MTC STAFF MEMO: STATE INCOME TAXATION of PARTNERS and PARTNERSHIPS - ISSUES & CONTEXT

DISCUSSION DRAFT

NOTE: "Partnership" and "partner" refer to business entities and their owners subject to IRC Subchapter K (§§ 701-. Specific terms including "general partnership," "limited partner," etc., refer to specific types of entities or their owners.

INTRODUCTION

State partnership tax rules have been described as "underdeveloped." This staff memo outlines issues those rules should address. But first, it discusses the important context that may fill in the answer when those rules are silent.

CONTEXT – NON-TAX FACTORS THAT DETERMINE OUTCOME

The federal partnership tax system was influenced by certain general legal and economic factors specific to partnerships, and those factors may determine the outcome of certain federal tax issues. These same factors, along with federal tax conformity, can also determine the outcome of state tax issues.

1. **Aggregate Versus Entity Theory** –

   Partnerships were first recognized under the common law. Traditionally, they were treated as a collective or aggregate of persons having joint rights. Later, partnerships began to be treated as entities in certain contexts. Both the aggregate and entity theories of partnerships influenced the development of the state statutory law that now governs partnerships. Those theories can also be seen in IRC Subchapter K.

   A. Aggregate Theory – The partners jointly own an undivided interest in the partnership assets, collectively make decisions, and are personally bound by the partnership's actions. Pass-through taxation of partnership income, where each partner recognizes a share of the items making up that income, is an example of the aggregate theory in practice.

   B. Entity Theory – Partnerships own their asset and make decisions, generally through a management structure, which bind the partnership but not the partners personally. Entity theory simplifies the manner in which partnerships can operate and deal with third parties.

   C. Examples Where Courts Looked to Entity Theory –

      (1) *Centex Int'l, Inc. v. Dep't of Revenue*, 750 S.E.2d 65 (2013), holding that a tax credit available to a "corporation" could not be claimed by a corporate partner of a partnership since the partnership was the entity engaged in the acts that qualified for the credit.

      (2) *Bell Atl.* NYNEX *Mobile, Inc. v. Comm'r of Revenue Servs.*, 273 Conn. 240, 242-243, 869 A.2d 611, 613 (2005), holding that a partnership is not a "taxpayer" (even though its partners may be) and therefore cannot claim a tax credit to pass through to its partners.

2. **Economic Substance** –

When partnerships were first recognized under the common law, a partnership's existence was determined from the partners' actions and their objective economic effects. The federal tax rules were developed in this context. Over the years, IRC Subchapter K has continued to seek to match the tax result with the real economic substance of the partners binding economic agreement.

A. Example – "Substantal Economic Effect." IRC § 704(b) requires tax items be allocated to the partners in a way that has substantial economic effect. This means that the allocation must match the partners' real and binding agreement to share in the related economic benefits and costs.

B. Example – IRC § 752 looks to whether partnership liabilities are truly recourse or non-recourse debts when giving partners credit for these liabilities in computing their partnership interest tax basis.

C. Example – Subchapter K has a number of so-called "anti-abuse" rules which set boundaries for when the other statutory rules will apply and prevent abuse of those rules—particularly where the goal is to use a partnership to change the tax result of a transaction or interaction between taxpayers. One anti-abuse rule, referred to as the abuse-of-entity rule, prevents persons from asserting that a partnership exists or that income or transactions are partnership-related when there is no real partnership relationship.

3. **Partnerships Distinguished from Other Persons** –

Partnerships may be treated differently than corporations or individuals under certain legal doctrines. Such distinctions may indirectly affect tax matters.

One important area where partnerships have been distinguished for different treatment involves adjudicatory jurisdiction. Such jurisdiction may affect the ability of states to impose withholding or information reporting requirements.

A. Example – *Carden v. Arkoma Assocs.*, 494 U.S. 185 (1990), holding that federal diversity jurisdiction requires all partners, both general and limited, to be diverse.

B. Example – *Lurie v. 8182 Maryland Assocs.*, 938 P.2d 676 (Mont., 1997), holding that Montana could not assert general jurisdiction over a limited partnership on the basis of a limited partner's residence there.

C. Example – *Waller Marine, Inc. v. Magie*, 463 S.W.3d 614 (Tex. App. Houston [14th Dist.] 2015), holding the presence of a partnership, unrelated to the matter in suit, cannot support specific jurisdiction over a nonresident partner.

D. Example – *Renda v. Peoples Federal Savings & Loan Ass'n*, 538 So.2d 860 (Fla. 1st DCA 1988), holding a court does not have jurisdiction over limited partners, who are analogous to stockholders.

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4. **Authority of State Law** –

NOTE: The model state laws governing partnerships are discussed in more detail later in this memo. Here, we note simply that state tax law provides the critical context for determining what a partnership is, as well as what certain actions or transactions mean, which can also determine the ultimate tax outcome.

A. Generally – Like corporations, partnerships are creatures of state law. State common law or statutory law, therefore, determines the nature, rights, duties, and obligations of partners and partnerships with respect to each other and to third parties. Many states have adopted versions of the Uniform Law Commission (ULC) model statutes governing the creation and treatment of various partnership forms, discussed in more detail later.

B. Influence on Federal Tax Issues – The federal courts recognize that some federal tax issues can only be resolved by looking to the state law governing partnerships, which not only defines partnerships and how they are formed, etc., but may fill in the gaps in partnership agreements.

(1) *Example*: *Fuchs v. Commissioner*, 80 T.C. 506, 512 (1983), holding that the Uniform Partnership Act (adopted generally by the majority of states) determines what events constitute dissolution of a partnership, and therefore determined when a federal tax election could be made by a partner versus the partnership.

(2) *Example*: *Jackson v. Commissioner,* 42 T.C.M. 1413, 1419 (1981), noting that to determine the proper treatment of a transfer of interests in a joint venture, it was necessary to look to California partnership law, and provisions in the law which allowed partner to transfer either full ownership rights or lesser interests and which allowed the partnership to continue even after a partner transferred an ownership interest.

C. Influence on State Tax Issues – As in the case of the application of federal tax rules, states must often refer to state statutes governing partnerships in order to make important state tax determinations.

(1) *Example: Matter of Megson v. New York State Tax Commn.*, 105 A.D.2d 481 (App Div, 3d Dept 1984), rejecting an argument by the taxpayer that his sale of a partnership interest terminated the partnership prior to his becoming a resident in the state and concluding that Subchapter K's rule for when a partnership terminates depended on provisions in the model partnership act adopted by that state and the partner's previous state of residence.

(2) *Example: In re Allcat Claims Serv., LP,* 356 S.W.3d 455 (Tex. 2011), holding that, under the entity theory embodied in the revised uniform partnership act which Texas has adopted, the Texas Franchise Tax does not violate the state constitution's prohibition against taxing the income of individuals because the tax falls on the entity.

(3) *Example*: *Perkins v. Oklahoma Tax Commission*, 428 P.2d 328 (1967), holding, as other states had, that under the uniform model act, a partnership interest is an intangible asset for estate tax purposes.

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5. **Federal Tax Conformity** –

The last factor affecting state partnership taxation is the federal tax law—which is also discussed in more detail in the following sections. Here, we note that the extent to which a state's income tax conforms to the IRC, in general, and Subchapter K, in particular, will provide the answer to many state tax questions.

A. <u>Pass-Through Versus Entity Taxation</u> – There are significant differences between pass-through versus entity taxation of partnerships.

(1) Pass-Through Taxation. Pass-through taxation refers to a system under which owners pay tax on the entity's current income. But this idea is deceptively simple.

(a) General Policy: The policy behind pass-through taxation is that substantive tax rules and partner-specific attributes should apply consistently whether the partner earns or incurs the tax item directly or through the partnership.

(b) Application of Substantive Tax Rules:

(i) The tax rules governing character, value, timing and recognition, and other tax treatment of transactions and activities are applied at entity level and, then, this substantive tax information passes through to the owners.

(ii) Example: Assume a partnership sells an asset. The substantive tax rules apply at the partnership level to determine whether or not there is gain or loss and how much, when any gain must be recognized, and whether it is treated as a short- or long-term capital gain or ordinary income. If, the partnership determines that it must recognize $100 of long-term capital gain in the current year, then the partners will report their share of this $100 as long-term capital gain in the current year.

(c) Application of Partner-Specific Attributes:

(i) The partner's own tax attributes—tax bracket, other taxable income, expense, gain, loss, etc.— will also apply to determine the tax owed.

(ii) Examples: A partner in a lower tax bracket or who has capital losses from other sources may pay less tax on her share of a partnership's capital gain than another partner who is in a higher bracket or has no other offsetting losses.

(2) Entity Taxation. When tax is imposed at the entity level, partner-specific attributes that might affect the tax calculation will be lost.

(a) Partnership Tax In Additional Versus In Lieu: Some states impose an entity-level tax on partnerships in addition to that imposed on partners, but such a tax may also be imposed in lieu of tax on partners.

(b) Tax Imposed in Addition: An entity-level tax imposed in addition to tax on the partners, may be imposed without disturbing the pass-through tax on the partners. The effect, however, will be different than the effect of tax on corporations and shareholders since shareholders do not pay tax until corporate income is distributed.

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(c) Tax Imposed in Lieu: Recently, in response to Congress capping the state and local tax deduction, states have allowed partnerships to elect to be taxed on their income at the entity level, with a credit allocated to the partners for their use against the state tax imposed on their share of that same income.

B. Other Effects of Federal Tax Conformity Generally – In addition to whether a state conforms to pass-through treatment of partnership income, whether a state conforms to federal tax law generally can have direct and indirect effects on state taxation of partnerships.

(1) *Example* – States will likely use the IRC § 761 definition of a partnership, rather than the general state law provision which governs partnerships and is narrower. In limited circumstances, therefore, a joint undertaking might be taxed as a partnership even though it doesn't qualify as a partnership for other purposes under state law.

(2) *Example* – Where a state decouples from the federal treatment of particular items (e.g. depreciation), it may need to require either the partnership or the partners to make the necessary adjustments, to ensure tax will be reported properly by resident partners even if the partnership itself is jurisdictionally remote.

6. **Summary –**

These five main factors – (1) aggregate versus entity theory, (2) economic substance, (3) partnerships distinguished from other persons, (4) authority of state law, and (5) federal tax conformity – may determine or affect the answers to many state tax questions in the partnership area. Aspects of the last two of these factors – state partnership law governing partnership forms and federal tax law – are discussed further below.

PARTNERSHIP FORMS AND STRUCTURES

As noted above, state law controls partnership forms. This section discusses what it means to be a partner, different partnership forms, and affiliated partnership structures. These structures can be extremely complicated. This, in turn, complicates pass-through taxation of partnership income.

1. **State Governing Statutes** –

A. Mandatory Versus Default Rules – States statutes allowing formation of different types of partnerships. These statutes contain *mandatory and default rules*. Mandatory rules provide a basic definition for that form, which entities must fit, or they impose certain rights and duties, which cannot be altered without changing the partnership form. Default rules create a framework where partnership agreements are silent and can be, and often are, altered by the owners through agreement without changing the basic form.

B. Choice of Law – It is the law of the state in which the partnership is created that determines the partners' general rights and duties with respect to the partnership, based on its form, and the partnership's relationship to third parties. The state in which the partnership is created is often called the "jurisdiction of formation."

C. Federal Securities Law is Generally Inapplicable – The federal law regulating securities markets will generally not be applied to partnerships unless that application is explicitly provided for. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

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2. **Inherent Flexibility** –

As compared to corporations, partnership structures provide much more flexibility, allowing owners not only to make differing contributions and have differing roles, but also to share in the partnership benefits and obligations in different ways.

Example – Individuals A, B, and C form a partnership. A contributes real property, B contributes cash and agrees to oversee the rental of that real property, and C agrees to underwrite financing to obtain funds for improvements. A, B, and C may share rents, expenses, gains, losses, and liability for partnership debts in different proportions, relative to their negotiated economic arrangement.

3. **Terms for What it Means to be a Partner** –

Various terms are commonly used to refer to basic rights and duties of partners. Usage of these terms is often informal or imprecise. Below is a summary of the most important terms and how they will be used here.

A. Ownership (Generally) – "Ownership" simply refers to a partner's role in and legal relationship to the entity—the proverbial bundle of rights—as distinguished from other third-parties.

B. Ownership Share, Ownership Interest, or Capital Account – "Ownership share" or "ownership interest" refers to the share of partnership assets a partner would receive from a hypothetical current liquidation. These terms are often mistakenly conflated with control or distributive share. Ownership interest may be represented by the partner's share of the book-value of partnership capital, that is, assets minus liabilities using financial accounting rules.

C. Majority or Minority Partners – A "majority" partner is a partner whose ownership share exceeds 50%. As used here, a "minority" partner is a partner whose ownership share is 50% or less. A partnership may nave no majority partners.

D. Control and "Equal Partners" – "Control" refers to the right of partners over significant partnership actions including significant transactions, changes in the partners, the appointment of managers, etc. Control may be vested in one partner or shared. It is generally represented by voting share, but control is ultimately determined by state law and the agreement of the partners and control arrangements can vary widely. Control is *not* necessarily tied to ownership share. Control over certain specific partnership actions may also vary. Sometimes the term "equal partners" refers to a partnership in which all partners have an equal vote on partnership matters.

E. Management – "Management" as used here refers to the day-to-day oversight and direction of partnership activities. The management of a partnership may be done directly by partners or may be done through appointed managers.

F. Active Versus Passive – Partners who perform the partnership's business activities are generally referred to as "active." A partner may have an active role in the business without having significant control. A partner can also be an active minority partner or a passive majority partner. (Although a limited partner that is "active" may be subject to certain types of liability.)

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G. Limited – The term "limited," when used to refer to partners or partnerships generally refers to protection from liability. A partner can be a majority, controlling, active partner and still have limited liability in some partnership forms.

H. Distributions and Distributional Interest – For both general law and tax purposes, a "distribution" is an actual transfer of assets from the partnership to one or more partners. Partners' shared interest in distributions is referred to in state statutes as the "distributional interest."

I. Distributive Share – In contrast with "distribution," the term "distributive share" is used under Subchapter K, and often generally, to refer to the portion of the partnerships income and expense that will be credited/debited to particular partners' capital accounts, increasing or reducing the partner's ownership share.

> Example: Smith, a partner in Partnership X, is entitled to receive, as a distributive share, 50% of the partnership rental income. In Year 1, the partnership has $100,000 of rental income. Smith has a distributive share of $50,000 in Year 1 even if Smith takes no distribution from Partnership X that year.

J. Partnership Interest – The meaning of "partnership interest" depends on the context. The term most commonly refers to the intangible asset representing the partner's ownership interest *plus* the partner's other ownership rights that are transferrable. Under the ULC model acts, the partnership agreement may limit the extent to which some rights (e.g. control) of a partner can be transferred. But IRC § 705(b) also defines "partnership interest" for purposes of determining whether allocation of partnership items have substantial economic effect.

4. Partners May Act Other than in Their Capacity as Partners

Partners may have relationships with each other or with the partnership that fall outside the partner-partnership relationship. For example, two companies that regularly contract with each other may also form a partnership to do business together. Or, a partner may lend money to a partnership. The ultimate tax result may be different depending on whether the partner is acting as a partner or not. For tax purposes, this determination is based on substance versus form.

5. **Importance of Management, Transferability, Continuity, and Liability –**

Partnership forms vary from corporate forms, and from each other, primarily in terms of their management, the transferability of ownership and continuity of entity, and the liability for partnership debts.

A. Management – Traditionally, general partnerships operated as collectives requiring a majority vote for the partnership to act. At the other extreme, LLCs may appoint a non-owner manager, with all owner-members taking only a passive investment role in the LLC.

B. Ownership Transferability and Continuity – Traditionally, transfer of a partner's interest might cause dissolution or discontinuation of the partnership, triggering other requirements, including tax filing. Today partnership interests may be transferred without affecting continuity.

C. Liability – Traditionally, general partners might be personally liable, or liable jointly and severally, for the debts or partnership obligations. Liability limitations are common now in all partnership forms. Even where the form of partnership may allow for limited liability, partners may separately guarantee the debts of a partnership.

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6. **Different Partnership Forms Under the ULC Model Acts –**

A. Common Forms **–** The Uniform Law Commission (ULC) and many states have recognized different forms of partnerships which include, most importantly:

(1) *General Partnership (GP)* – A traditional form of partnership that provides collective management and no limitation on liability.

(2) *Limited Liability Partnership (LLP)* – A GP that elects to provide limited liability for certain partners that are not active or engaged in partnership management.

(3) *Limited Partnership (LP)* – A non-GP form of partnership that traditionally provided limited liability for all partners not participating in control or management.

(4) *Limited Liability Limited Partnership (LLLP)* – An LP that provides elective limited liability for all partners (including controlling partners).

(5) *Limited Liability Companies (LLC)* – A form of partnership that, like LLLPs, also provides limited liability for all owners ("members") of the company and may provide for management by a non-member.

(6) *Single Member LLC (SMLLC)* – An LLC that has only one member and is disregarded for tax purposes, or may be treated as a corporation if the SMLLC so elects.

(7) *Series LLCs* – An LLC that issues different membership shares to different owner groups reflecting rights in different sets of assets so that each series is treated as a separate LLC for certain purposes.

B. ULC Models – Common Provisions – For every form of partnership, the ULC models typically:

(1) Define the basic requirements to meet the form of partnership.

(2) Define how the partnership is formed and whether filings are required.

(3) Impose certain duties (care, loyalty, etc.) on the partners.

(4) Require the partnership to keep records and to allow a partner to inspect those records.

C. ULC Models - Major Differences –

(1) *Mandatory versus Default Rules.* As noted above, the ULC models commonly provide both mandatory and default rules for the particular forms of partnerships which they govern.

(2) *State Variation.* As with all model acts, states may vary provisions of the ULC model acts when they adopt those acts. Often times, these variations affect which provisions are mandatory and which apply only if the partnership agreement is silent.

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7. ULC Model Acts –

A. General Partnership (GP)

(1) *The ULC Model Act* – The ULC model Uniform Partnership Act establishes rights and duties of partners in a GP. The ULC has amended the act over time, substantially revising it in 1997. See the current version of the model act on the ULC's website, here: https://www.uniformlaws.org/viewdocument/final-act-with-comments-118?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44&tab=librarydocuments). This revised version of the UPA is referred to as the Revised Uniform Partnership Act, or RUPA, last amended in 2013.

(2) *Widespread Adoption.* Prior to revision, almost all states had enacted a version of the UPA. Since the revised act was issued, most states (37 as of today) have adopted that version.

(3) *No Filing*. GPs, unlike all other forms of partnership, can be created without registration or other public filing. GPs also may not be required to qualify in other jurisdictions in order to do business.

(4) *Liability.* All partners have joint and several liability for partnership debts, however, a judgment against the partnership is not a judgment against a partner.

B. Limited Liability Partnerships (LLP)

(1) *Provided for Under the RUPA (see above)* – The ULC model RUPA, which permits formation of GPs, also allows for the partnership to elect to be a limited liability partnerships. See RUPA, Art. 9.

(2) *Liability of Partners may be Limited* – RUPA Sec. 306(c) provides for a corporate-styled liability shield that protects some partners of the GP from personal liability for partnership obligations incurred while a partnership is an LLP.

(3) *Registration and Filing Requirements* – The partnership must register and file annual reports to become an LLP.

(4) *Qualifying to do Business in Other Jurisdictions* – The RUPA has a "doing business" provision that governs when a foreign LLP must register with another state or file annual reports. This rule allows substantial activity in a state before this requirement is triggered and also applies only to the entity—but this lenient standard explicitly does not limit state jurisdiction.

C. Limited Partnerships (LPs) and Limited Liability LPs (LLLPs)

(1) *The ULC Model Act* – The ULC adopted the Uniform Limited Partnership Act (ULPA) in 2001 (last amended 2013). The provisions of this act were previously part of the Uniform Partnership Act, but the ULPA is now a stand-alone act. See the latest version of the model on the ULC's website, here: https://www.uniformlaws.org/viewdocument/final-act-with-comments-108?CommunityKey=d9036976-6c90-4951-ba81-1046c90da035&tab=librarydocuments.

(2) *Widespread Adoption* – About half of the states have adopted the ULPA.

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(3) *Liability Protection at Creation* – Unlike an LLP, an LP is created from the outset in a form that gives all but the general partner(s) limited liability for partnership debts.

(4) *Election for LLLP Status* – The ULPA provides that LPs may also elect to give any general partner who would otherwise have liability a shield against that liability.

(5) *Requirement to Register and File Annual Reports* – As with a GP that elects to be treated as an LLP, a LP, whether or not electing to be an LLLP, must register with the state of formation and must file annual reports.

D. Limited Liability Companies (LLCs) and Single Member LLCs (SMLLCs)

(1) *The ULC and ABA Model Acts*. The ABA first drafted a model act for the formation of LLCs that was adopted by a number of states. The ULC then drafted a model that was closer in form to its other model acts. In 2006, the ULC issued a revised version of this act, referred to as the Revised Limited Liability Company Act (RLLCA). The most recent version of the RLLCA is available on the ULC website, here: https://www.uniformlaws.org/viewdocument/final-act-with-comments-109?CommunityKey=bbea059c-6853-4f45-b69b-7ca2e49cf740&tab=librarydocuments.

(2) *Adoption.* Slightly less than half the states have adopted the ULC version of the model act, although all states have some form of statute allowing the creation of an LLC.

(3) *Reasons for the LLC Form*. LLCs were created to provide for a non-corporate entity, taxed as a partnership, that would not be dissolved with changes in ownership, could be managed by member owners or by a non-member manager, and provided liability protection for all members.

(4) *Filing of a Certificate or Articles*. LLCs cannot be formed without filing a certificate or articles of organization with the state. This filing is much simpler than for forming a typical corporation.

(5) *Operating Agreement*. The organic document for the members of an LLC is called an operating agreement.

(6) *SMLLCs*. An LLC can have a single member. SMLLCs have a particular federal tax treatment, discussed below.

E. Series LLCs

(1) *Emerging Form.* A minority of states allow formation of an LLC that, once formed, may segregate assets and operations so that members have rights and duties only with respect to those assets and operations. Each series will have its own operating agreement under a master operating agreement for the LLC.

(2) *The ULC Model Act.* The ULC model act called the Uniform Protected Series Act, adopted in 2017, is available on the ULC website, here: https://www.uniformlaws.org/viewdocument/final-act-with-comments-121?CommunityKey=11843f3f-6ba5-4010-be96-8c2125fe7d31&tab=librarydocuments.

(3) *Aspects of a Series LLC.* Under the ULC model act, a series LLC:

(a) Segregates identifiable sets of assets owned by the LLC.

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(b) Each segregated group has its own identity, name, right to conduct business, etc. as though it was a stand-alone LLC.

(c) The LLC must keep records for each separate series.

(d) Liability of the series is limited to the assets of that series.

(e) Members of the LLC may have separate rights as members with respect to each series.

(f) A series may have the LLC itself as a member.

8. **Partnership Structures –**

"Partnership "structure" is used here, in contrast to the term "form," to refer to multiple entities that are interrelated, in part, through partnership ownership.

A. Partnership Structure Flexibility Creates Complexity - There is no limit on the size of partnerships or the number of tiers—that is—partnerships which own other partnerships. This allows the creation of large multi-entity structures, often called multi-tiered structures. This general complexity, in turn, creates a number of issues that affect taxation:

(1) *Lack of Transparency.* To quote congressional findings in the Corporate Transparency Act: "Very few States require information about the beneficial owners of the corporations and limited liability companies formed under their laws." This makes determination of the ultimate owners, who may also be the ultimate taxpayers, difficult.

(2) *General Decentralization.* In complicated structures, it may be difficult to determine which entities or partners are acting, or are required to keep records or provide information, or whether those entities or partners have connections to the state.

B. Opportunity for Abuse – Complexity combined with a lack of transparency and decentralization, as well as the pass-through method of taxation, all create opportunities for noncompliance and abuse.

(1) *Noncompliance.* Because partnerships are not taxed at the entity level, there can be partnerships or other passthrough entity tiers between the entity which engages in actions giving rise to tax items, and the person who will ultimately owe tax on those tax items. This makes tracking, identification, and assessment difficult.

(2) *Abusive Tax Strategies.* Historically, partnerships have been used in a number of federal income tax strategies that have been found to amount to tax evasion or unlawful tax shelters. Many of these strategies have been addressed under Subchapter K and other IRC provisions with so-called "anti-abuse" rules.

C. Intercompany Transfer Pricing - Conducting business in large, complex partnership structures will inevitably require recognition, or imputation, and pricing of inter-company transactions to properly determine the tax effects. The related issues are likely to be more pronounced for states since states typically apply allocation and apportionment and determine taxes owed on an entity-by-entity basis.

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IMPORTANT FEDERAL PARTNERSHIP TAX CONCEPTS

This section's purpose is to summarize important federal tax concepts that may affect state partnership taxation. For a more comprehensive discussion of federal partnership rules, we recommend The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships by Laura and Noël Cunnigham.

1. **Terminology –**

   In addition to the terms discussed on page 6, the following terms or concepts, some of which will be discussed at greater length, are used generally in the federal tax context:

   A. Subchapter K – The IRC Subchapter that deals with how partnership tax items, calculated under other IRC provisions, and other partnership-related transactions and activities are treated by the partnership and the partners, and how the accounting and tracking of certain partner information is maintained to ensure that the partners pay tax properly.

   B. Partnership – An entity required to comply with IRC Subchapter K.

   C. Partner – A person who directly or indirectly owns a partnership.

   D. Direct Partner – A direct owner of a partnership.

   E. Indirect Partner – An indirect owner of a partnership.

   F. Tiered Partner – A partnership that owns another partnership.

   G. Tiered Structure – A group of related partnerships where one or more partnerships own interests in one or more partnerships.

   H. Contribution – The transfer(s) of money or assets by a person or a partner to a partnership in exchange for ownership interest.

   I. Distribution – A transfer of money or assets from a partnership to a partner with respect to that partner's ownership interest. A liquidating distribution terminates the partner's ownership.

   J. Tax Item – A separate item of income, expense, gain, or loss that goes into both federal and state calculation of partnership net income, with any state adjustments.

   K. Separately Reported Tax Item – A tax item that, under Subchapter K, may have to be reported to partners separately because the item's character affects the tax calculation in a particular way (e.g. exempt income, capital gains, depreciation expense, etc.).

   L. Outside Basis – The tax basis of a partner's partnership interest, determined under IRC § 722, which takes into account contributions and distributions as well as the partner's distributive share of tax items reported over time.

   M. Inside Basis – The basis in partnership assets and the amount of that basis that may be assigned to particular partners (e.g. contributing partners).

   N. Capital Account – The calculation of the book (financial statement) value of partnership capital (assets minus liabilities) and the amount of that capital that may be properly assigned to particular partners.

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O. Allocation – Unless otherwise indicated, means the partnership's determination of the distributive share of partnership tax items, as reported by the partnership on Schedule K-1s, to one or more partners.

P. Substantial Economic Effect – The standard imposed under IRC § 704(b) that allocations must meet in order to be respected.

Q. Partner's Interest in the Partnership (PIP) – A ratio determined under IRC § 704(b), which takes into account a partner's share of the partnership capital along with other elements and is used to reallocate tax items if the original allocation does not have substantial economic effect.

R. Special Allocation – Any allocation of a distributive share of a partnership item that does not match the partner's interest in the partnership.

S. Guaranteed Payment – A fixed amount allocated to a partner irrespective of the partnership's profit. These payments reduce tax items that may be allocated to other partners.

T. Built-In Gain or Loss – The difference between an asset's fair market value and tax basis at the time of some event—typically at the time of the asset's transfer.

2. **Competing Definitions of a Partnership** –

A. State Law vs. Federal Tax Law – As discussed above, state law defines what a partnership is for general purposes. Federal tax law, however, contains a separate definition of what constitutes a partnership. State tax law typically looks to the federal tax definition to determine what entities will be treated as partnerships.

B. Partnerships vs. Common Ownership or Expense Sharing – Common ownership of property, even income producing property, or agreements to share expenses do not, by themselves, create a partnership for federal tax purposes. For a partnership to exist, there must be a joint profit motive. *See* Treas. Reg. §301.7701-1.

(1) *Impact on tax results.* There are many instances when the tax result under Subchapter K will differ from the tax result if the participants were, instead, treated as mere co-owners of property or sharing expenses.

(a) There are times when it is advantageous for taxpayers to treat an arrangement as a partnership, even if they are not truly engaged in a business or for-profit endeavor. In these case, the IRS may apply an anti-abuse rule, known as the "abuse of entity rule," to disregard the purported partnership. See Treas. Reg. § 1.701-2(e).

(b) At other times, where a partnership does exist, the partnership will have filing responsibilities (including elections) in addition to the tax filing requirements imposed on the participants.

(2) *Check-the-box rules.* In addition to the definition of a partnership in federal regulations, so-called check-the-box rules will also apply. Under these rules, if the entity's shares are publicly traded, it will be treated as a C corporation regardless of its form under state law. All other non-corporate entities will be taxed as partnerships unless they make an election to be taxed as a C corporation. A single-member LLC or similar entity will be disregarded unless it makes the election to be taxed as a C corporation.

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3. **Partnership Record-Keeping, Accounting, & Tax Reporting**

A. Record-Keeping Functions – Under Subchapter K, partnerships must keep records to allow the partnership to properly report information necessary for their partners' tax compliance.

(1) *Partnership Agreement*. The partnership agreement is critical in determining the proper tax treatment under Subchapter K. The partners may have access to records establishing the partnership agreement, but this is not always the case, especially where the partner is a passive, minority, or indirect partner. The partnership must generally have records establishing the partnership agreement, whether or not that agreement is a separate written document or must be filed with the state in which the partnership is created or is doing business.

(2) *Business Records.* Partnerships, like all businesses, must produce and maintain reliable business records to substantiate the nature and amount of transactions and activities. Under state law, partnerships are obligated to provide partners with the ability to inspect records and will generally provide information to partners when necessary. However, a passive or indirect partner may often simply lack the real access to partnership records.

(a) *Note:* Not all records necessary for partners to compute their tax will be maintained by the partnership. Instead, the partners themselves would maintain these records. Examples may include:

(i) Information on a partner's transactions with other partners where the parties maintain that the transaction would not affect the partnership.

(ii) Detailed information on a partner's sale of all or a portion of the partner's interest in the partnership.

(iii) Other information on a partner's separate dealings with third-parties who may also have dealings with the partnership.

(iv) Information on the activity of "tiered partners," that is, partnership partners whose activities indirectly affect the taxes owed by the ultimate taxpayer-partners.

B. Accounting - Accounting, as distinguished from record-keeping, refers properly tracking partner accounts and partnership financial or similar information to ensure that the partners are properly sharing in the economic results of the partnership, per their agreement. Examples include:

(1) *Effect of Contributions and Distributions.* The partnership will keep track of any contributions and distributions made by or to partners and the effect that these contributions and distributions have on the partners' capital accounts.

(2) *Distributive Share of Income and Expense.* The partnership will record the allocation of economic results to the partners, whether or not they have any tax effects. These allocations also affect the partners' capital accounts.

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C. Tax Reporting – Under Subchapter K, the partnership is responsible for additional tracking and maintaining of information necessary for proper tax reporting. This includes:

(1) *Tax Basis Generally.* With some exceptions (e.g. disguised sales) a partnership takes carryover basis in assets contributed by the partners and the partners also take carryover basis in assets distributed. The partnership must track tax basis in any assets acquired by the partnership in order to properly calculate partnership tax items (e.g. gains on the assets sold).

(2) *Tax Capital.* Subchapter K requires that partnerships track partnership capital and partners' capital accounts according to certain rules that may be different than the accounting which partnerships do for financial purposes. The most common difference will be how assets with built-in gains or losses are treated.

(3) *Form 1065 Information:* Each year, the partnership must properly recognize, value, characterize, and report tax items and other information necessary to prepare the federal Form 1065.

(4) *Schedule K-1s*: Each year, the partnership must properly allocate the distributive shares of partnership tax items, as well as guaranteed payments, and report other related information, including capital account balances, to partners on the partners' federal Schedule K-1s.

(5) *Effects of Changes in Ownership*. The partnership must also track and reflect in its tax capital the effects of changes in partnership ownership where those changes require a restatement of certain items.

4. **Note on Tiered Partners**

Although a tiered partner does not have to pay tax, that partner must perform record keeping, accounting, and tax-reporting functions. There are a few things to keep in mind about how tiered partners affect the ultimate tax that maybe reported:

A. Character of Partnership Tax Items Does Not Change – The fact that partnership tax items may pass from a lower-tier partnership through multiple tiered partners to the ultimate taxpayer partner will not generally change the character of the partnership tax items as originally determined by the lower-tier partnership. This can add significant complexity to reporting of tax information.

B. Related Partnership Transactions – Just as with related corporations, related partnerships may have intercompany transactions or other activities that require tax items to be recognized or imputed and valued.

C. Reporting Difficulties – While the amounts reported on Schedule K-1s issued by a tiered partner will depend on the Schedule K-1 that the tiered partner received from the partnership in which it is, in turn, a partner (and any lower tiers), the ultimate taxpayer partners will only receive a Schedule K-1 from a partnership in which they are direct partners. Therefore, the tax-reporting by a tiered partnership structure has to be done in a single tax period, so that taxpayer-partners receive the information they need to file their own tax returns.

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5. **Distributive Share of Partnership Items**

A. Generally – Under IRC § 704(b) and related regulations, partners may agree to vary the distributive share of partnership items that will be allocated. This creates the necessary flexibility to properly reflect the true economic agreement between the partners. However, this flexibility also creates the potential for abuse. Many of Subchapter K's anti-abuse rules are focused on ensuring that allocations of partnership items have economic substance.

(1) *Different Tax Items May be Allocated Differently.* This has been said before, but it cannot be stressed too much. Partners often agree to share in specific items of partnership income, expense, gain, or loss in different ways. So that one item of income might be shared by the partners equally, for example, while another item of income might be allocated entirely to one partner. This will often not be apparent on the face of the partner's tax return—especially the return of a corporate partner.

(2) *Limits on Special Allocations.* To the extent that the allocation of a partnership item does not match the share of the partner's interst in the partnership (PIP), the item is generally referred to as a special allocation and is subject to limitations and anti-abuse rules.

(3) *Substantial Economic Effect.* The most important limit on special allocations is that they must have substantial economic effect. While this standard is defined, in detail, by IRS regulations under IRC § 704(b), it is primarily focused on the partners' real and binding agreement to share in the economic benefits and obligations of the partnership.

(a) The Problem: The problem with the idea of substantial economic effect as a standard is that it looks to the ultimate division of economic benefits and obligations among the partners—where these benefits and obligations may not be actually realized by the partners for years.

(b) The Solution: In order to determine what the substantial economic effect of the allocations may ultimately be, in the present, the federal regulations rely on evidence of a binding agreement among the partners to credit partnership items to particular partners so that the effect will be represented properly in the partners' capital accounts and so that the partners' ultimate financial interests are determined by these capital accounts.

(4) *Other Anti-Abuse Rules.* The substantial economic effect standard may, in some cases, not be sufficient to eliminate all forms of abuse. Therefore, Subchapter K and IRS regulations set out other limits on special allocations that may apply.

B. Significance for State Partnership Taxation – States will generally rely on the IRS to enforce federal tax rules with which the states conform. But in 2015, Congress recognized that the IRS has been unable to effectively audit large partnerships and provided the IRS with additional authority. This development may meant that partnership tax compliance will receive new attention by taxpayer-partners and practitioners—and this will put pressure on state tax rules, as well.

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6. **Differences in Partners Affect Ultimate Tax Paid** –

Various types of persons may be partners, including individuals and married couples, corporations taxed either as C or S corporations, trusts, estates, tax-exempt entities, and other partnerships. Under federal tax law, each may be taxed somewhat differently on their partnership income, which can affect the total tax paid on that income. For example, under TCJA, some non-corporate partners can deduct 20% of qualified business income from partnerships.

In addition to federal tax differences between types of partners, this section also summarizes the general state tax differences.

A. Individuals –

(1) *Federal Tax.* The tax rules for individuals and corporations vary. Partnerships generally determine the treatment of their tax items under the general substantive rules for unincorporated businesses—which would apply, as well, to sole proprietorships. Individuals who are married couples may each be partners and they may file a joint return or may file separately.

(2) *State Tax.*

(a) Residents generally pay tax on 100% of their income to their state of residence and take a credit for taxes paid to other states.

(b) Nonresidents generally pay tax on a source basis—meaning that they may pay tax to a state based on where that income is earned or where underlying assets have a situs. In the case of partnership items recognized by individual partners, most states will require the allocation and apportionment of these items at the partnership level, including the use of partnership apportionment factors.

B. C Corporations –

(1) *Federal Tax.* C corporations are taxed at the entity level, including some partnerships that elect to be treated as corporations or are publicly traded. The IRC applies different substantive tax rules (including Subchapter C) to corporations rather than those that apply to individuals or non-corporate businesses. These different rules may affect the corporate partner's treatment of some partnership items.

(2) *State Tax.* States that conform to the federal substantive rules will conform to the treatment of partnership income for corporations as well. States must also fairly apportion the income of C corporations taxed at the entity level.

C. Trusts and Estates – Most trusts and estates are taxed under the general rules for individuals but some may not be taxed on income that they currently distribute. Instead, the beneficiary of will report and pay tax on that income.

D. Tax-Exempt Entities – Partners may also be entities that are exempt from federal or state income taxes.

E. S Corporations – If a state conforms to IRC Subchapter S, the income of entities electing to be taxed under this Subchapter will not be subject to entity-level taxation but will pass through to the owners. Electing S

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corporations must conform to certain strict structural and ownership requirements which limit multi-tiered structures and require shareholders share tax items on a pro-rata basis. The issues that affect partnership partners also affect S corporations generally and are discussed in F, below.

F. Other Partnerships – Like S corporation partners, a partnership partner will not pay tax on partnership items allocated to it, but will re-allocate those items to its owners. Unlike S corporations themselves, partnerships may have partners that are other partnerships or pass-through entities. So a partnership partner may have income which it allocates, in turn, through additional tiers of partnership-partners.

(1) *Federal Tax.* Assuming the partnership-partner is not a taxable entity under federal law, the income received from lower-tier partnerships will be re-allocated to the partners of the upper tiers until that income is, finally, allocated to taxable or tax-exempt partners. The items retain their tax characteristics and values through this process.

(2) *State Tax.* Partnership partners raise two significant questions for state purposes. The first is how inter-company transactions will be treated. The second, and related question, is how a partnership's tax items will be fairly apportioned to the state.

(a) Example: Partnership A operates 100% in State X. Partnership A is owned, in part, by Partnership B, which operates 100% outside State X. Partnership B is owned, in part, by Individual. How should Individual determine the portion of partnership income from Partnership A taxable in State X?

7. **Categories of Partnership-Related Tax Items –**

In addition to differences in how different types of partners may be taxed, and the effect of partnership-partners on the tax ultimately owed, there are certain significant categories of items arising from partnership ownership that affect the tax owed by partners:

A. Shares of Partnership Tax Items – A partner must report the share of the partnership tax items allocated to the partner for the tax year as reported on the Schedule K-1.

(1) *Individual, Trust, or Estate Partners* – The partnership tax items allocated to individuals, trusts, or estates are taken into account in the partner's tax return under the general rules for individuals having income from an unincorporated business, as if they were earned or incurred directly by the partner. Partnership losses are generally deductible as if incurred directly by the partner, but their use may be limited by outside basis in the partnership, at-risk rules, and passive loss limitations. Unused losses are generally subject to carryover.

(2) *Corporate Partners* – The partnership tax items allocated to corporations are taken into account in the partner's tax return under the general rules for corporations, as if they were earned or incurred directly by the partner. Partnership losses are generally deductible as if incurred directly by the partner, but their use may be limited by outside basis, at-risk rules, and, to the extent they apply, passive loss limitations. Unused losses are generally subject to carryover.

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(3) *NOTE on State Decoupling* – When states decouple from the computation of a tax item, then the state adjustment must either be reflected in the state partnership return and state K-1s, or the adjustment must be made directly by the partner's on their own returns. Some adjustments, particularly depreciation, create differences in tax-basis for state purposes and differences in gains and losses that might be reported for federal versus state tax.

B. Distributions in Excess of Basis – While partnership distributions are generally not taxable, distributions in excess of the partner's outside basis will be taxed as gains.

C. Transactions of Partners with Each Other or the Partnership – If partners are determined to be engaging in separate transactions with each other or the partnership, this will affect the tax owed. For example, while contributions generally do not trigger recognition of gain, a contribution of property by one partner which is later distributed to another partner will be treated as a "disguised sale." Or, for example, a partner who lends money to the partnership may have taxable interest income rather than a tax-free partnership distribution.

D. Sale/Purchase of Partnership Interests – The sale or purchase of a partnership interest often effects only the parties to the partnership, and not the partnership itself. But this is not always the case. Sometimes partnership assets have substantial built-in gains or losses. In that case, presumably, the amount paid for the partnership interest should reflect these differences.

While a discussion of the particular rules is beyond the scope of this summary, suffice it to say that when a partnership has assets that have substantial built-in gains or losses, the partnership may, or in some cases must, track a portion of those gains and losses that should accrue to the period before the transfer of the partnership interest and then make adjustments to the allocation of inside basis among the partners so that future income, gains or losses recognized will be properly attributed to the remaining partners versus the incoming partner.

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WORKING DRAFT – ISSUE OUTLINE

This issue outline draws on the information in the preceding sections as well as preliminary research into existing state rules to identify state partnership tax issues that may need to be addressed. This issue outline generally assumes states follow the pass-through approach to taxation of partnership income. The way in which the issues are captured here is subject to change as the outline is developed.

Issues Related to Taxing Partnership Income/Items

1. Nexus/jurisdiction – generally.

   General Assumptions –

   - *States have nexus and jurisdiction over a partnership doing business in the state or having other minimum connections with the state.*
   - *States have nexus and jurisdiction to tax partnership income, wherever derived, of resident/domiciliary partners.*

   A. Jurisdiction over a partnership through a direct resident partner.

      (1) Does a state have jurisdiction to require information reporting from a partnership whose only connection with the state is a resident direct partner? (Example: Can State X require Partnership ABC to file a state information return if ABC's only connection to State X is a single partner resident in State X.)

         (a) Does it matter what type of partner the resident partner is (minority/majority, general/limited, active/passive)?

   B. Jurisdiction over a tiered partner through an indirect resident partner.

      (1) Does a state have jurisdiction to require information reporting from a partnership whose only connection with the state is a resident indirect partner? (Example: Can State X require Partnership ABC to file a state information return if ABC's only connection to State X is a tiered-partner, Partnership DEF, which, in turn, has a single partner resident in State X.)

         (a) Does it matter what type of partner the resident partner is (minority/majority, general/limited, active/passive)?

   C. Nexus over a direct nonresident/nondomiciliary partner of a partnership deriving income in the state.

      (1) Does a state have jurisdiction to tax a nonresident/nondomiciliary direct partner on the partner's share of partnership income derived from (e.g. allocated or apportioned to) the state, assuming this is the partner's only connection to that state? (Example: Can State X require Smith, a nonresident, to pay tax on Smith's share of partnership income derived from the state where this is Smith's only connection to State X?)

         (a) Does it matter if the person is an individual, corporation, or other entity?

         (b) Does it matter what kind of direct partner the person is (minority/majority, general/limited, active/passive)?

   D. Nexus over an indirect partner nonresident/nondomiciliary partner of a partnership deriving income in the state.

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(1) Does a state have jurisdiction to tax a nonresident/nondomiciliary indirect partner on the partner's share of partnership income ultimately derived from (e.g. allocated or apportioned to) the state, assuming this is the partner's only connection to that state? (Example: Assume Smith is a partner in Partnership A which, in turn, is a partner in Partnership B, which operates partially in State X. Also assume that Smith and Partnership A have no other connection with State X than Partnership B. Can State X require Smith, a nonresident, to pay tax on Smith's share of partnership income derived indirection from Partnership B, through Partnership A?)

(a) Does it matter if the person is an individual, corporation, or other entity?

(b) Does it matter what kind of partner the person is in the partnership in which the partner owns a direct interest (minority/majority, general/limited, active/passive)?

2. Business/Nonbusiness (Operational/Investment) Income

A. Pass-Through Income – Direct Partners

(1) If income or some other partnership item is determined to be business or operational income (and apportionable) or nonbusiness or investment income (and allocable) in the hands of the partnership, does the income or other item retain that character when it passes through to the direct partner? (Example: Partnership ABC properly determines that a gain from the sale of an investment is nonbusiness income and allocates that gain, properly, to State X. Should the direct partners of Partnership ABC report their share of that gain as sourced to State X?)

(a) Does the answer depend on whether the partner is majority/minority, general/limited, or active/passive?

B. Pass-Through Income – Indirect Partners

(1) If income or some other partnership item is determined to be business or operational income (and apportionable) or nonbusiness or investment income (and allocable) in the hands of the partnership, does the income or other item retain that character when it passes through one or more tiered partners to indirect taxpayer-partners? (Example: Partnership ABC properly determines that a gain from the sale of an investment is nonbusiness income and allocates that gain, properly, to State X. Assume Smith is a partner in Partnership DEF, which is a partner in Partnership ABC. Should Smith report her share of that gain as sourced to State X?)

(a) Does the answer depend on whether the partner is majority/minority, general/limited, or active/passive?

3. Formulary Apportionment and Other Sourcing

A. What is the proper approach to apportioning partnership income, generally?

(a) Apportion at the level of the partnership that recognizes the tax item using that partnership's factors,

(b) Apportion at the top level in a tiered structure using the top tier entity's factors,

(c) Apportion at the partner level using the partner's factors, or

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(d) Roll-up a portion of the factors from the entity that recognizes the item and include those factors in the partner's factors?

(2) Does it matter whether the taxpayer-partner which is going to pay tax on the apportioned partnership income is a C corporation or a nonresident individual?

(3) How should nonbusiness income be allocated?

(a) Based on facts at the level of the partnership that recognizes the tax item,

(b) Based on facts at the top level in a tiered structure, or

(c) Based on facts at the taxpayer-partner level?

4. Combination of Unitary Operations

A. When, if ever, is it proper to determine state-sourced income or items of a group of related pass-through entities by combining all or a portion of their operations or factors?

(1) When tiered partners act entirely or primarily as holding companies?

(2) When there is 100% common ownership, directly or indirectly, by a single taxpayer-partner?

(3) When there is 100% common ownership, directly or indirectly, by a discrete group of taxpayer-partners?

(4) When the ultimate taxpayer-partners are all C corporations?

(5) When necessary to avoid income-shifting through related-entity transactions?

(6) Other?

5. State Adjustments

A. Should adjustments required to be made to federal tax items under state law be reported by the partnership which recognized the item, or the taxpayer-partner, or both?

B. If state adjustments require the separate tracking of partnership-level tax attributes, particularly basis in partnership assets, can partners rely on information available to determine that adjusted basis.

C. If state adjustments require the separate tracking of partner-level tax attributes (e.g. outside basis, partners' capital accounts, etc.) for state tax purposes, how does this affect partners who may have sourced income to the state as residents or non-residents over the relevant period.

Issues Related to Taxing Sales of Partnership Interests

6. Sourcing of Gain/Loss on Partnership Interest

A. Does it matter if the gain/loss is "business" or "operational" income in the hands of the partner?

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B. Does it matter whether the partner is a nonresident individual or corporation?

C. Does it matter whether the partner sold a direct partnership interest or was allocated a share of the gain/loss through a tiered partners?

D. Does it matter the partner is a majority/minority, general/limited, or active/passive partner?

Administration and Other

7. Credits for Tax Paid

A. How should the credit be determined?

(1) Based on actual tax paid?

(2) Based on apportioned share of income at the resident effective rate?

(3) Other?

B. Should credits be given for foreign taxes paid, and if so, to what extent?

8. Information Reporting

A. What types of state-level information reports are necessary to ensure compliance with rules?

(1) Do the application of the rules vary depending on whether the partnership files a composite return?

(2) Do the application of the rules vary by size of the partnership?

B. How are partnerships audited and should states consider a centralized audit regime, similar to the federal regime recently adopted?

9. Other

A. Given the complexity of partnership taxation, should some sort of entity level tax in lieu of pass-through tax on the partners be applied?

(1) How would such a tax function?

(2) Should the tax be elective?

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