership Income – Example 1



	Income	State A Sales	State B Sales	Total
Corp.	\$1 million	\$8 million	\$0	\$8 million
Partnership	\$1 million	\$0	\$4 million	\$4 million

## Partnership-level apportionment to State B:

Partnership income of \$1 million X 100% State B = \$1 million sourced to State B X 50% =

**\$500K Corporation income sourced to State B**

## Combined apportionment to State B:

Corporation combined income = \$1 million + 50% of \$1 million = \$1.5 million

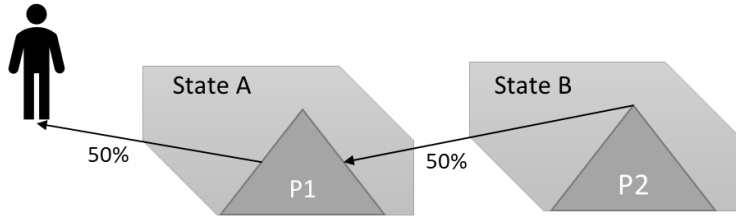
Corporation combined State B sales factor = 50% of \$4 million = \$2 million divided by \$8 million + 50% of \$4 million = 20%

20% combined sales factor X \$1.5 million combined income = **\$750K Corporate income sourced to State B**

# Sourcing of Partnership Income

- QUESTION: For corporate partners that apportion items of partnership income along with other apportionable income, **do states generally combine (“roll up”) a portion of the partnership factors** to include with the corporate partner’s factors?
  - ANSWER: Yes. This is clearly the majority rule among the states that have explicitly addressed the issue. A few states may provide explicitly that the factors may not roll up where the corporation owns a limited/passive/minority interest—but instead—the partnership income would be included in corporate income apportioned using just the corporation’s factors.

# Sourcing of Partnership Income – Example 2



Partnership-level apportionment to State B:

**Smith would have income in State B of \$1 million X 50% X 50% = \$250K**

Combined apportionment to State B:

P1 has combined income of \$1 million + 50% of \$1 million = \$1.5 million

P1 has a combined State B sales factor of 50% of \$4 million = \$2 million divided by \$8 million + \$2 million = 20%

P1 income apportioned to State B = \$1.5 million X 20% = \$750K

**Smith income apportioned to State B = 50% of \$750K = \$375K**

	Income	State A Sales	State B Sales	Total
P1	\$1 million	\$8 million	\$0	\$8 million
P2	\$1 million	\$0	\$4 million	\$4 million

# Sourcing of Partnership Income

- QUESTION: In a **tiered partnership structure**, do states generally combine **partnership factors** from the various tiers when apportioning income?
- ANSWER: Unclear.

# Next Steps

- Cover remaining issues on treatment of partnership income
  - Multi-tier partnership apportionment – further analysis
  - Transfer pricing – especially how related-company transactions may affect sourcing of partnership income
  - Treatment of state adjustments
- Possibly –
  - Compare “investment partnership” definitions
- Draft report and recommendation to the Uniformity Committee