

MTC PROJECT – STATE TAXATION OF PARTNERSHIPS

ISSUE OUTLINE

Current as of January 12, 2023.

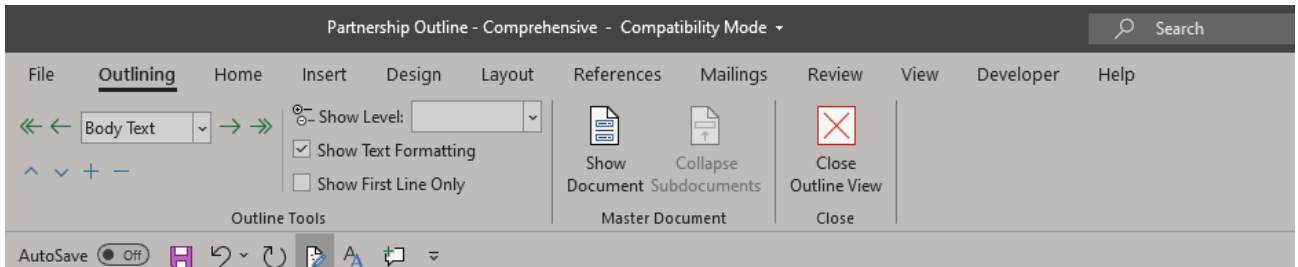
With substantive changes and additions to Section 2.3. and other substantive changes highlighted.

This issue outline is a working draft and is subject to change.

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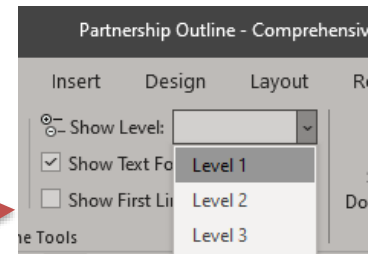
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Introduction

Most states conform to the federal partnership tax system set out in IRC Subchapter K. That system differs from the corporate tax system in three important ways.

- Partnerships are taxed on a pass-through basis. That means information essential to tax-reporting is split between the entity and its owners.
- Partners have economic flexibility that corporate shareholders generally lack—to share partnership items in proportions that differ from other items and from their ownership interests. Subchapter K allows this flexibility as well.
- Partnership income is taxed once—generally when earned. Partnership distributions (and gains from sales of partnership interests) are excluded from tax to the extent amounts received represent income already taxed.

The Reason for and Problem with the Federal Passthrough Tax System

By passing through the partnership's tax items to the partners in a way that attempts to match their tax effect with their true economic effect, the federal partnership tax system attempts to ensure that conducting activities through a partnership form will not alter the tax that would result if the partners conducted those same activities directly. And partnership tax items can have significantly different effects on the federal tax owed by different partners—especially given the substantial differences in federal tax rates.

But these same attributes of the federal partnership tax system—especially flexibility needed to match diverse economic agreements—open the door to strategies that artificially shift, defer, or lower partners' taxes. Subchapter K, therefore, has a number of anti-abuse rules as well as proxies for tracking and testing whether the tax matches the true economic results. Consequently, the federal pass-through system has “a well-earned reputation as one of the most complex areas of the tax law.”¹

The Problem Affects States as Well

States that follow the federal system must rely on the Internal Revenue Service to ensure partnership income is properly reported. But the IRS has been unable to audit large partnerships and is just now implementing its new centralized partnership audit regime. The same attributes of the federal partnership tax system may be used to artificially shift, defer, or lower *state* taxes in ways that do not change federal tax liability—and will not, therefore, be addressed by this new federal audit regime. These issues fall to the states to handle.

Need for Clear Administrable Rules

This project is the result of a general recognition that there are gaps in existing state partnership tax rules. Filling these gaps will require wrestling with the complexity in the current system. It may also be that what works in theory is not practical or will not suffice to address all potential for abuse.

Skeptics have sometimes expressed doubts that specific rules, alone, will improve the system and may, instead, simply create additional complexity or may bind the states to a particular position that, in certain complex circumstances, leads to an inequitable or unintended result. Given the struggles of the federal government with similar problems, this appears to be a reasonable concern. Therefore, it will likely also be necessary to consider tools like information reporting, record-keeping, and centralized audits as well as anti-abuse rules.

¹ The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 6th, Laura E. Cunningham and Noël B. Cunningham. This outline relies heavily on this basic guide as well as other explanatory materials.

Current State Approaches to Taxation of Partnership Income

Most states tax partnership income in three different ways, depending on circumstances and other rules:

1. At the partner level, on a pass-through basis, sourcing income entirely to the residence or domicile of partners;
2. At the partner level, on a pass-through basis, sourcing income using apportionment or specific sourcing for corporate and nonresident partners and a hybrid system for resident partners;
3. At the entity level, applying sourcing on a hybrid approach, with or without offsets for partners.

Method 1 is the method most states use for income of investment partnerships (covered in more fully in a separate white paper). Method 2 is the method generally used for operating partnerships. Method 3 is now being used for so-called PTE taxes or SALT-cap workarounds.

Types of Gaps in State Partnership Tax Rules

The gaps in state partnership tax rules fall into two broad categories:

- **Lack of Details**: Most of the gaps represent a lack of detailed guidance on specific issues or particular facts and circumstances where general provisions may not be sufficient. For example, should built-in gains on contributed property be apportioned at the partnership level, or sourced differently, given the gain accrued prior to the contribution to the partnership? Or should the rules for sourcing guaranteed payments be different than for distributive shares of partnership income?
- **Fundamental Gaps**: Other gaps represent more fundamental questions, including constitutional issues, which may only be fully addressed through the courts. Where such issues have been raised, different courts may have applied different reasoning or come to different results. For example, if a partnership has no other connection to a state than a resident, indirect limited partner, does the state have authority to compel that partnership to keep records and file information returns? And if a partnership does business in the state, does that state have jurisdiction over a nonresident indirect limited partner?

Approach to the Project

The project work group has outlined a general approach to the project:

1. Identify and generally describe a comprehensive list of potential issues.
2. Note the important relationships between those issues.
3. Select a particular issue and develop generally recommended practices or positions.
4. Repeat step 3 until all major issues have been addressed and reconcile any differences.
5. Agree on overall set of recommended practices/positions for all issues.
6. Begin creating draft models, etc., to carry out the recommended practices/positions.

Steps one and two above are summarized in this Issue Outline.

The partnership work group may consider the following (or other similar criteria):

- What states are currently doing, or any position taken on an issue, both majority and minority rules, to the extent the issue is addressed;
- What the federal or international approach may be to analogous issues;
- How the issue would be treated in other contexts (e.g. proprietorships, corporations, etc.);
- Whether the approach to the issue is administrable or enforceable; and
- Expressed policy reasons for different approaches to the issues.

ISSUE OUTLINE

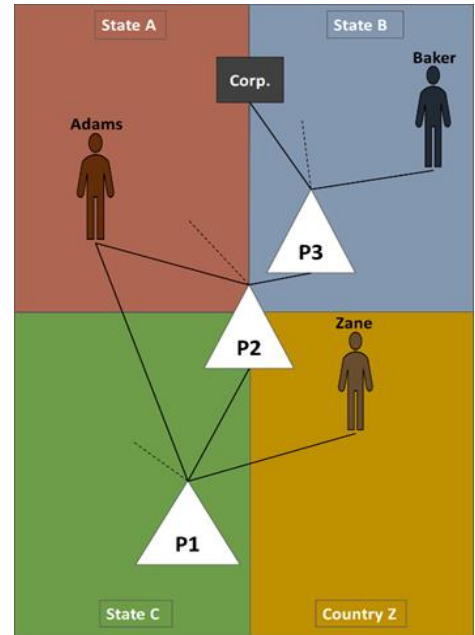
The general structure of this outline is as follows:

- Terminology
- Taxation of Partnership Income and Items
- Taxation of Gain (Loss) from Sale of Partnership Interest
- Administrative and Enforcement

The diagram here depicts limited portions of partnership structures and relationships that will be referred to in the outline.

Note on Corporate Versus Individual Partners

States may tax partnership income to corporate and individual partners in somewhat different ways. Therefore, this outline may divide certain general substantive issues between these two main categories of taxpayer partners and cover each separately.



1. General Terminology

NOTE: While the use of these terms varies, this outline will use the following terms as defined here. Unless otherwise noted, terms not defined will have the same general meaning as under IRC Subchapter K.

1.1. Terms Describing Partnerships

1.1.1. Partnership

Any entity that is taxed under IRC Subchapter K including general partnerships, limited partnerships, limited liability partnerships, and limited liability companies (LLCs).

1.1.2. Investment Partnership

A general term referring to a partnership that is primarily or exclusively engaged in investing the funds of the partnership in other entities. The term may also be specifically defined by statute or other rule.

1.1.3. Operating Partnership

A partnership other than an investment partnership. This term is generally used in the context of discussing the treatment of investment partnerships.

1.1.4. Lower-Tier and Upper-Tier Partnerships

“Lower-tier partnership” will refer to a particular partnership in which a tiered partner holds an interest, and “upper-tier partnership” will refer to that tiered partner. [Diagram – P1 is a lower-tier partnership and P3 is an upper-tier partnership. P2 is both.]

1.1.5. K-1 Partnership

The particular partnership that provided the K-1 to the partner—that is, the partnership in which the partner directly owns a partnership interest—whether or not some portion of the items allocated to the partner on the K-1 consist of items from lower-tier partnerships.

1.1.6. Recognizing Partnership

The particular partnership that recognized the tax item (e.g. income, expense, gain, loss, etc.) in the first instance—whether or not that tax item is then passed through tiered partners prior to being subject to tax by one or more indirect taxpayer partners.

1.2. Terms Describing Partners

1.2.1. Partner

Persons who hold interests, directly or indirectly, in partnerships, including members of LLCs.

1.2.2. Corporate Partner

A partner taxed under IRC Subchapter C.

1.2.3. Individual Partner

Unless otherwise noted, a partner taxed as an individual under state law, including taxing on a residency basis. This may include trusts and estates.

1.2.4. Resident and Nonresident Partners

An individual partner that is resident, or not resident, in the state for tax purposes.

1.2.5. Direct and Indirect Partners

A direct partner holds an interest in a particular partnership whereas an indirect partner holds an interest in a tiered partner. [Diagram – Adams is a direct partner in P2 and Baker is an indirect partner in P1.]

1.2.6. Active and Passive Partners

Any partner who takes a role in carrying out the business of the partnership beyond merely investing in the partnership, is an active partner, even if the partner lacks the authority to bind the partnership. A passive partner's role is limited to providing funding to the partnership.

1.2.7. General Partner (GP) or Managing Member (MM)

A partner or LLC member who has general authority for management of the partnership or LLC, whether or not they have any general liability for partnership debts.

1.2.8. Limited Partner

Any type of partner who does not have general liability for partnership debts.

1.2.9. Majority Partner

A partner that has, directly or indirectly, a controlling ownership interest or voting rights in a partnership, applying general attribution rules. Note that due to the nature of partnerships and their dependence upon the agreement of partners as to how they will be managed and controlled, it is possible for a partner to have rights that amount to a majority economic interest, but for that same partner to lack the ability to exercise majority control.

1.2.10. Minority Partner

Any partner other than a majority partner.

1.2.11. Taxpayer Partner

A direct or indirect partner that is subject to tax on a particular partnership's income.

1.2.12. Tiered Partner

A partnership or pass-through entity that is, itself, a partner in a particular partnership. [Diagram – P2 and P3 are tiered partners.]

1.3. Other Terms

1.3.1. Pass-through Entity

Any entity that is not subject to tax, including partnerships, Subchapter S corporations, and certain trusts.

1.3.2. Pass-through Taxation

The general method used under IRC Subchapter K (as well as Subchapter S) where the elements of the income tax calculation—or partnership items—are determined at the partnership level and then passed through to partners who pay the tax on those items.

1.3.3. Allocate/Allocation

Determination by the partnership of the distributive share of partnership items for particular partners. For example—partnership A *allocates* 50% of its income to Partner Smith.

IMPORTANT NOTE: This term is also commonly used in discussing certain types of state sourcing rules—as in the income is *allocated* entirely to domicile. To avoid confusion, this outline will use the term “specific sourcing” to refer to this method of sourcing.

1.3.4. Information-Reporting Requirements

Information-reporting requirements generally include the filing of partnership returns (1065's) and partner information reports (Schedule K-1s). For state purposes, this information would also include information necessary to make state adjustments to income items, properly characterize income as business/nonbusiness, and information for sourcing income or items.

1.3.5. Partnership Return (1065)

The federal or state return filed by the partnership in which it characterizes and determines the value of the items of income, expense, gain, and loss (etc.) and reports other related information necessary for taxpayer partners to determine the federal or state taxes owed.

1.3.6. Schedule K-1 (or K-1)

The federal or state information report provided by the partnership to the direct partners reporting their shares of partnership items and other information necessary for taxpayer partners to determine the federal or state taxes owed.

1.3.7. Source and Income Sourcing

Determining the partnership income or items, or share of those items, that are taxable in a state—using residency/domicile, situs, or apportionment, including UDITPA or other general state methods.

1.3.8. Formulary Apportionment or Apportionment

Determining the share of multistate income or items subject to tax in a particular state using the ratio of general business factors related to the income that are located in that state.

1.3.9. Specific Sourcing

Determining the share of multistate income or items subject to tax in a particular state using a method other than formulary apportionment—including assignment to the location of the property from which the income is derived or assignment to the domicile of a business.

1.3.10. Situs

The location of property for tax or other purposes.

1.3.11. Partnership or Entity Sourcing

Determining the share of multistate partnership income or items subject to tax in a particular state using only the information of the recognizing partnership, including apportionment factors or information for specific sourcing of items.

1.3.12. Blended Sourcing

Determining the share of multistate partnership income or items subject to tax in a particular state using information, including apportionment factors or information for specific sourcing of items, of both the recognizing partnership and the partner.

1.3.13. Partner Sourcing

Determining the share of multistate partnership income or items subject to tax in a particular state using information, including apportionment factors or information for specific sourcing of items, solely of the partner. Partner sourcing may use residence or domicile of the partner or the location where the partner is acting.

2. Taxation of Partnership Income and Items

2.1. Jurisdiction and Nexus Issues

This section 2.1 addresses jurisdiction over the partnership to require recordkeeping and reporting as well as nexus to tax the partnership income to the partners.

2.1.1. Jurisdiction/Nexus Over Partnerships Doing Business in the State

2.1.1.1. States may assert jurisdiction to impose reporting requirements on, and nexus to tax income of, partnerships doing business in the state.

It is a generally accepted principle that states have jurisdiction to require a partnership that is doing business in the state to comply with tax recordkeeping and information reporting requirements and also have nexus to tax the income earned by the partnership.

2.1.2. Jurisdiction to Require Reporting by Partnerships Not Doing Business in the State

The pass-through tax system relies on the entity to maintain and report information both to taxpayer partners and to the state, enabling proper calculation of state tax. This tax-related information includes not only information necessary to source income (e.g. apportionment information), but also any information necessary to adjust the federal tax base for state purposes—including any add-back adjustments for intercompany transactions that may apply. As a result states may need to assert jurisdiction over a partnership on the basis of resident partners—who are taxed on 100% of their income, wherever earned.

2.1.2.1. States impose reporting requirements on partnerships not doing business in the state if they have a direct partner in the state.

States generally assert authority to require a partnership to comply with tax recordkeeping and information reporting requirements even if the partnership is not doing business in the state, provided the partnership has a direct partner resident or doing business in the state. This primarily affects the ability of resident or corporate partners to obtain information necessary to properly calculate the state tax base (e.g. where the state requires adjustments to the federal tax base).

2.1.2.2. Question – May a state impose reporting requirements on a partnership if its only connection to the state is an indirect or limited/passive partner?

Whether states can and will enforce recordkeeping and information reporting requirements on a partnership solely due to the presence in the state of an indirect resident or corporate partner is uncertain. Again, this primarily affects the ability of these partners to obtain information necessary to properly calculate the state tax base.

2.1.3. Factor-Presence Nexus Standards Applied to Partnerships

2.1.3.1. States may apply factor-presence nexus standards at the entity level.

The MTC adopted a model factor presence nexus standard that is applicable to partnerships as follows:

“Pass-through entities, including, but not limited to, partnerships, limited liability companies, S corporations, and trusts, shall determine threshold amounts at the entity level. If property, payroll or sales of an entity in this State exceeds the nexus threshold, members, partners, owners, shareholders or beneficiaries of that pass-through entity are subject to tax on the portion of income earned in this State and passed through to them.”

2.1.4. Application of P.L. 86-272 to Partnership Income

2.1.4.1. P.L. 86-272 generally applies to “persons”.

The federal statute limits the tax on “the income derived within such State by any person . . .” if certain conditions are met. These conditions apply to activities “by or on behalf” of the person. Therefore, the conditions apply to the activities of the partnership, including the activities of partners or others on behalf of the partnership.

P.L. 86-272 also states:

The provisions [that is the protection] of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to ----

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident, of such State.

There are questions as to how “transferrable” the unprotected activities of a partner may be to a partnership and vice versa, which have not been definitively answered by the courts. For example:

- If the partnership has a corporate partner which is domiciled or conducting activities generally unrelated to the partnership’s business in a state, does this mean the partnership may lose the protections of P.L. 86-272?
- Does the fact that an individual limited, passive partner is resident in the state mean that the partnership loses the protections of P.L. 86-272? What if that partner owns a majority interest in the partnership?
- Does the fact that a partnership does business in the state mean that its corporate partner loses protection for that corporate partner’s separate business which would otherwise be protected?

2.1.5. Nexus to Tax Partners

As noted above, states clearly have nexus to tax the income of partnerships doing business in the state. But if they follow the federal pass-through system, states must also consider questions concerning whether they have nexus to impose tax on an out-of-state partner whose only connection to the state is the partnership.

2.1.5.1. States assert nexus to tax partners based on partnership activities in the state.

States generally assert nexus to tax direct partners of a partnership doing business in the state even if the partner has no other connection to the state. See Hellerstein, Hellerstein & Swain, State Taxation ¶16.12. It should be noted here that there are a number of state court cases addressing this issue, but the holdings must often be parsed to determine whether the court is addressing constitutional nexus or state law tax imposition statutes. Many states, but not all, interpret these statutes as co-extensive with constitutional nexus. The issue addressed in this section is constitutional nexus. A later section addresses state imposition statutes.

2.1.5.2. Question – Does the nature of the partner affect nexus to tax that partner?

While state statutes and regulations may not make any specific exceptions concerning nexus to tax partners who derive income from a partnership doing business in the state, there is some uncertainty with respect to limited, passive, minority, or indirect partners, in part because existing authorities are split.

2.1.5.2.1. Authorities indicating the state does have nexus:

- See Hellerstein, Hellerstein & Swain, *State Taxation* ¶ 20.08[2][a][ii] Limited Partners.
- John A. Swain, “State Income Taxation of Out-of-State Corporate Partners,” 18 Chap. L. Rev. 211 (2014).
- *Borden Chemicals & Plastics, L.P. v. Zehnde*, 312 Ill. App. 3d 35, 726 N.E.2d 73 (App. 1st Dist. 2000) – holding that a nondomiciliary limited corporate partner could be taxed on the income of a partnership doing business in the state.
- *Prince v. State Dep’t of Revenue*, 55 So. 3d 273 (Ala. Civ. App. 2010) – distinguishing *Lanzi* (below) and ruling that a nonresident limited partner could be taxed on the gain on an IRC § 338 stock sale, treated as the sale of assets, of an S corporation that was doing business in Alabama.
- *Wirth v. Commonwealth*, 626 Pa. 124, 95 A.3d 822 (2014) – holding that nonresident limited partners with an indirect interest in a partnership that operated a skyscraper in Pittsburgh were subject to tax and distinguishing *Lanzi* (below) on the basis of the type of property owned.
- *Preserve II, Inc. v. Div. of Taxation*, 30 N.J. Tax 133, 2017 BL 363663 (Tax Ct. 2017) – holding that a 99% limited corporate partner could be taxed on income derived from a limited partnership doing business in the state (quoting Professor Hellerstein’s treatise and a separate treatise by Professor Swain for support).
- *Revenue Cabinet v. Asworth Corp.*, No. Nos. 2007-CA-002549-MR and 2008-CA-000023-MR., 2009 BL 251460 (Ky. Ct. App. Feb. 05, 2010) – holding that a 99% limited corporate partner could be taxed on income of the partnership doing business in the state.

2.1.5.2.2. Authorities indicating the state does not have nexus:

- *Lanzi v. Alabama Dep’t of Rev.* (Ala. Civ. App. 2006) – a plurality opinion holding that the state did not have jurisdiction to tax a nonresident, passive, limited partner of a partnership managed in Alabama where the income came mainly from intangible assets.
- *BIS LP v. Director, Div. of Taxation*, 26 N.J. Tax 489 (N.J. Super. Ct. App. Div. 2011) – holding that an “investment” partner (a limited partner whose only activity was investment) was not unitary with and could not be taxed on income from its 99% interest in a limited partnership doing business in the state.

2.1.5.2.3. Analysis of the authorities:

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 would seem to matter to determining nexus over those partners. Rather, what appears to matter 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). In fact, in the past, the only way a partner could maintain limited liability for partnership debts was to retain only a passive role in the partnership. But today, different forms of partnerships in all states allow active, and even managing owners, to maintain limited liability.

Also, state rules may be clearer with respect to indirect corporate partners. See for example Mich. Dept. of Treas., Rev. Admin. Bull. 2014-5 (Jan. 29, 2014), and Wis. Stat. § 71.22(1r) which assert nexus generally over any corporate partner, limited, direct or indirect, for tax on income earned by a partnership and derived within the state.

The authorities above have also focused on the nature of the income—whether it represents operational income of a business or purely investment income. States have generally

addressed this through enactment of statutes and regulations that source the income of defined investment partnerships to the partners' residence or domicile. Investment partnerships will be discussed in the section on sourcing of partnership income, below.

2.1.6. General State-Law Exceptions to Tax Imposition

2.1.6.1. Whether states have constitutional authority to tax certain partnerships or partners, states may also statutorily exclude some types of partners or partnership activity from their doing business or tax imposition provisions.

For a statutory exception to tax imposition (as interpreted by a state court) 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 doing business in the state was not, itself, doing business.

However, the majority rule appears to be that state “doing business” tax imposition statutes apply to partners doing business through a partnership—in part, using the aggregate theory. See John A. Swain, “State Income Taxation of Out-of-State Corporate Partners,” 18 Chap. L. Rev. 211 (2014), which noted that this appears to be the rule in most states and that no exceptions are made simply because the partner is a limited partner.

However, one exception to this general rule is the state treatment of investment partnerships and partners generally. Many states tax the income of investment partnerships only on a domiciliary or residency basis and may base this sourcing rule on the state's authority to tax a non-resident investment partner on that partner's share of the partnership income.

2.2. Partnership Tax Base – Federal Conformity and Treatment of Items

NOTE: This January 12, 2023 version of this section contains substantial changes and has been reorganized.

This Section 2.2 focuses on the partnership tax base and the treatment of different items that make up that base. As with income taxes generally, the federal tax rules are critical to state partnership taxation—since states largely conform to those rules. Conformity, in turn, may raise state tax implications or questions that states should consider.

This section is broken into three main parts.

2.2.1 – Federal Pass-Through Conformity – In General – which provides an overview of the major categories of federal tax law that affect partnership taxation and to which states generally conform.

2.2.2 – Critical Rules of the Pass-Through System – which lists a number of the most important basic rules that govern the taxation of partnership income, giving a brief description of the rule.

2.2.3 – State Tax Questions Raised by Conformity to the Federal Pass-Through System – which lists some issues flowing from federal conformity that states may wish to consider and address.

2.2.1. Federal Pass-Through Conformity – In General

“Conformity” refers to the incorporation of federal tax rules into the state tax system. There are various ways of doing this. States need not restate or reference federal law. Instead, they may simply look to amounts calculated by applying that law. But however conformity is accomplished, it can be and often is modified or adjusted by states, which is generally done through explicit exceptions or limitations.

The four aspects of federal conformity that have important implications for state partnership taxation are set out below:

2.2.1.1. Conformity to the definition of a partnership and check-the-box rules:

Whether a partnership or other similar legal entity exists is entirely a matter of state law—which determines the legal relationships of the actors to the purported entity and to each other. Entities that fail to comply with state law requirements for a particular form of entity may be deemed to be engaging together in some other form and their purported relationships, rights, duties, etc. may be altered by operation of state law.

But when it comes to whether purported entities will be recognized as partnerships and taxed under Subchapter K, states generally conform to the federal definition of what is a partnership including IRC § 761 and the check-the-box rules of Treas. Reg. § 301.7701. Under these regulations, the IRS simplified the rules for when entities will be treated as partnerships for tax purposes.

2.2.1.2. Conformity to substantive tax rules applicable to partnership income and items:

Subchapter K specifies that it is the rules for individuals which generally apply to the recognition, valuation, characterization, and treatment of partnership income, expense, gain, and loss. See IRC § 703. Most states that tax partnership income on a pass-through basis generally conform to these substantive rules as well, but they may also require certain modifications or adjustments be made for state purposes. The pass-through system of Subchapter K can complicate the reporting and tracking of these modifications and adjustments—since they may affect the partnership, the partners, or both.

2.2.1.3. *Conformity to Subchapter K's attribution of partnership activities to the partners:*

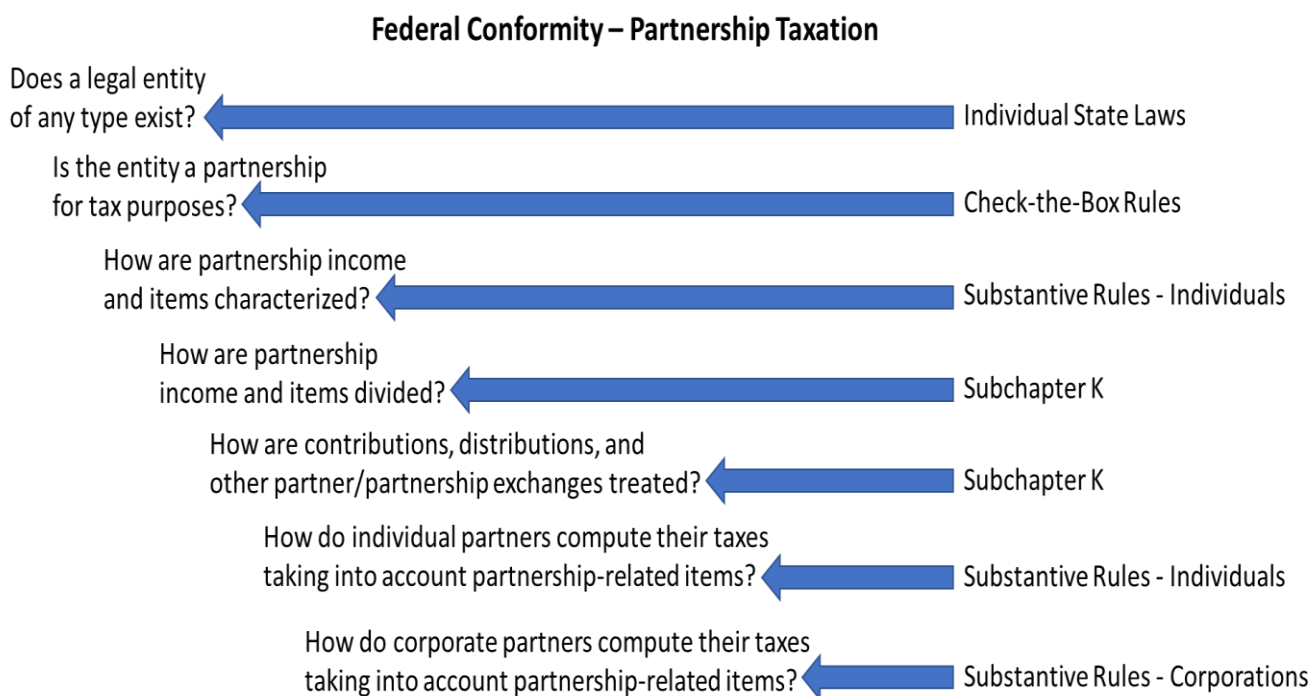
Because it is the partners and not the partnership that are taxed on the partnership income and items, the activities that give rise to essential tax attributes are attributed to the partners as if they had engaged in the same activities to earn or incur the items directly. This means the attributes of items determined at the partnership level do not change as they pass through to direct and indirect partners, regardless of their ownership share or role. See IRC 702(b). Were this not the case, the pass-through system would effectively allow the use of partnerships to alter the application of the substantive tax rules.

The role of Subchapter K is not to change the substantive rules but to set out how partnership income and items will be divided between the partners, and how contributions, distributions, and other partner-to-partnership, or partner-to-partner transactions are treated. Subchapter K also sets out anti-abuse rules to prevent this pass-through system from being misused.

2.2.1.4. *Conformity to substantive rules applicable to individuals and corporations:*

Partnership items that pass through to partners are then subject to the federal substantive tax rules for calculating the tax of the individual or corporate partners—which may, in turn, depend on the partners' own attributes. Again, while states generally conform to these federal rules, states may require that modifications or adjustments be made to calculate a partner's state income subject to tax. In general, these adjustments may be somewhat less complicated than those made at the partnership level. In any case, the modifications or adjustments that states may apply almost always depend upon the partnership items being characterized properly under federal rules in the first place.

The following graphic illustrates the interaction of these four essential types of conformity. As it shows, Subchapter K is central to the system of taxing partnership income, but it is not the only element of that system.



2.2.2. Critical Rules of the Pass-Through System

To help understand the state tax implications and questions that conformity to the federal partnership tax system may create, this subsection provides general descriptions of some of the system's most important elements.

NOTE: Subchapter K, like the rest of the IRC, sets out general provisions along with specific exceptions. Often, the exceptions are in place to avoid abuse. This summary notes the general provisions and some of the most important exceptions for state tax purposes, but it is not intended to be exhaustive. The ultimate tax results are often the product of applying multiple provisions to particular circumstances.

2.2.2.1. *Rules for Contributions from Partners to Partnership*

- A. Contribution of cash and assets receives nonrecognition treatment. – Contributions of cash and assets to a partnership do not result in gain or loss for either the contributing partner or the partnership. IRC § 721.
- B. Contribution of services for a capital interest creates ordinary income for contributing partner. – Non-recognition treatment does not apply to the contribution of services in exchange for a capital interest (that is, an interest in the existing assets of the partnership). In that case, the contributing partner will recognize ordinary income. Treas. Reg. § 1.721-1(b)(1).
- C. Contribution of services for a profits interest does not create income or gain. – Contribution of services in exchange for a “profits interest,” where the partner receives no interest in the partnership capital at the time of contribution, does not give rise to the recognition of income or gain by the contributing partner. Rev. Proc. 93-27.
- D. Character of assets is maintained. – Assets contributed retain the same character (ordinary or capital) they had in the hands of the contributing partner. IRC § 724.
- E. Basis of assets is maintained. – The partnership takes carry-over basis in contributed assets. IRC § 723.
- F. Partner's outside basis is increased. – The amount of cash or adjusted basis in assets contributed increases the partner's tax basis in the partnership interest or “outside basis.” IRC § 705.
- G. Partner's capital account is increased. – Contributions also increase the partner's capital account maintained for purposes of determining whether allocations of partnership income and items have substantial economic effect. Treas. Reg. § 1.704-1(b)(2)(iv).

2.2.2.2. *Rules for Distributions from Partnership to Partners*

- A. Current and liquidating distributions may be treated differently. – There are two types of distributions addressed by Subchapter K – current distributions and liquidating distributions. The latter terminate the partner's interest in the partnership.
- B. Distributions are not required. – Distributions depend on the partners' agreement. They need not be made each year or to all partners, nor do distributions need to be in the same amounts as distributive share (discussed below).
- C. Distributions have no tax effect on partnership – Distributions do not result in gain or loss to the partnership. IRC § 731(b).
- D. Partners receiving certain distributions in excess of outside basis will recognize gain. – Distributions of cash or certain marketable securities to a partner will result in the recognition of gain if the distribution exceeds outside basis. § 731(a)(1). This gain will be treated the same as gain from the sale of a partnership interest. IRC § 731(a)(2).

- E. Partners may recognize losses from liquidating distributions. – Liquidating distributions may trigger loss if the amount distributed is less than outside basis. This loss will be treated the same as a loss from the sale of a partnership interest. IRC § 731(a)(2).
- F. Partners may recognize gain or loss if property they contributed is distributed to another – If property contributed by one partner is distributed to another within seven years, the contributing partner will recognize some amount of gain (loss) to the extent the fair market value of the property was greater or less than the tax basis at the time of contribution. IRC § 704(c).
- G. Basis in assets generally carries over. – The distributee partner’s basis in distributed assets will generally be the carryover tax basis unless limited by the partner’s outside basis less any cash or marketable securities that may have been distributed. IRC § 734.
- H. Partner’s outside basis is reduced. – Distributions to a partner reduce the partner’s outside basis by the amount of cash or marketable securities distributed and the carryover basis that the partner takes in any assets distributed. IRC § 733.
- I. Partner’s capital account is reduced. – Distributions also reduce the partner’s capital account maintained for purposes of determining whether allocations of partnership income and items have substantial economic effect. Treas. Reg. § 1.704-1(b)(2)(iv).
- J. Disproportionate distributions may trigger deemed sale. – “Disproportionate distributions” of ordinary versus capital assets, which may effectively shift the recognition of ordinary versus capital income for partners, are treated as a deemed sale by the partner of one type of asset and purchase of the other. IRC § 751.

2.2.2.3. Rules for Determining the Tax Character of Partnership Items

- A. Substantive tax rules for individuals apply to partnership income (loss) and specific tax items – The partnership’s net income (loss) and tax effects of separate items of income, expense, gain, and loss are generally determined by applying the individual substantive tax rules to the activities of the partnership that earns or incurs these items. See IRC § 703 and Federal Form 1065.
- B. Tax character of partnership items remains the same. – The relevant tax character of partnership items (e.g., exempt, capital, ordinary, deductible, etc.) remains the same when the items pass through to taxpaying partners. That is, a taxpaying partner will treat the partnership items as though the partner had engaged directly in the same activities giving rise to those items. IRC §§ 702(b) and 703. This is true regardless of the partners interest in the partnership, the partner’s role, or direct or indirect relationship. See also IRC § 706(d).
- C. U.S. sourcing of partnership income and items generally remains the same. – Like other aspects of the tax character of items, the domestic or foreign sourcing of partnership income or loss from trade or business in the U.S. is determined at the partnership level and passes through to the ultimate direct or indirect taxpaying partners. See IRC §§ 864(b) and 1446(a). The best resource for how the sourcing rules apply to partnership income is the IRS guidance for withholding on the U.S. partnership income of foreign partners, available here: <https://www.irs.gov/individuals/international-taxpayers/helpful-hints-for-partnerships-with-foreign-partners>. But see guaranteed payments discussed below.
- D. Federal regulations may take an aggregate approach to application of Subpart F and GILTI. – The application of certain foreign income recognition requirements under the federal tax system generally require the determination of whether a U.S. person is a shareholder of a controlled foreign corporation (CFC) and meets other ownership tests for recognizing income. Under IRS regulations, these determinations may depend on whether the partnership is a U.S. partnership, whether the partners are U.S. partners, and whether certain elections are made by the partners. See Treas. Reg. § 1.958-1.

- E. Partnerships must separately report items that have differing tax effects –Partnerships must provide not only the shares of income or items a partner is allocated, but other information on the items, including information on items passed through from lower tier partnerships that effect tax treatment. See IRC § 702 and federal Schedule K-1. Partners must also generally treat these items consistently when reporting them—or must disclose any inconsistent treatment. IRC § 6222 and IRS Form 8082.

2.2.2.4. Rules for Allocation of Distributive Share

- A. Distributive share = allocation of partnership income and items. – Distributive share generally refers to the partnership’s allocation of the share of its current year income, or particular items of income, expense, gain, or loss, to the partners. IRC § 704.
- B. Distributive share ≠ distribution. – Taxpaying partners pay tax on their distributive share of partnership income and items whether or not they receive any distribution. IRC §§ 701 & 702.
- C. Partners’ interests in the partnership determine allocations, unless partners agree otherwise. – If partners have no agreement (written or otherwise) as to how partnership income and items will be shared, then IRC § 704(b) assumes they will be shared according to the partners’ interests in the partnership—which represent the partners’ relative economic interests.
- D. Partners may generally agree to make “special allocations” of income or items. – Subchapter K generally allows the partners to share income or one or more items in some proportion other than according to their interests in the partnership. IRC § 704(a). These so-called “special allocations” may be made for any of a number of different reasons. So, for example, two partners who have an equal interest in the partnership might agree to share income or certain items 60/40 based on their different roles.
- Priority allocations – allocate to one or more partners certain amounts of income before any amounts are allocated to other partners.
 - Targeted allocations – aim to achieve the partner’s agreement as to the ultimate liquidating value they will receive on their investment.
- E. Exception – special allocations that lack substantial economic effect will be reallocated. – The main exception to the rule that the partners may agree to make special allocations is found in IRC § 704(b)—which requires that the allocations have substantial economic effect. Regulations on this subject are extensive and provide a kind of safe harbor for partnerships that properly track the effect of allocations and other events on the partners’ capital accounts and provide that liquidating distributions will be made according to these accounts. In general, special allocations must reflect the economic reality of the partner’s agreement and any federal tax effects must have a corresponding economic effect and not amount to “shifting” or “transitory” allocations. Treas. Reg. § 1.704-1(b)(2). Allocations lacking substantial economic effect will be reallocated according to the partners’ interests in the partnership. Treas. Reg. § 1.704-1(b)(3).
- F. Exception – pre-contribution built-in gain or loss is allocated to the contributing partner. – Property contributed to a partnership may have a fair market value greater or less than its tax basis—a difference referred to as “built-in” gain or loss. When the partnership recognizes certain income, gain, loss, or deduction related to that property, IRC 704(c) requires the items be shared among the partners so as to take account of “the variation between the [carryover] basis of the property to the partnership and its fair market value at the time of contribution.” In effect, the contributing partner will recognize the tax effects of this built-in gain or loss through these required allocations.
- G. Exception – allocations of losses exceeding basis are deferred. – If an allocation of loss to a partner exceeds that partner’s outside basis, the loss is limited but may be carried forward. IRC § 704(d).

2.2.2.5. Rules for Certain Exchanges Between Partners and their Partnership

- A. Partners acting other than in their “capacity” as partners will be treated as unrelated parties. – Partners and partnerships may engage in transactions—providing property and services—where each is acting in their own separate capacity. Such exchanges are properly classified as having separate economic and tax results on the parties (e.g., sale of services and recognition of expense), rather than as a contribution and distribution. IRC § 707(a). The IRS may recast “related” contributions and distributions as an unrelated party exchanges. IRC § 707(a)(2).
- B. Exception - losses from certain property exchanges are disallowed. – Under IRC § 707(b)(1), losses on certain exchanges of property with “controlled” partnerships (defined by majority ownership) will be disallowed but may serve to reduce the gain on a subsequent exchange.
- C. Exception - gains from certain property exchanges are treated as ordinary income. – Under IRC § 707(b)(2), gains on certain exchanges of property with “controlled” partnerships (defined by majority ownership) will be treated not as capital gains but as ordinary income.
- D. Guaranteed payments to partners acting as partners receive hybrid treatment. – IRC § 707(c) recognizes that partnerships may provide partners with payments for “services or the use of capital” that are “determined without regard to the income of the partnership.” Guaranteed payments are given hybrid treatment. For the partnership, they reduce partnership income in the same way as expenses, which then reduces the income allocable to the partners. But for partners, guaranteed payments are generally treated as distributive share—with certain exceptions.
- E. Exception – the QBI deduction does not apply to guaranteed payments. – The qualified business income (QBI) deduction under IRC § 199A does not apply to guaranteed payments.
- F. Exception – guaranteed payments for services are sourced differently. – While sourcing is considered part of the character of partnership income determined at the partnership level (see 2.2.2.3 above), guaranteed payments for services by partners are generally sourced to the location of the partner. Rev. Ruls. 81-300 and 81-301 and PLR 7939005.

2.2.2.6. Rules Limiting Use of Losses (applicable at partner level)

- A. Use of partnership losses may be limited by a partner’s outside basis. – Partners may deduct partnership losses only to the extent of their outside basis. Unused losses may generally be carried forward. IRC § 704(d).
- B. Use of capital losses may be limited. – Under IRC § 1211, corporations and individuals have limits on the ability to offset capital losses against income or gains from other sources. These limits would apply to capital losses passed through from partnerships as well.
- C. Use of losses may be limited by “at risk” rules. – Under IRC § 465 (“at-risk” rules), limits will apply to the use of individual and closely-held corporate partners’ shares of partnership losses. IRS regulations (proposed) are complex and extensive. They are designed to prohibit the shifting of certain losses to partners for use when that partner’s activities or capital are not at economic risk, and to curtail use of artificial losses. The limits under § 465 apply on the basis of “activity.” Aggregation of certain “activities” may be allowed. The IRS has never said clearly whether aggregation may apply to other activities if conducted by separate entities.
- D. Use of losses may be limited by “passive loss” rules. – The passive loss rules of IRC § 469 also limit the ability of closely held corporate and individual partners to offset losses. The passive loss rules group activities into active, passive, and portfolio (investment) groupings, based on both the nature of the activity (trade/business versus investment) and the role of the partner (whether the partner “materially participates”). Losses may only be offset against other income or gains from the same group.

2.2.2.7. General Anti-Abuse Rules

- A. Federal partnership regulations set out a broad anti-abuse rule. – Treas. Reg. § 1.701-2 requires that the partnership be bona fide and that each partnership transaction or series of related transactions (individually or collectively) be entered into for a substantial business purpose. A partnership lacking substance will be disregarded. Factors that will be considered include whether:
- The partners' taxes are substantially less than if they had engaged in the activities directly,
 - Certain necessary partners are protected from risk or have only nominal ownership,
 - Partners are closely related, and
 - Special allocations of profit are made to exempt partners.
- B. Federal transfer pricing rules generally apply to partnerships. – The IRS has authority under IRC § 482 to address certain kinds of related-party income shifting by recasting the income and expense of the parties. Related-party transactions between partnerships may also be subject to being § 482, which applies to “organizations, trades, or businesses.” Courts have even found that § 482 applies to transactions between individual partners and their partnership. See *Aladdin Indus., Inc. v. Commissioner*, 41 T.C.M. (CCH) 1515, 1519 (1981). At the federal level, these rules are generally applied in the international context.
- C. Federal tax law gives the IRS general authority designate questionable transactions. – To combat common abusive tax strategies, the IRS has authority to designate them and require disclosure or impose penalties. This authority has been used over the years to combat such strategies using partnership structures. See IRC § 6011 and instructions for IRS Form 8886.

2.2.2.8. State Rules Critical to Partnership Taxation

- A. States do not use federal sourcing rules but apply formulary apportionment to business income. – Federal sourcing rules typically apply a form of geographic accounting using specific sourcing criteria for different categories of income or gain, applied to separate items by type. Then, expenses and losses are allocated to that income. IRC §§ 861-865 and Treas. Reg. §§ 1.861-8 through 1.861-18. In contrast, when states source business income, they generally apply formulary apportionment to the net income or loss of a business. See UDITPA.
- B. Formulary apportionment may be limited by the unitary business principle. – Formulary apportionment uses one or more factors which can be geographically located based on rules. The ratio of the factors located in the jurisdiction determines the portion of net income or loss sourced to that jurisdiction. States may apply formulary apportionment to the income of an entity or a group of entities. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). Under constitutional precedent, however, there must be a sufficient relationship between the factors used by the taxing jurisdiction and the items of business income to be apportioned using those factors. This is generally referred to as the unitary business principle. Items of income may be included in the base subject to formulary apportionment even if the payee is not unitary with the payor. See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992). Where formulary apportionment cannot be used, states use some alternative method of specific sourcing.
- C. States may supplement federal transfer pricing rules with add-back statutes. – States often go beyond the anti-abuse rules under § 482 in order to address abusive income shifting by imposing certain add-back requirements for related-party transactions. While combined filing of a unitary business and formulary apportionment will eliminate income shifting, states generally do not require taxpayers to report foreign operations and income in their state returns—so that income shifting may occur where federal rules are inadequate. In any case, the pass-through system makes it difficult or impossible to impose combined filing on partnerships, even for domestic purposes, and § 482 rules may be insufficient as discussed further in the next subsection.

2.2.3. State Tax Questions Raised by Conformity to the Federal Pass-Through System

When taxing income under the federal pass-through tax system, states may face a number of questions that do not have clear answers. Many implicate state sourcing, which is the subject of the next Section 2.3 and where possible answers will be analyzed further. Other questions implicate the need for anti-abuse rules. This section attempts to identify the most important questions and why the answers may not be clear. As with other sections of the outline, it is not exhaustive.

2.2.3.1. *Questions implicating state sourcing.*

NOTE: The issues summarized here may also be addressed in the Section 2.3 below.

- A. Should state sourcing of income or items, like federal sourcing, be a characteristic that is determined based the activities of the recognizing partnership and passed through to partners?

As noted above (2.2.2.3), federal tax characteristics of partnership items, including domestic or foreign sourcing, are generally determined at the partnership level based on the entity's relevant activities. The sourcing of the items is maintained as the income or items are allocated to the partners, regardless of their ownership share or whether they take an active or passive role. This approach has an effect on the tax base for conforming states in that foreign sourced partnership income is not included in the U.S. tax base. But it also has implications for state sourcing.

One question is whether the difference in state sourcing rules (2.2.2.8 above) would alter the way in which sourcing becomes a characteristic of the income and items which then pass through to the partners intact. So, for example, if the partnership has income from a unitary business conducted in, and properly sourced to one state, is the sourcing of that income properly attributed to all partners including a minority, passive partner in a different state?

- B. Are guaranteed payments for services done by partners sourced to the partner's location?

As noted above (2.2.2.5), federal sourcing rules treat guaranteed payments made for services as earned in and sourced to the location where the partner performs those services, rather than based on where the partnership activities are conducted or income is sourced. Given that state sourcing rules differ (2.2.2.8 above), should states follow this federal treatment of guaranteed payments? If states adopt different answers to the sourcing of guaranteed payments, it may result in duplicative or nowhere taxation of the income.

- C. Does the treatment of built-in gain/loss affect sourcing of related items?

IRC § 704(c) attempts to ensure that the tax effects of any built-in gain or loss on contributed property (not recognized at contribution) eventually flows to the contributing partner (2.2.2.4 above). This raises state sourcing questions.

Example: Corp. X operating mainly in State A contributes an asset with a \$1 million built-in gain to Partnership operating mainly in State B. Partnership relocates the asset to State B and later sells it. As a result, \$1 million of resulting gain is properly allocated back to Corp. X along with X's share of the remainder of the (post-contribution) gain. Should the \$1 million portion be sourced to State A or State B?

This is a very simple example, but there can be many other more complicated effects on a contributing partner's share of items—including the allocation of depreciation expense—that may make special sourcing of built-in gain/loss more complicated. If sourcing of the built-in gains or losses are not specially sourced, however, it could create the potential for abuse and the need for an anti-abuse exception that might apply in certain cases.

D. Are any conflicts created by the federal treatment of losses and the state sourcing of partnership gain/loss as applied to individual and corporate partners?

While the focus of tax policy is often on income, losses are also critical, especially in the context of partnerships. Under the partnership pass-through system, the use of losses is not necessarily confined to the entity that generated the loss—through, for example, carrying the loss forward. Rather, individual and corporate partners may be able to use their share of losses from a partnership to offset income or gains from other sources, including other partnerships, subject to limitations discussed above (2.2.2.6). These limits were put into place to curb abusive practices of generating losses and shifting them between taxpayers—but not to eliminate the use of losses to offset income and gains from other sources.

Where losses are not limited, the sourcing of losses and income or gains has implications for individual versus corporate partners. An individual allowed to fully offset losses from one partnership against income/gains from another under federal rules—resulting in no net income—may nevertheless owe state tax to the extent that partnership sourcing would result in the losses being sourced to a different state than the income/gains. This might not be the result if the partner is a corporation, if the state allows the corporation to simply net its share of losses against the income/gains in computing apportionable income. This disparity caused by using partnership-level sourcing for individual partners may result even where the partnerships generating losses are part of a unitary business with the partnerships generating the income/gains.

E. Do special allocations of partnership income or items affect state sourcing? –

While special allocations of partnership income or items do not change the tax character, including the sourcing of those items under the federal substantive tax rules (2.2.2.3 and 2.2.2.4 above), the reasons that the special allocations are made could have implications for their treatment for state sourcing purposes.

Example: Assume States 1, 2, and 3 have identical income tax rules. Partners A and B are individuals residing in State 1. They form an equal partnership. They agree that Partner A will oversee the business operations in State 2, while Partner B will oversee operations in State 3. They also agree to special allocations where A will receive 90% of the income from operations in State 1 and B will receive 90% of the income from operations in State 2.

There is an argument that income subject to these separate allocations should be sourced separately. Federal rules do not answer the question. Instead, states must first consider how the state sourcing rules (2.2.2.8 above) should apply—and especially whether the activities in the two states are part of a unitary business. Then the question is whether the particular reason for the special allocations should alter apportionment of the activities as a whole.

F. Can and should income of separate partnerships be combined for state sourcing purposes? –

See the example in E above. Assume the same facts except that the business activities are now conducted through two separate partnerships—one operating in State 1 and the other in State 2. Partners A and B together are equal partners in each sharing the income of one 90/10 and the other 10/90. In this case, also assume the activities are part of a unitary business. Should state tax sourcing rules be applied to the partnerships separately or to their combined income? What if the second partnership were to include Partner C—would this affect the answer, at least for that partner? These and other related questions highlight the difficulties of reconciling the differences between taxing income on a passthrough basis while applying state sourcing which looks to the unitary business.

- G. If state sourcing of income and items is generally determined at the partnership level, is that sourcing affected when the income and items pass through a tiered structure, and if so, how?

Again, as with question E above, this question highlights the inherent conflict between the pass-through system—where federal sourcing is a characteristic generally determined at the partnership level based on the entity’s activities—and state sourcing rules which generally look to the activities of the unitary business.

If income from a lower-tier partnership passes through an upper-tier partnership before being allocated to an individual partner, state sourcing rules for business income might be applied in three different ways (as discussed further in Section 2.3 of this outline). The income might be sourced solely based on the lower tier’s factors. It might be sourced solely based on the upper tier’s factors. Or it might be sourced based on a combination of the lower and upper tier’s factors (blended apportionment). Sourcing of income through tiered partnership structures is one of the most complex of the issues that states using the pass-through system face.

2.2.3.2. Questions on the Application of Anti-Abuse Rules

- A. Should states adopt federal-style anti-abuse rules to remove any uncertainty as to the application of those rules in cases where the tax effected is state rather than federal?

Federal anti-abuse rules, including those that apply specifically to partnership taxation (2.2.2.7 above), are widely viewed as essential to making the very general rules of the pass-through system work without creating unintended tax consequences. The determination that a structure or transaction violates these rules is often based on whether the beneficial federal tax result in question matches the economic reality or has a corresponding economic effect. Such determinations will also have a positive effect on state taxes.

However, it is also possible for the same type of abusive transactions or strategies to affect only the state tax results, with no corresponding federal effect. In that case, it may be difficult for a state to argue that they violate federal anti-abuse rules. But care must be taken since such issues may arise even where states have specifically adopted similar federal language. See, for example, *Utah State Tax Comm’n v. See’s Candies, Inc.*, 2018 UT 57, 435 P.3d 147 (concerning whether a state law provision based on IRC § 482 must be applied following federal regulations).

One option to remove this uncertainty is for the state to adopt more detailed rules that specify the application of the anti-abuse rule to situations affecting state taxes. For example, the MTC has a Model Statute on Disclosure of Reportable Transactions which would also apply to partnerships and that imposes rules similar to the IRS under IRC § 6011. See that model here: https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Final%20-%20Reportable%20Transactions%20Statute.pdf.

- B. Does the substantial economic effect test under § 704(b) apply when state rather than federal taxes are affected?

As noted above (2.2.2.4), special allocations lacking substantial economic effect will not be allowed under IRC § 704(b). Similar to other anti-abuse rules, the federal rules for substantial economic effect generally look first to whether the allocation provides a federal tax benefit and then whether there is a corresponding economic benefit. The federal rules do not address whether special allocations that provide a *state* tax benefit without a corresponding economic benefit will be allowed.

To understand the implications for state taxation, it is important to remember that under the pass-through system, partnership income and items generally retain their character, as they pass through to and are reported by the partners. (See 2.2.2.3 above.) Assuming the character of items generally includes their treatment and sourcing for state tax purposes, partners might use special allocations to improperly shift the benefits of these state tax attributes to partners without actually sharing economic results in a corresponding fashion. In addition, special allocations may be combined with related-party transactions (discussed below) to shift income or shield it from state taxation.

C. Should states apply add-back or similar requirements to related partnership transactions?

Under the pass-through system, where the owners rather than the entity pay tax on partnership income, it is difficult if not impossible to impose combined filing. Nevertheless, using related party transactions for income shifting— one of the problems combined filing was meant to address—can be done using partnership structures as well as corporate structures. Partnerships also have the flexibility to use related party transactions, special allocations, or guaranteed payments for the purpose of assigning tax items in a way that shifts taxable income at the state level. This creates an enhanced need for state anti-abuse rules, such as add-back requirements, that can be used in the partnership context. A few states appear to have such provisions applicable to partnerships but they may not anticipate all types of shifting that can be done using partnerships.

D. Does UDITPA Section 18 equitable apportionment authority apply when sourcing partnership income effected by intercompany transactions?

While most states apply UDITPA or a similar set of sourcing rules to income of partnerships, they appear to have little experience applying UDITPA Sec. 18, which allows for equitable apportionment, in the context of sourcing partnership income. In one case in Tennessee, however, the application of Sec. 18 was upheld in varying the apportionment formula for a business conducted by a corporation in the state through a controlled partnership structure. *Vodafone Ams. Holdings, Inc. v. Roberts*, 486 S.W.3d 496 (Tenn. 2016).

2.3. Sourcing of Partnership Income

There are different methods by which partnership income or items may be sourced. The method used may significantly change the ultimate result. Therefore, states should consider the effect of different methods and the policy implications. Also, the method used may be subject to constitutional or practical constraints.

2.3.1. Terms – Situs-Based and Apportionment-Based Sourcing

2.3.1.1. Situs-based sourcing refers to rule-based sourcing.

The term “situs” or situs-based sourcing will be used here to refer generally to specific rule-based sourcing of items of income, most often to a particular geographic location. Under UDITPA, for example, so-called nonbusiness (or nonapportionable) income is specifically sourced according to rules based on the nature of the income so that, for example, the sale of real property might be sourced to the location of that real property. See UDITPA, Art. IV Sec. 2.

2.3.1.2. Apportionment-based sourcing refers to formulary apportionment.

The terms “apportion” and “apportionment-based sourcing” will refer to sourcing of items of income using a formula based on certain factors (property, payroll and/or sales) so that the item may be divided between multiple locations. The term “apportionment” here is used broadly to encompass the use of the income-producer’s (or investee’s) factors, the owner’s factors, or a combination of both.

2.3.2. Differences Between Corporate and Individual Partners

2.3.2.1. States typically source partnership income to corporate partners using apportionment.

Because states generally tax corporate income based on the source of the income, and because corporations also have their own apportionment factors, states may use the corporate partner’s apportionment factors, the partnership’s factors, or a combination. If the nature of the income is non-business, or purely investment income, the state may source the income based on the corporation’s domicile.

2.3.2.2. States typically use a hybrid method to tax income of individual resident and non-resident partners.

Most states apply tax to nonresident individual partners on a source basis and to resident individual partners on 100% of their partnership income, from whatever source, giving a credit for taxes paid to other states on a source basis.

2.3.2.3. Unlike corporate partners, individual partners do not have their own apportionment factors.

Even when states tax nonresident individual partners on an apportioned basis, there is a difference between these partners and corporate partners in that individual partners do not have their own apportionment factors. Therefore, states must use the partnership factors to source the income passing to individual partners.

2.3.3. Five Methods of Sourcing Partnership Income - Generally

There are five primary ways in which partnership income may be sourced. These primary methods combine either situs-based or apportionment-based sourcing with the use of one of three general methods—using information from the recognizing partnership where sourcing is retained on a pass-through basis, using information from the partner alone, or using on a combination of partnership and partner information. (See the effects of tiered partnerships in the following sections.)

2.3.3.1. Situs-based sourcing – using partnership information.

Example: Partnership X has income from sale of real property. The income might be sourced to the location of that property and this sourcing result would then pass through and determine the sourcing of the individual or corporate partner’s share of that income, as well.

2.3.3.2. Situs-based sourcing – using partner information.

Example: Partnership Y is an investment partnership. The income of Partnership Y might be sourced to the corporate partner’s domicile or an individual partner’s residence.

2.3.3.3. Apportionment-based sourcing – using partnership information.

Example: Partnership X has ordinary income from a business. The income might be sourced using the partnership’s own apportionment factors and this sourcing result would then pass through and determine the sourcing of the individual or corporate partner’s share of that income, as well.

2.3.3.4. Apportionment-based sourcing – using corporate partner information.

Example: Partnership Y has ordinary income from a business. If the partner is a corporation, the income might be sourced using the corporate partner’s own apportionment factors.

2.3.3.5. Apportionment-based sourcing – using a combination of the partnership and corporate partner’s apportionment factors.

Example: Partnership Z has ordinary income from a business. If the partner is a corporation, the income might be sourced using a combination of a portion of the partnership’s factors along with the corporation’s apportionment factors. This is sometimes referred to as “rolling up” the partnership’s factors. Note that it is a generally accepted rule that when combining apportionment factors, the same share of the partnership factors is included in the calculation as the share of income or other items the partner recognizes.

2.3.4. Effect of Tiered Partnership Structures on Sourcing – Three Additional Methods

In addition to the five primary ways of sourcing partnership income for individual and corporate partners (described in the section above), a tiered partner might also affect the sourcing of income or items of a lower-tier (recognizing) partnership.

2.3.4.1. Lower-tier pass-through sourcing.

The income might be sourced using information of the lower-tier (recognizing) partnership with that sourcing result associated with the particular income and passing through any tiered partners to the ultimate taxpaying partners.

2.3.4.2. Upper-tier sourcing.

The income may be sourced using only the upper (highest) tiered partner information.

2.3.4.3. Combination sourcing.

The income might be sourced using a combination of the lower-tier and tiered partner information (including some or all tiered partners in that structure)—for example, by combining portions of the apportionment factors (“rolling up” the factors) of the entities. Note that, as with corporate partners, it is a generally accepted rule that when combining apportionment factors, the same share of the factors is included in the calculation as the share of income or other items that the tiered partner recognizes.

2.3.5. Example – Differences in Results Between Methods Used

In the diagram here, assume that P1 has income that will be allocated to its partners (and their partners) through the structure shown.

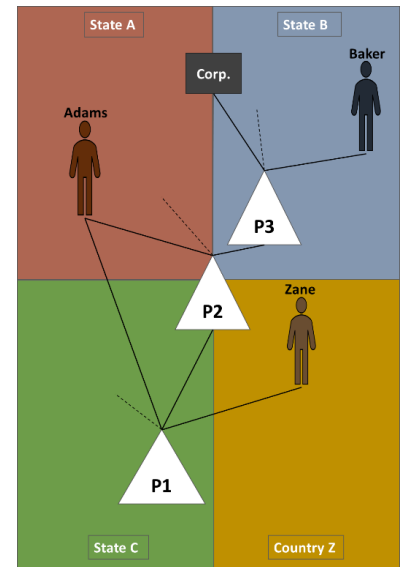
2.3.5.1. Situs-based sourcing will differ depending on the method.

2.3.5.1.1. Situs determined at the recognizing partnership level (P1), with that sourcing information passed through to each of the taxpayer partners.

RESULT - All partners source their share of P1 income to the same location (State C).

2.3.5.1.2. Situs determined at the partner level.

RESULT: Partners source income to different locations (their residence or domicile).



2.3.5.2. Apportionment-based sourcing will also differ depending on the method used.

Even though the diagram above shows a structure which is not particularly complicated, the result of apportionment-based sourcing may vary considerably depending on the exact method used.

For this purpose, assume the various partners direct and indirect shares of the P1 income are as follows:

P1 Direct/Indirect	Adams	Baker	Zane	Corp	P2	P3	Other	Total
Direct Shares P1	40%		10%		40%		10%	100%
Direct Shares P2	40%					40%	20%	100%
Direct Shares P3		50%		40%			10%	100%
Indirect Shares P1	16%	8%		6.4%			9.6%	
Total	56%	8%	10%	6.4%			19.6%	100%

Assume that each of the jurisdictions above have single sales-factor apportionment. Also assume we are looking for the amount of the P1 income that would be apportioned to State C. The table below illustrates the different factors that might be calculated—given the amounts of sales by entity shown.

Sales & Sales Factors	State A	State B	State C	Country Z	Total
P1 Sales			\$1,000		\$1,000
Factor	0%	0%	100%	0%	100%
P2 Sales	\$500	\$500	\$500	\$500	\$2,000
Factor	25%	25%	25%	25%	100%
P2 Share of P1	\$0	\$0	\$400	\$0	\$400
P2 Plus Share of P1	\$500	\$500	\$900	\$500	\$2,400
Factor	21%	21%	38%	21%	100%
P3 Sales		\$4,000			\$4,000
Factor	0%	100%	0%	0%	100%
P3 Indirect Share of P1	\$0	\$0	\$160	\$0	\$160
P3 Share of P2 & P1	\$200	\$200	\$360	\$200	\$960
P3 Plus Indirect Share of P1	\$0	\$4,000	\$160	\$0	\$4,160
Factor	0%	96%	4%	0%	100%
P3 Plus Share of P2 & P1	\$200	\$4,200	\$360	\$200	\$4,960

Factor	4%	85%	7%	4%	100%
Corp Sales	\$5,000	\$5,000			\$10,000
Factor	50%	50%	0%	0%	100%
Corp Indirect Share of P1	\$0	\$0	\$64	\$0	\$64
Corp Indirect Share of P2 & P1	\$80	\$80	\$144	\$80	\$384
Corp Share of P3, P2 & P1	\$80	\$1,680	\$144	\$80	\$1,984
Corp Plus Indirect Share of P1	\$5,000	\$5,000	\$64	\$0	\$10,064
Factor	50%	50%	1%	0%	100%
Corp Plus Indirect Share of P2 & P1	\$5,080	\$5,080	\$144	\$80	\$10,384
Factor	49%	49%	1%	1%	100%
Corp Plus Share of P3, P2 & P1	\$5,080	\$6,680	\$144	\$80	\$11,984
Factor	42%	56%	1%	1%	100%

As this example illustrates, depending on whether the partner has a direct or indirect interest in P1 and is an individual or a corporation, the apportionment method use might result in that partner sourcing 0%, 1%, 4%, 7%, 25%, 38% or 100% of P1 income to State C.

This is a simple example illustrating the differences in approaches when applied to a fairly simple structure. Even if the structure remained simple, as shown, however, the results could be further complicated if the partners received special allocations, guaranteed payments, or allocations of built-in gains and losses from contributed property (discussed briefly in the section on federal conformity above), since those types of income might be treated somewhat differently for sourcing purposes. The treatment of these types of distributions will be discussed further in sections below.

From a general survey of existing state rules, it appears that most states do not have sufficiently detailed guidance to address the issues raised partnerships and the sourcing of partnership income. Therefore, the following sections on sourcing of partnership operating income will cover basic principles to provide a foundation for the development of more detailed rules and will also summarize the questions and issues that might be addressed.

2.3.6. Constitutional Principles – Sourcing of Partnership Operating Income

There are no U.S. Supreme Court cases that specifically address the application of general sourcing rules or formulary apportionment to partnership operating income taxed on a pass-through basis. A few cases have touched on the subject, particularly *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542 (2015), in which Maryland (like other states) taxed nonresident individuals on income derived from subchapter S corporations operating in the state.

Because of a lack of specific authority on the sourcing of partnership income, this section will look to general constitutional principles.

NOTES: In reviewing the principles in this section, keep in mind the following:

- **Relationship of Nexus and Sourcing:** Both nexus and sourcing issues are governed by constitutional principles. Nexus issues are discussed in prior sections of this outline (for operating income) and in later sections (for sale of a partnership interest). This section focuses on constitutional principles that apply to sourcing of operating income.
- **“Apportionment” May Mean Attribution:** The U.S. Supreme Court may use the term “apportionment” to refer to any method of attributing tax base to a particular state. See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)(involving a gross sales tax on products delivered in the state). So in this sense, the term “apportionment” as used by the Court may encompass what this outline refers to as situs-based or apportionment-based sourcing.

2.3.6.1. Constitutional principles applicable to sourcing – generally.

The following constitutional principles apply to sourcing generally:

- Rational Relationship –

There must be a rational relationship between the business in the state and the income the state seeks to tax. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U. S. 425 (1980).

- Fair Apportionment –

The Supreme Court’s jurisprudence requires that apportionment generally be “fair.” As described in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), there are two primary requirements for fairness:

- Internal Consistency –

Internal consistency is met when a state’s apportionment method, if duplicated by every other state, would not subject intrastate commerce to multiple taxation. Specifically, the Court has said that states taxing residents on a 100% of their business income and nonresidents on an apportioned share must give residents a credit for taxes paid to other states. *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542 (2015). This credit mechanism is discussed further in the below.

- External Consistency –

External consistency requires that the state’s share of the tax base fairly reflect the relative benefits and protections the state provides to the taxpayer. The burden of showing that a tax is not externally consistent is high. See *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

2.3.6.2. Constitutional principles applicable to formulary apportionment.

As noted above—there are no U.S. Supreme Court cases directly addressing the sourcing of partnership operating income taxed on a pass-through basis—nor any cases addressing formulary apportionment of such income. Therefore, the general principles below must be applied.

Also note that the cases addressing formulary apportionment typically address whether the taxpayer’s income, or particular items of income, are sufficiently connected to the taxpayer’s business conducted in the state so as to be subject to apportionment using the factors of that business. See: *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113 (1920); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm’n*, 266 U. S. 271 (1924); *Butler Brothers v. McColgan*, 315 U.S. 501 (1942); *Mobil Oil v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *Exxon Corporation v. Wisconsin*, 447 U.S. 207 (1980); *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354 (1982); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982); and *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

In addition to the general principles above, the following principles apply specifically to formulary apportionment:

- States may use formulary apportionment instead of specific attribution –

In *Container* (cited above), the U.S. Supreme Court held that states are not bound to use specific geographic attribution of income, the method used internationally, but may use formulary apportionment instead. Later Supreme Court holdings have confirmed that: “Because of the complications and uncertainties in allocating the income of multistate businesses to the several

States, we permit States to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State.” See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778 (1992).

- The unitary business principle applies to formulary apportionment –

In addressing early challenges to the application of formulary apportionment to particular income, the Supreme Court developed the unitary business principle which connects nexus and sourcing principles. A taxpayer’s apportionment factors in a state (as a ratio of all of its factors) can be used to apportion income that is derived from the taxpayer’s unitary business conducted in that state. See *Exxon Corp. v. Department of Revenue of Wis.*, 447 U. S. 207 (1980).

- A state may combine the income and factors of related entities that are part of a unitary business –

The Supreme Court in *Container* (cited above) recognized that a state may apportion income of a unitary business conducted by separate legal entities provided the unitary business is related in some concrete way to the in-state activities. The connection may be shown by some sharing or exchange of value as well as by traditional characteristics of a unitary relationship.

- The Supreme Court has recognized certain tests for a unitary business –

In *Allied-Signal* (cited above) the court also said: “In the course of our decision in *Container Corp.*, we reaffirmed that the constitutional test focuses on functional integration, centralization of management, and economies of scale. . . . We also reiterated that a unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities.”

- Certain income may be included in apportioned base even if the payor is not unitary –

If the income is paid by another entity to the taxpayer, it is not necessary for the payor to be unitary with the taxpayer in order for the income to be apportioned using the taxpayer’s factors. The income must be derived from, or the asset generating it must serve, an operational rather than a purely unrelated investment function. See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992). The Court has often used the term “passive” to describe investment assets not subject to apportionment. See *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 173 (1983).

- Separate apportionment formulas may be applied to taxpayers with multiple unitary businesses –

As noted in the introduction to this subsection, challenges to formulary apportionment of income are often based on the argument that the factors (property, payroll and sales) used to source the income to the state are unconnected with the income at issue. But what is often unstated is the assumption that the particular income at issue (e.g. from investments) is not from a *separate unitary business that could be separately apportioned* to the state under a separate formula. If that were, instead, the case, it is also assumed that the income could be subject to apportionment using the factors of that unitary business. (The MTC model statutes for combined filing provide for this circumstance.)

- Constitutional standard for apportionment formulas - “out-of-all proportion” –

To show that an apportionment formula applied to particular income is unconstitutional, a taxpayer must prove by clear and cogent evidence that the income attributed to the state is in fact out of all appropriate proportions to the business transacted in that state or has led to a grossly

distorted result. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983)(which cites *Hans Rees’ Sons*, where a single tangible property factor created distortion “so as to reach profits which are in no just sense attributable to transactions within its jurisdiction”).

2.3.7. Use of UDITPA and Similar Sourcing Rules

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 sourcing rules which may be based on UDITPA) applies to partnership income generally—or may apply to certain kinds of partnership income—whether or not the ultimate taxpaying partner is a corporation.

See for example:

- Colorado Revised Statutes, C.R.S. § 39-22-109—which provides specific rules for partnerships but also allows partnerships to use UDITPA.
- Delaware Code, 30 Del. C. § 1623(d)—which provides that the state apportionment rules apply unless the income is allocated or specifically sourced to the state.
- Kansas Form 120S – Partnership or S Corporation Income Tax Return Instructions - which provide instructions on sourcing pass-through income using the same UDITPA provisions as for corporations.
- Administrative Rules of Montana, ARM 42.15.120 – Partnerships also use special apportionment rules adopted by Montana for application to corporate income tax.

The following should also be noted about application of UDITPA in the partnership context.

- UDITPA and similar sourcing rules incorporate constitutional principles –

The constitutional principles above have generally been incorporated into UDITPA, including the MTC’s recommended version of UDITPA, and other similar sourcing rules and apportionment formulas.

- UDITPA generally assumes tax is imposed at the entity level –

While UDITPA applies broadly, it is important to recognize that the model statute and similar state rules were often adopted for taxable corporations and, therefore, these rules assume that the tax is imposed on income of the same person whose information is used to source that income. When it comes to applying UDITPA and similar sourcing rules in the pass-through context, therefore, there are gaps that are not explicitly addressed.

- UDITPA distinguished between business (apportionable) and nonbusiness (nonapportionable) income –

UDITPA has long separated what is traditionally termed “business” from “nonbusiness” income. These distinctions represent what can be apportioned using the unitary business’s apportionment factors and what must be sourced using some other method. In the MTC’s recommended version of UDITPA, the terms used are “apportionable” and “nonapportionable” income. In that version, “apportionable income” generally means “all income that is apportionable under the Constitution . . . including: (A) income arising from transactions and activity in the regular course of the taxpayer’s trade or business, and (B) income arising from tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer’s trade or business.”

- Sourcing of Nonbusiness Income –

UDITPA effectively assumes that it would be unconstitutional to simply use the taxpayer’s apportionment factors related to its unitary business (or businesses) to source nonbusiness income—and that there must, therefore, be alternative means for “allocating” or specifically sourcing that income to the states for tax purposes. Again, as noted above, UDITPA also assumes that the person whose information is used in sourcing this income is the same person who will pay the tax (the “taxpayer”), and so these general rules may be inadequate to specifically address pass-through taxation. So, for example, UDITPA does not specifically address how to source the distributive share of partnership income, assuming it is “nonbusiness” income to the taxpayer.

2.3.8. “Model General Allocation and Apportionment Regulations”

The MTC has issued model regulations interpreting and applying its recommended version of UDITPA. (Available here: <https://www.mtc.gov/Uniformity/Adopted-Uniformity-Recommendations>.) Those regulations do not specifically address partnerships other than in the rules for what is a unitary business and the common ownership requirement and also what is a related entity for purposes of sourcing sales between related entities. Therefore, there may be specific partnership-related issues that are not adequately addressed in the model regulations.

2.3.9. MTC Combined Filing Models – Partnership Provisions

The MTC has recommended to the states that they use combined filing for taxing the unitary income of related corporations and has developed a model statute for that purpose which has two options—so-called *Finnigan* or *Joyce* methods. (Available here: <https://www.mtc.gov/Uniformity/Adopted-Uniformity-Recommendations>.) That model contains the following provisions applicable to partnership income (taken from the Finnigan model):

- Inclusion of partnerships in the unitary business –

“Unitary business” means a single economic enterprise made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. “A unitary business includes that part of the business that meets the definition in this Section 1.1. and is conducted by a taxpayer through the taxpayer’s interest in a partnership, whether the interest in that partnership is held directly or indirectly through a series of partnerships or other pass-through entities.” (Note that what considered a unitary business and what is a controlled group of entities is addressed in the MTC Model General Allocation and Apportionment Regulations.)

- Rolling up of partnership factors –

The model combined filing statutes also provide that if a member of the combined group holds a partnership interest from which it derives apportionable income, the share of the partnership’s apportionment factor[s] to be included in the apportionment factor[s] of the group is determined by multiplying the partnership’s factor[s] by a ratio the numerator of which is the amount of the partnership’s apportionable income properly included in the member’s income, whether received directly or indirectly, and including any guaranteed payments, and the denominator of which is the amount of the partnership’s total apportionable income. If a member of the combined group directly or indirectly receives an allocation of a partnership tax item, such as an item of loss or expense, so that it is not possible to determine the member’s share of apportionable income, the [Director] may provide rules for inclusion of particular partnership

factors, or portions of factors, in the combined group's factors. Also, if a unitary business includes income from a partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income.

2.3.10. Potential Effect on Sourcing of Aggregate versus Entity Theory of Partnerships

In applying the general principles and methods of sourcing income discussed above, there are two competing legal theories of partnerships that may be important. These theories are embodied in state law provisions under which partnerships are formed (which are also generally based on uniform laws) as well as in the federal tax code.

- **Aggregate Theory** – Under the aggregate theory, the partners are viewed as jointly owning an undivided interest in the partnership assets. They also are viewed as collectively making decisions, and are personally bound by the partnership's actions.
- **Entity Theory** – Under the 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 and is a more modern theory of partnerships.

The federal pass-through system is a combination of aggregate and entity theories. In the federal pass-through system, tax items are tracked and characterized at the partnership level and these attributes flow through to the partners—which is an example of entity theory in practice. But in the federal system, each partner also recognizes and pays tax on a share of the items making up that partnership income, applying that partner's own tax attributes—which is an example of the aggregate theory in practice.

- Examples where courts looked to aggregate theory –
 - *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991), discussing at length the difference between aggregate and entity theory, including the state law applicable to the partnership (Massachusetts) and the federal partnership law, and finally determining that the foreign taxpayer's interest in a limited partnership doing business in the U.S. gave that taxpayer a permanent establishment in the U.S. (But see *Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner*, 926 F.3d 819 (D.C. Cir. 2019) dealing with a similar issue where the IRS ultimately abandoned its argument based on aggregate theory.)
- Examples where courts looked to entity theory –
 - *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.
 - *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.
 - *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.

2.3.11. Questions and Issues – Applying Sourcing Principles and Methods to Pass-through Taxation Generally

As the example at the beginning of this section on sourcing above illustrates, differences between approaches to sourcing can lead to very different results. This section raises questions for which most states may not have provided specific detailed answers and also notes how the principles discussed and general sourcing methods used might be adapted to fit sourcing of pass-through income.

2.3.11.1. Partnership or partner information may be used to source partnership income and the approach may depend on whether the partner is a corporation or individual.

As the principles above illustrate, there are a number of determinations necessary for sourcing multistate income. Under the pass-through system, these determinations can be based on the partnership's information alone, on the partner's information alone, or a combination of both. But differences between corporate and individual partners may also affect the determinations.

2.3.11.1.1. Question: What information is used to determine if partnership income or items are business (apportionable) versus nonbusiness (nonapportionable) income?

- **Partnership-Level Information** - An item of income, expense, gain, or loss recognized by the partnership may be determined to be business or nonbusiness using relevant information from the partnership's activities and operations as an entity.

Example: A partnership may acquire property that includes assets for which it has no use as part of its business and disposes of the assets incurring losses which would be nonbusiness losses.

- **Partner-Level Information** - The share of partnership income or an item of partnership income may be determined to be business or nonbusiness using relevant information concerning the partner's relationship to the partnership.

Example: A partner may have only a minority, passive ownership interest in a partnership and may, based on this and other relevant information, determine that the partnership income derived is nonbusiness.

2.3.11.1.2. Question: Assuming partnership income or items are nonbusiness (nonapportionable) income, what information is used to source that income or item?

- **Partnership-Level Information** - An item of nonbusiness income, expense, gain, or loss recognized by the partnership may be sourced based on partnership-level information such as the location of partnership property giving rise to the income or the partnership's own domicile.
- **Partner-Level Information** - The share of partnership income or an item of partnership income determined at the partner level may be sourced by the partner based on the partner's own information—for example, the partner's domicile or residence.

2.3.11.1.3. Question: Assuming partnership income or items are business (apportionable) income, what information is used to source that income or item?

Because of differences between partnership-level sourcing and between individual and corporate partners, state sourcing rules will need to address specifically the methods to be used in different circumstances and the information used.

- Partnership-Level Information – Generally – Business income of a partnership may be sourced using formulary apportionment and including only the partnership’s own factors.
- Partner-Level Information – Individuals – Because individuals typically do not have apportionment factors, the only option for apportioning the partnership’s income for individual partners is to use the partnership’s own factors.
- Partner-Level Information – Corporations – In contrast to individuals, corporations do have apportionment factors so there are three options for applying formulary apportionment to partnership income:
 - Using the partnership’s factors alone. (For example – the income would be apportioned at the partnership level and the corporation’s share would not be included in the corporation’s separate apportionable tax base—but instead, that share would be specifically sourced based the partnership’s apportionment.)
 - Using the corporate partner’s factors alone. (For example – the corporation’s share of the partnership income would be included in the corporation’s apportionable income but no share of the partnership factors would be included in the corporation’s apportionment formula.)
 - Using a combination of the partnership’s and partner’s factors. (For example – the corporation’s share of the partnership income and a share of the partnership’s factors would be included in the corporation’s formulary apportionment of its income.)

2.3.11.2. Question: Does the role or status of partners in the partnership affect sourcing?

It appears that a number of states have at least considered the effect of the partner’s role or status in the partnership on the sourcing of that partner’s share of the partnership’s income. But more often, states have general rules that do not address particular types of partners. Even if the state determines that there should be no difference in treatment, it may also be useful to provide explicit guidance to that effect.

The particular roles or status of partners will depend on the type of partnership and the state law under which the partnership is formed. This outline defines terms that we will use here including:

- Direct and Indirect Partners

A direct partner holds an interest in a particular partnership whereas an indirect partner holds an interest in a tiered partner.

- Active and Passive Partners

Any partner who takes a role in carrying out the business of the partnership beyond merely investing in the partnership, is an active partner, even if the partner lacks the authority to bind the partnership. A passive partner’s role is limited to providing funding to the partnership.

- General Partner (GP) or Managing Member (MM)

A partner or LLC member who has general authority for management of the partnership or LLC, whether or not they have any general liability for partnership debts.

- Limited Partner

Any type of partner who does not have general liability for partnership debts.

- Minority Partner

Any partner other than a majority partner.

- Majority Partner

A partner that has, directly or indirectly, a controlling ownership interest or voting rights in a partnership, applying general attribution rules.

Other categories to consider might be based on:

- Percentage of ownership
- Share of partnership income

2.3.11.3. Question: Should states consider providing different sourcing treatment for income of operating versus investment partnerships?

IMPORTANT NOTE: This question is covered more fully in a separate white paper.

The majority of states recognize investment partnerships as different from operating partnerships, to some extent, and provide that the income of investment partnerships is essentially treated as nonbusiness income in the hands of nonresident partners, so that the income is subject to sourcing to the residence of those individual partners, and sometimes to the domicile of corporate partners. A number of states, however, do not recognize this difference explicitly and a few states specifically provide that investment partnership income is treated no differently.

A number of states have statutes or rules that specifically define investment partnerships, either more broadly or narrowly. These state statutes often have particular tests that must be met by the partnership in order to qualify for this treatment, but the general focus is on identifying partnerships whose activities are investment activities and whose partners are mostly passive. See for example, Cal. Rev. & Tax. Code §§ 17955(a)(1)-(2) and (c)(1); N.M. Admin. Code § 3.11.14(C); Regs. Code tit. 830, § 62.5A.1(3)(b).

The exceptions made for investment partnerships appear to be based on reasoning that includes the nature of the partnership and its activities—that is, investment rather than operations—and the nature of the partners for whom the exception applies—that is, passive partners that do not engage in oversight or management of the partnership’s investing activities. There are differences in these exceptions for investment partnerships and so this may be an area where uniformity would be useful.

See, for example:

- Ala. Admin. Code r. 810-3-24.2-.03(3)(b).
- Ark. Code Ann. § 26-51-202(e).
- Cal. Rev. & Tax. Code § 17955(a)(2).
- Conn. Gen. Stat. § 12-214(a)(3)(C); Conn. Gen. Stat. § 12-213(a)(26).
- 35 ILCS 5/305(c-5); Ill. Admin. Code tit. 86, § 100.3500(d)(1).

- North Carolina Personal Taxes Bulletin 2020, Section VII(15).

But see:

- Utah Private Letter Ruling No. 96-151, holding that a nonresident partner's income from an investment-type partnership would still be sourced to the state.

2.3.11.4. Questions and Issues: How can states conceptualize the issues involved in sourcing partnership income so as to provide specific guidance?

The questions above demonstrate that the nature of the partnership or the nature of the partners may affect sourcing. And, as was discussed in the prior section on determining the tax base, it may be that states would also source some types of partnership income or items—including special allocations, guaranteed payments, or built-in gains/losses—differently. Combined, these variables may be difficult to conceptualize or anticipate various situations for which specific guidance is needed.

The matrix on the following page illustrates just one way in which all these various factors might be considered in determining the sourcing of partnership income or items.

	Nature of the Partnership		Nature of Income Generally - Business or Non-business Determination				Information Used for Sourcing - Type of Partner			Sourcing Rule – Variation Based on Nature of Partner (If Any)					
	Operating or Investment Partnership		Made at the Partnership Level		Made at the Partner Level		Individual, Corporate, or Tiered Partner			Majority or Minority		Active or Passive		Direct or Indirect	
	Operating Partnership	Investment Partnerships	Business	Non-business	Business	Non-business	Individual	Corporate	Tiered	Majority	Minority	Active	Passive	Direct	Indirect
Partnership Income or Item – Shared According to Partnership Interest															
Partnership Income or Item – Special Allocation															
Guaranteed Payments															
Built-In Gain/Loss on Contributed Property															
Other Partnership Income or Item															

2.3.12. Application: When Situs-Based Rather than Apportionment-Based Sourcing Has Been Used (NOTE: This section has been reorganized.)

Attributes of partnerships, partners, and types of income, as outlined in the matrix above, may serve for states to determine whether situs-based or apportionment-based sourcing will be used. As the prior sections also summarize, there are constitutional principles to be applied. But states may have other reasons for designating a particular method of sourcing in particular circumstances.

This section will review some of the main circumstances in which states have applied situs-based sourcing to partnership income, rather than any type of formulary apportionment. The next section will address differences in how states may have applied formulary apportionment to specific types of income or other circumstances, including special allocations, guaranteed payments, and built-in gains/losses.

Note: Sourcing rules may be found in withholding and composite return rules. The final section of this outline will address administrative and enforcement related issues, including state requirements for partnership withholding and composite return rules. Here, it should be noted that some of the authority for sourcing of partnership income can be found in these particular rules—which address sourcing for purposes of nonresident partners.

2.3.12.1. Rationales used by states for situs-based sourcing include whether income is business or nonbusiness, the nature of the partnership, the nature of the partners, or other rationales.

2.3.12.1.1. Situs-based sourcing applied to income determined to be nonbusiness at partnership level:

Situs-based sourcing can be applied at the partnership level under general state sourcing rules. So, for example, under rules similar to those used for sourcing corporate income, a state may determine that the income of a partnership is nonbusiness income at the partnership level and should be sourced based on the type of income and specific rules for sourcing that type of income to a particular jurisdiction—rather than by formulary apportionment.

Some states have explicitly provided that the nature of the income—business (apportionable) or nonbusiness (sourced to situs)—must first be made at the partnership level and then the sourcing of that income determined accordingly. That sourcing information then flows through to the partners along with their distributive share of the income.

See, for example:

- Ark. Code Ann. § 26-51-802(c)(2); Ark. Regs. 1.26-51-405; Arkansas Form AR1050: Instructions for Partnership Income Tax Return.
- Cal. Code Regs. tit. 18, § 25137-1(f).
- Colo. Rev. Stat. § 39-22-203(1)(a).
- Ill. Admin. Code tit. 86, § 100.3500(b)(2).
- Code of Massachusetts Regulations, 830 CMR 62.5A.1, Non-resident Income Tax – stating explicitly: “The income of a pass-through entity that derives

from or is effectively connected with the conduct of a trade or business or the ownership of real or tangible personal property in Massachusetts retains its character as it passes through a tiered structure of pass-through entities before becoming income to the non-resident. Thus, income that is derived from a trade or business does not convert to non-business-related income as it passes through a series of entities.”

- Missouri Regulations, 12 CSR 10-2.190.

Some states do not explicitly address this particular question, but it may be assumed from their general rules as applied to partnerships that the determination of the character of the income would be made at the entity level. Also, the question of whether the character of income is retained when it flows through multiple tiers is often not specifically addressed in state statutes or regulations, although it may be addressed elsewhere.

In general, this “flow-through” of the nonbusiness character of the income to the partners, whether directly or through multiple tiers, matches the federal treatment. Under Subchapter K and IRS regulations, the character of income is determined at the partnership level and flows through, even in a multi-tiered structure. See IRC Reg. §1.1362-2(c)(4)(ii)(B)(4), §1.1362-2(c)(5) Ex. 4.

However—states generally appear to recognize that partnership income can also be nonbusiness income in the hands of the partners even if it was determined to be business income in the hands of the partnership that recognized that income. Therefore, this rule that the character of the partnership income flows through may hold only where the character is determined to be *nonbusiness* income in the hands of the partnership recognizing that item. If, instead, the income was determined to be *business* income in the hands of the partnership, it might still be nonbusiness income in the hands of the partners or might be sourced to domicile or residence based on other rationales.

2.3.12.1.2. Situs-based sourcing applied based on the nature of the partnership – investment versus operating partnerships:

A significant minority of the states have explicitly determined that income of investment partnerships is sourced to situs—either for nonresident individuals or both nonresidents and corporations—using the residence or domicile of the partners.

The approach to this issue differs somewhat from state to state, however.

- In some cases, the designation of investment partnership is used to exclude from taxable income the income of nonresident partners that might be attributed to the state due to the partnership’s activities there.
- In other cases, the designation is used as a means of defining either partnerships that are not considered doing business in the state or that do not have business income in the state. In those states, the designation would affect the sourcing of income for both corporate and individual partners.
- And in other cases, states have made explicit that the designation of investment partnership does not affect the sourcing of income for corporate

partners. This may be because the state has specific rules for corporations and whether any investment income is apportionable (using the corporation's factors) or subject to allocation to the corporate domicile.

In general, for those states that have addressed the issue, the following appear to be the most common requirements for being considered an investment partnership:

- Investment assets must comprise at least 90% of the partnership's assets.
- Investment-related income must comprise at least 90% of the partnership's income.
- If the partnership holds interests in other partnerships, those partnerships must also be investment partnerships under the first two requirements.

The nature of the investments is often spelled out to include shares of stock in corporations and other common securities, but there are questions as to whether the following would qualify:

- Loans or interest on loans made to entities in which the partnership also holds an ownership interest—or in which the partnership hold no ownership interest.
- Fees charged to entities in which the partnership hold no ownership interest.

Examples:

- Alabama - § 40-18-24.3 -- Taxation on distributive share of interest, dividends, etc., of nonresident member of qualified investment partnership.
- Arkansas - § 26-51-202 -- Nonresidents.
- California - § 17955 -- Amounts excluded from gross income in specified circumstances; "Investment partnership"; "Qualifying investment securities".
- Idaho - § 63-3026A -- Computing Idaho taxable income of part-year or non-resident individuals, trusts and estates.
- Illinois - ILCS § 5/1501 Definitions and ILCS § 5/305 Allocation of Partnership Income by partnerships and partners other than residents.
- New York - NYCRR 20 §1-3.2(a)(5) ; NYCRR 20 §1-3.2(a)(6)(i) .

2.3.12.1.3. Situs-based sourcing applied based on the nature of the partner – passive (limited) versus active:

Here, the outline uses the distinction of passive rather than limited partners versus active partners. Traditionally, under state law, there were no forms of partnership that allowed a partner to have limited liability for partnership obligations but to also participate actively in the partnership's business. This has changed and it is not uncommon for partners to have both limited liability and an active role. It appears that it is really the distinction between active involvement in the business of the partnership versus a purely passive, investor role that has influenced the

use of situs-based apportionment. Nevertheless, state authorities that have addressed the issue often do so in the context of limited partners.

Most states do not make an explicit distinction between passive (or limited) and active partners when it comes to sourcing the income of partnerships—or requiring that situs-based sourcing be applied. (Some states simply do not address the issue.) The minority of the states that do make the distinction may treat passive corporate and individual partners somewhat differently. And while the rationale for the different sourcing treatment may not be clear, it may be based in the following:

- **Nexus** – As noted in the section addressing nexus above, in limited instances, state courts have ruled that states may not have constitutional jurisdiction to impose tax on partners that have only a limited interest or passive role in the partnership doing business in that state. See the *Lanzi v. Alabama Dep't of Rev.* and *BIS LP v. Director, Div. of Taxation* cases cited above.
- **Nonbusiness Income** – There is also a potential relationship between the partner's passive role in the partnership and the treatment of the income as non-business or investment income to the partner—which may determine sourcing under state law rules that would prescribe situs-based sourcing in that case.
- **Statutory Doing Business Standard** – Alternatively, the question may be one of state law—whether the partner is deemed to be doing business in the state.

2.3.12.1.4. Situs- versus apportionment-based sourcing as applied to indirect partners:

A significant minority of states have not explicitly addressed whether indirect partners would source their partnership income differently, to situs (domicile or residence), rather than using formulary apportionment. For states that have explicitly addressed the sourcing of income of indirect partners, some have done so in the context of withholding requirements—where the partnership doing business in the state is required to source the income and determine. In those states, the income is sourced at the partnership level and, if apportioned, that will presumably be the basis for sourcing the income in the hands of the partners as well.

2.3.13. Application: Apportionment-Based Sourcing – As Used in Different Circumstances.

Assuming that the state would apply apportionment-based sourcing to partnership income, there are many differences in circumstances that might affect the method used as well as the result (as the example in the earlier section illustrates). This section summarizes how states have addressed certain circumstances.

2.3.13.1. Application of apportionment differs between individual and corporate partners.

Individual partners do not have apportionment factors. Therefore, when states require partnership income to be sourced using formulary apportionment, it is the partnership factors that are applied. This is generally provided for in forms and instructions—as well as in rules for withholding of tax on partnership income.

2.3.13.2. Application of apportionment to corporate partners—states may require rolling up of partnership factors.

For corporate partners, the question is whether the partnership factors should be used to apportion the income, the corporation's own factors, or a combination—sometimes called “rolling up” the partnership factors. The majority rule appears to be that corporate partners must roll up a share of the partnership's factors in apportioning the partner's share of partnership income. See, for example:

- Delaware Code, 30 Del. C. § 1623(d)(2).
- Hawaii Administrative Rules, HAR § 18-235-29-04(a).
- Georgia Rules and Regulations, Ga. Comp. R. & Regs. r. 560-7-7-.03(5).
- Indiana Administrative Code, 45 IAC 3.1-1-153(b)— but only to the extent that the corporation and the partnership are part of a unitary business.

As Indiana's rule and rules in other states may indicate—states may choose whether to include partnership income, which is otherwise not sourced as nonbusiness income, into the income of the corporate partner to be apportioned using only the corporate partner's factors. One circumstance in which this might arise is where the partnership income is operational income to the corporate partner even though that partner owns less than a controlling interest in the partnership and would, under state rules, not be considered “unitary” with the partnership.

2.3.13.3. Application of apportionment in circumstances where there are tiered partners—states may not have explicitly addressed the issue.

As noted in sections above, tiered entities present a question similar to the one faced when using formulary apportionment to source the partnership income of corporate partners. That is—should the factors of the lower-tier, recognizing partnership be used so that the sourcing information is retained as it flows through, or should the factors of the tiered entities be combined, or perhaps used instead of the lower-tier.

Most states have not addressed this issue explicitly or in detail. To the extent that states have addressed it, it may be in the context of the withholding or composite return rules. In that case, it appears that its most often the case that the state would apportion the income at the lower-tier, recognizing partnership level, using only that partnership's factors, and then retain that sourcing for the income as it passes through to the indirect taxpaying partners.

2.3.13.4. Application to different types of income or allocations – effects on the apportionment formula.

Even where it is determined that formulary apportionment should be applied—and it is clear whose factors should be used—there can be questions as to whether the formula might be varied depending on the type of income.

Under a partnership agreement, certain partners may be entitled to a share of partnership income or certain items, or may be provided with special, or preferential, allocations or payments from partnership income, or payments not dependent upon partnership income. There are many economic-based reasons for these agreements, although the agreement does not have to make those reasons explicit. And sometimes the lines

between different arrangements are blurred. But they raise questions as to the proper apportionment formula.

For example – assume Partner Adams has a 10% interest in a partnership. If the partners agreed, Partner Adams might receive:

- A. A pro-rata (10%) share of the partnership income.
- B. A special allocation of 15% of the partnership income.
- C. A special allocation of the first \$10,000 of partnership income and 5% of the remainder.
- D. A special allocation of 20% of capital gains or losses from sale of certain partnership assets and 5% of other partnership income.
- E. A guaranteed payment of \$50,000, regardless of partnership income, and a special allocation of 5% of the partnership income.
- F. A guaranteed payment of 5% of the amount that Adams contributed, regardless of income, plus a special allocation of 5% of the partnership income.
- G. A guaranteed payment of 5% of the amount Adams contributed, plus a guarantee of the return of that capital over time.

The following sections will summarize rules states may consider in apportioning these different types of partner income and allocations.

2.3.13.4.1. Category of partner allocation determined under Subchapter K – IRC § 704(b), § 707(a), or §707(c):

- Distributive Share per IRC § 704(b) – Examples A, B, C and D –

Distributive share is the amount of the partnership’s income or items allocated to partners—whether in proportion to the partner’s interest (Example A above), or a “special allocation,” which includes any allocation not in accordance with the partner’s partnership interest (Example B above), any preferential share (Example C above), and any special allocation of a particular partnership item (Example D above).

Distributive share under IRC § 704(b) is not an expense deduction for the partnership in determining its income. Rather, it is an allocation of the partnership income or items. The nature of the income or items in the hands of the partnership follows the distributive share and determines the character of the income or items in the hands of the taxpayer partners.

- Payments Made to Partners Acting in the Capacity as Partners not Dependent upon Partnership Income – Guaranteed Payments - § 707(c) – Exemplified E and F –

Under IRC § 707(c), partners may agree to receive amounts from the partnership in their capacity as partners that are not dependent upon the partnership income. These payments are called guaranteed payments and may often be paid in lieu of compensation. From a conceptual standpoint, the general difference between guaranteed payments and distributive share

income is that the partner has no entrepreneurial risk associated with the guaranteed payment—since it will be owed to the partner regardless of whether the partnership is profitable. See Prop. Reg. § 1.707-1. Examples E and F above are examples of guaranteed payments.

- Other Payments Made to Partners Acting Not in Capacity of Partners – IRC § 707(a) –

Under IRC § 707(a), partners may also have transactions with partnerships that are in the nature of unrelated transactions. In that case, it is the nature of the transaction that will determine the character for tax purposes. The partnership will recognize expense or a capitalized expenditure and, similarly, the partner will have income or gain as though the transaction was with a stranger—as in the case of Example G, above, which may be treated as a loan by the partner to the partnership.

2.3.13.4.2. Apportionment applied to special allocations – state rules are uncertain:

Circumstances in which the nature of distributive share income might indicate a variation in the apportionment formula used may not be common—but may nevertheless come up in particular circumstances, especially involving special allocations.

For example, assume that partners A and B form a partnership involving real property located in different states. They agree to special allocations of income from the properties so that A receives mostly the income from one state and B receives mostly income from the other state.

Whether this should or does affect the formula used to source the income is not clear and few states appear to have explicitly addressed the question.

2.3.13.4.3. Apportionment applied to guaranteed payments – states are split:

Based on a survey of authorities – the states are split in how to apply apportionment to guaranteed payments. Also, most states that have addressed the issue only address it in the context of individual income tax.

States that source guaranteed payments along with distributive share (using the same apportionment formula):

- California – See Cal. Rev. & Tax. Cd. § 17854 Guaranteed payments to non-resident partner. CA: Cal. Code Regs. 17951-4 Income from a business, trade or profession.
- Minnesota - 2016 Partnership Instructions Change - Schedule KPII, line 23, Page 10 of the Partnership Form M3 Instructions. See also Minnesota Rules 8002.0200, subpart 3.
- Oregon - *Pratt & Larson Tile v. Dep't of Revenue*, 13 Or Tax 270, 05/04/1995.
- Utah - Utah Advisory Opinion, No. 93-006DJ, 03/22/1990.

- Illinois - Illinois Dept. of Rev. General Information Letter IT 12-0028-GIL, 09/27/2012.

States that source at least some guaranteed payments differently from distributive share:

- Colorado – Sourced generally as wages (based on where the work is performed). General Information Letter, No. GIL-20-001, 02/28/2020.
- Idaho – Some sourced as wages (based on where the work is performed). Idaho Tax Update, No. 08/27/2018, 08/27/2018.
- Michigan – Some are sourced as wages, others (capital) to domicile. Michigan Revenue Administrative Bulletin 1988-31, 05/27/1988.
- North Dakota – In the case of a professional service partnership where the guaranteed payment represents a reasonable salary the guaranteed payment is sourced like salary (based on where the work is performed). N.D. Cent. Code § 57-38-08.1
- Montana - Payments to individuals for services are sourced where the services are performed and to a retired individual based on that person's domicile. Otherwise they are apportioned as with distributive share.

States may not only need to address whether guaranteed payments are apportioned using partnership factors, as distributive share, or based on where services are performed, as compensation, but also whether those guaranteed payments should be included in the apportionment factor as payroll.

2.3.13.4.4. Apportionment applied to built-in gains and losses on contributed property – IRC § 704(c) – state rules are uncertain:

Under IRC § 704(c) and IRS regulations, built-in gain or loss on contributed property which may be triggered when the partnership ultimately disposes of the property, will be allocated back to the contributing partner. In that case, the gain or loss represents valuation gains or losses that accrued to the partner prior to the property being used by the partnership. It would be logical, therefore, to adjust the method for sourcing that built-in gain or loss—so as to use the partner's factors or information rather than the partnership's factors or information. It does not appear that most states have explicitly addressed this issue.

2.3.14. Apportionment Applied to Gains Recognized on Liquidating Distributions

Actual distributions to partners typically do not trigger tax. But if a partner receives a distribution that terminates the partner's interest in the partnership, it is considered a liquidating distribution, and may trigger a gain or possibly a loss. Therefore, liquidating distributions have attributes that are similar to gains on sale of partnership interests, discussed in the next section. Under Subchapter K, the amounts received in excess of the partner's basis will be considered capital gains, with exceptions for amounts representing the partner's share of the value of the accounts receivable and inventory, which will be considered ordinary income. See IRC § 731 and related regulations.

As with the sale of a partnership interest, this excess value received in a liquidating distribution likely represents the value of the going concern of the partnership or accumulated

value from operations. Therefore, it may be appropriate for states to consider using a variation of formulary apportionment in the case of liquidating distributions that looks back over some period of time. (This is also discussed further in the following sections on sale of partnership interests.)

2.3.15. Apportionment Applied to Taxes Paid by the Partnership

States that have adopted taxes paid by the partnership, including PTE taxes, as well as composite return taxes and withholding taxes which also require sourcing of the partnership income. (These taxes are discussed further in the section on administration and enforcement below.) State rules for sourcing partnership income in these contexts generally track the sourcing of partnership income for purposes of taxing the partners on a pass-through basis—although there may be a few differences. For example, when sourcing at the partnership level for a PTE tax, it is not possible to take into account certain partner information that might otherwise affect sourcing—such whether a corporate partner’s factors should be taken into account in apportioning the income.

2.4. Credits for Taxes Paid – Resident Individuals

2.4.1. General Requirement

States that tax residents on 100% of their income and nonresidents based on the income derived within the state must generally give their residents a credit for taxes paid to other states on the same income. See *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542 (2015). This requirement derives from the internal consistency principle (discussed in the summary of constitutional principles above).

2.4.1.1. The determination of the credit may be affected by the state’s sourcing rules.

Because the credit for taxes paid is based on the internal consistency principle, states may limit the credit to the tax that a nonresident would pay in that state under the same circumstances—including both the rate of tax imposed and the sourcing of the income.

Example: Assume State A taxes certain partnership income apportioned at the partnership level and other income based on the individual partner’s residence. That state would not have to give a credit for tax paid elsewhere on the income that it sources based on the partner’s residence.

Nothing prevents a state from giving greater credit for taxes paid and some states appear to do this—adjusting the credit only for the rate of tax that the state would apply. For states that limit the credit to the income that the state would tax to a nonresident under similar circumstances, the method of sourcing used by the state will affect the method of calculating the credit and this should be considered when adopting sourcing rules.

2.4.1.2. PTE, Withholding, and Composite Return Taxes

Pass-through entity taxes, withholding and composite return taxes are discussed under the section on administration and enforcement in this outline, below. Assuming that these taxes are imposed on or in lieu of taxes on the partners, including nonresident individual partners, states generally give credits for these taxes to their resident partners as well.

3. Taxation of Gain (Loss) from Sales of Partnership Interest

3.1. Jurisdiction and Nexus Issues (Note: this section has been reorganized)

3.1.1. Most states appear to generally assert nexus over a nonresident or out-of-state corporate partner on the basis of holding a direct or indirect interest in a partnership doing business in the state.

Therefore, while states may not address the question of nexus to tax the sale of a partnership interest directly, it is reasonable to assume that a state will assert nexus unless it specifies otherwise. However, for individual partners, the ultimate answer to the nexus question in a particular state may be influenced by the state's statutory provisions specifying what state-sourced income is and whether the state applies the general principles developed in the corporate income tax context, including UDITPA, to nonresidents.

There have been very few reported cases addressing the question of nexus to tax a nonresident on the sale of a partnership interest. This section analyzes notable cases:

3.1.1.1. Ohio Cases:

- *Corrigan v. Testa*, 149 Ohio St. 3d 18, 73 N.E.3d 381 (2016). This is a case involving nexus to tax a nonresident partner on the sale of a partnership interest. Ohio generally imposed tax on such gains realized by any nonresident owner that held a 20%-plus interest during the three years prior to sale. The gain was apportioned using the partnership's factors for that period.
 - In this case, the taxpayer acquired a majority interest in the business, an LLC, which was already operating throughout the country. Corrigan was the managing member of the LLC and engaged in oversight of the business. The court nevertheless found that he was not active in the business and was not engaged in unitary activities with respect to the business. So, while there was no doubt that this majority partner was taxable on the income of the partnership, apportioned to Ohio, on a pass-through basis, the Ohio Supreme Court held that the gain from the sale of the interest was different. The court distinguished the gain as "investment" income and also determined that nexus was lacking over the transaction. The court also focused on the need to use the investee's apportionment factors to source the gain—as opposed to the traditional method of sourcing such gains from the sale of personal intangible property to the owner's domicile.
- *T. Ryan Legg Irrevocable Tr. v. Testa*, 149 Ohio St. 3d 376, 75 N.E.3d 184 (2016)(cert. denied). Shortly after *Corrigan* was decided, the Ohio Supreme Court distinguished and limited it. In addition, a concurring opinion filed in the later case would have held that *Corrigan* was wrongly decided. The concurring opinion would have held that *Corrigan* was wrong to say that the default situs for investment income was domicile and, instead, would have determined that using the type of

apportionment provided for under Ohio law was permissible. The concurrence likened this to the sale of real estate located in the state.

- See also *Substance and Form in Jurisdictional Analysis: Corrigan v. Testa*, Walter Hellerstein (June 13, 2016) available at [https://www.mtc.gov/MTC/media/Partnership/Hellerstein-\(June-13,-2016\).pdf](https://www.mtc.gov/MTC/media/Partnership/Hellerstein-(June-13,-2016).pdf).

3.1.1.2. Other Important Cases

- *VAS Holdings & Investments LLC vs. Commissioner*, 489 Mass. 669, 186 N.E.3d 1240 (2022). In *VAS Holdings*, Massachusetts sought to tax the gain realized by VASHI, a nondomiciliary corporation, on the sale of an interest in Cloud5 LLC, a pass-through entity doing business in the state. Before ultimately holding that Massachusetts lacked the statutory authority to tax the gain, the Massachusetts Supreme Judicial Court engaged in a robust constitutional analysis that agreed with the commissioner “that the protections, opportunities, and benefits provided by the Commonwealth to Cloud5, suffice to meet the constitutional requirement of a nexus between the Commonwealth and VASHI; and, because the tax imposed by the Commonwealth reflects the apportionment formula of Cloud5, the tax is circumscribed to capture the value of those protections and benefits.” The court also agreed “that Cloud5 flourished within the Commonwealth and that nexus satisfies the due process and the dormant commerce clauses, permitting the Commonwealth to extend its taxing authority to the fiscal measure of Cloud5’s growth — the Cloud5 gain realized by VASHI, Cloud5’s fifty percent owner.” The court observed that the question presented in this case was similar to the one answered by the United States Supreme Court in *International Harvester Co. v. Wisconsin Dep’t of Taxation*, 322 U.S. 435, (1944) and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444, (1940). In those cases, the Court upheld a Wisconsin tax on dividends paid to their investors, regardless of whether those investors were domiciled in Wisconsin, because “the incidence of the tax as well as its measure [was] tied to the earnings which the State of Wisconsin has made possible.” The court found that “these cases provide strong support for the commissioner’s position that the tax imposed by the Commonwealth on VASHI, a nondomiciliary shareholder of Cloud5, passes constitutional muster,” and “the fact that the present case involves profit in the form of capital gains rather than dividends is of no constitutional significance.”
- *Goldman Sachs Petershill Offshore Holdings (Delaware) Corp. v. N.Y.C. Tax Appeals Tribunal*, N.Y. Slip Op. 2361 (Apr. 12, 2022). In *Petershill*, the New York Supreme Court, Appellate Division, First Department held that the capital gain arising from petitioner’s sale of its minority membership interest in Claren Road Asset Management, LLC — a limited liability company taxed as a partnership and conducting business in the City — [was] subject to the General Corporation Tax (GCT) even though petitioner itself [had] no other presence in the City.” The court found that Claren’s activities in the City were sufficient to provide nexus between the taxpayer’s capital gain and the City.

3.1.1.2.1. Business Situs of Intangible Property

Traditionally, states treat the sale of a partnership interest as the sale of an intangible and source the gain or loss to the domicile of the partner. But some states have recognized an exception to the general rule when the partnership has developed a business situs. In *Whitney v. Graves*, 299 U.S. 366, 372 (1937) the U.S. Supreme Court explained

that “[w]hen we speak of a “business situs” of intangible property within a taxing state, we are indulging in a metaphor. We express the idea of localization by virtue of the attributes of intangible property in relation to the conduct of affairs within a particular place.” Two years later, in *Curry v. McCanless*, 307 U.S. 357, 366 (1939), the court elaborated that,

In cases where the owner of intangibles confines his activity to the place of his domicile it has been found convenient to substitute a rule for a reason by saying that his intangibles are taxed at their situs and not elsewhere, or, perhaps less artificially, by invoking the maxim *mobilia sequuntur personam*, which means only that it is the identity or association of intangibles with the person of their owner at his domicile which gives jurisdiction to tax. But when the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state, in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax. Whether we regard the right of a state to tax as founded on power over the object taxed, . . . through dominion over tangibles or over persons whose relationships are the source of intangible rights; or on the benefit and protection conferred by the taxing sovereignty, or both, it is undeniable that the state of domicile is not deprived, by the taxpayer's activities elsewhere, of its constitutional jurisdiction to tax, and consequently that there are many circumstances in which more than one state may have jurisdiction to impose a tax and measure it by some or all of the taxpayer's intangibles. Shares of corporate stock may be taxed at the domicile of the shareholder and also at that of the corporation which the taxing state has created and controls; and income may be taxed both by the state where it is earned and by the state of the recipient's domicile. Protection, benefit, and power over the subject matter are not confined to either state. The taxpayer who is domiciled in one state but carries on business in another is subject to a tax there measured by the value of the intangibles used in his business.

- Relying on this principle, in *Wisconsin v. J.C. Penny Co.*, 311 U.S. 435 (1940) and *International Harvester Co. v. Wisconsin Dept. of Revenue*, 322 U.S. 435 (1944), the U.S. Supreme Court upheld a tax on dividends paid to nonresident owners that had no connection to the state.
- And in *Ariz. Tractor Co. v. Ariz. State Tax Comm'n.*, 566 P.2d 1348 (App. Div. 1 1977), the Arizona Court of Appeals ruled that losses incurred by a domestic corporation's ownership in a limited partnership doing business in another state were not deductible on the domestic corporation's Arizona income tax return because the domestic corporation had established a business situs in another state.
- While it is clear that a state has the power to tax a gain arising from the sale of a partnership interest when the gain resulted from business done in the state, there will need to be some mechanism in place to enforce collection. In *International Harvester* and *J.C. Penney*, the tax involved a transaction between the corporation and

the shareholder, so withholding at the corporation was sufficient to enforce collection. The best method of enforcement is unclear when a partnership interest is transferred from one nonresident to another nonresident.

3.1.1.2.2. Question: How do state definitions of business income and the unitary business principle determine whether a partner is subject to tax on the gain resulting from the disposition of a partnership in the state?

- In *Noell Indus., Inc. v. Idaho Tax Comm'n*, 470 P.3d 1176 (2020), cert. denied, 141 S. Ct. 1391 (2021), the Idaho Supreme Court held that the state could not tax a capital gain realized by a nondomiciliary holding company's sale of a majority interest in a pass-through entity operating in Idaho. The court ruled that the gain was not apportionable in Idaho because it did not meet the definition of business income, and the holding company was not engaged in a unitary business with the operating partnership.
- Conversely, in *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59 (Tenn. 2011) the Tennessee Supreme Court held that a holding company was unitary with a limited partnership it owned, notwithstanding the fact that the entities were not functionally integrated, did not have centralized management, and did not benefit from economies of scale. The court reasoned that that courts must "look beyond the superficial divisions between parent corporations and their subsidiaries to the underlying activity generating the income," and in the case before it the only "underlying activity" generating income for the holding company was the partnership's operations. (citing *Mobil*, 445 U.S. 425, 440-41). Therefore, the court concluded, the holding company was unitary with the limited partnership's business.
- In *YAM Special Holdings, Inc. v. Comm'r of Revenue*, 947 N.W.2d 438 (Minn. 2020), the Minnesota Supreme Court held that Minnesota could tax the gain from the sale of a majority interest in a partnership because the income was business income of a unitary business, and the unitary business had a sufficient connection to the state.
 - In each of these cases, the court's ruling turned, in part, on whether the owners were found to be in a unitary business with the pass-through business doing business in the state. But it is not clear what the proper test is for determining unity when a holding company owns the interest in the pass-through.

3.1.2. Taxes on Exchange of Partnership Interests - Generally

- There are two competing theories about how partnerships should be treated for federal tax purposes, the aggregate theory, and the entity theory. Under the entity theory, a partnership is thought of as a separate entity and the gain from the sale of an interest in the partnership would be treated as an intangible. Under the aggregate theory, the partnership is thought of as an aggregation of the partners. Each partner would be considered a co-owner who shares in the assets and liabilities of the partnership and gain from the disposition of an interest in the partnership would be determined on an asset-by-asset basis.

Subchapter K of the Internal Revenue code has taken a hybrid approach that embraces each theory depending on the context of the transaction. In the case of the sale of a partnership interest, IRC § 741 adopts the entity theory and treats the gain as arising from the sale of a capital asset. But other provisions of the Code ensure that the aggregate theory predominates by looking through to the partnership assets to determine the character and amount of gain.

For instance, under IRC § 751(a) treats part of the gain or loss as ordinary to the extent it is attributable to assets that would produce ordinary income. Additionally, Section 743 provides for a special basis adjustment to partnership assets if a Section 754 election is in place or if there is a substantial built-in loss.

- Most states conform to IRC § 741 and treat the sale of a partnership interest as the sale of a capital asset. But as will be discussed below, a number of states look to the assets of the partnership to determine the source and character of the gain.

3.1.3. Effect of State Adjustments on Basis

- For federal purposes, IRC § 705 provides that the adjusted basis of a partner's interest in a partnership is the amount of property, including money, contributed to the partnership:
 - increased by the sum of the partner's distributive share (not including any guaranteed payments) for the current and prior tax years of:
 - the taxable income of the partnership;
 - the income of the partnership exempt from tax; and
 - the excess of the deductions for depletion over the basis of the property subject to depletion; and
 - decreased by distributions by the partnership and the sum of the partner's distributive share for the current and prior tax years of:
 - losses of the partnership; and
 - expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.
- Most states conform to the federal method for determining the partner's basis in the partnership. But, as discussed in Section 2.2 of this outline, there are a number of state-specific adjustments that could result in an outside basis that is different for state purposes than for federal purposes.

3.1.4. Distributions in Excess of Outside Basis

Under IRC § 731, gain is recognized when partners receive a distribution in excess of their outside basis. Any gain or loss is considered as gain or loss from the sale of the distribute partner's interest. In some circumstances, distributions can represent the value of the going concern of the partnership or accumulated value from operations. In those instances, it might be appropriate to consider apportionment methods that look back to prior years of the partnership's operations.

3.2. Sourcing of Gain (Loss) (Note: this section has been updated)

The sourcing rules for gains/losses from the sale or transfer of a partnership interest are much more developed in the corporate income tax context. In general, if the gain/loss is business or operational income, it is subject to apportionment, and if is nonbusiness or investment income, it is most often sourced to the corporation's domicile. There are a few states, however, that appear to assert the ability to use a ratio based on the partnership's presence or activities to specifically source nonbusiness/investment gains and losses.

But even in the corporate tax context, the rules for how to apportion the gain (whether business or nonbusiness) may raise unanswered questions, such as how to treat the gain when calculating the sales factor. Nor has the Supreme Court ever weighed in on the question of whether a nonbusiness/investment gain may be sourced using the investee's factors or presence in a state. See *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 31, 128 (2008). Also, some states continue to maintain a "liquidation exception" to the definition of business income—either as an interpretation of state law, or an interpretation of the constitutional limits of apportionment generally.

In the individual income tax area, how gain/loss on the sale of a partnership interest would be sourced is much more uncertain. The lack of clear rules is an issue because the concept of taxing an individual's gain from the sale of a partnership interest on an apportioned basis is not self-executing. Unlike corporations, individuals typically do not have their own apportionment factors. Specific state rules are needed in order to implement this approach. Therefore, without these rules, some may presume that the gain/loss will be sourced to domicile.

Only a few states have currently adopted such specific apportionment rules, and those rules differ. See for example:

3.2.1. State Rules

3.2.1.1. California

In *Appeal of Holiday Inns Inc.*, (Cal. State Bd. Equal. April 9, 1986) the taxpayer sold an interest in a partnership that had significant real estate holdings in California. The California Franchise Tax Board ("FTB") assessed the taxpayer additional franchise tax on the theory that the nonbusiness gain should be sourced to California. The FTB argued that the practical effect of selling the partnership interest was the same as selling the real property that was held by the partnership, and alternatively, that the partnership had developed a business situs in the state. In rejecting both arguments, the Board of Equalization noted that California had adopted UDITPA for apportioning income, and "the UDITPA provisions are the exclusive method to be used for apportioning and allocating that taxpayer's business and nonbusiness income."

As a result of the decision in *Holiday Inns*, California adopted a specific rule for sourcing gain and loss resulting from the disposition of an interest in a partnership. Pursuant to the new California statute, gain or loss on the sale of a partnership interest is sourced to California based on the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere. Cal. Rev. & Tax Code § 25125(d). This new statute effectively reversed the decision in *Holiday Inns*, by requiring a look through the partnership structure to the assets of the partnership to determine the source of the gain. Hawaii, Maine, Minnesota, Montana, and North Dakota have all adopted a rule very similar to California's.

3.2.1.2. Oregon

- Or. Admin. R. 150-316-0171(2)(c) S corporation stock. In general, a nonresident's gain or loss from the sale, exchange, or disposition of S corporation stock is not attributable to a business carried on in this state and is not Oregon source income. The gain or loss from the S corporation stock may not be used in the determination of Oregon taxable income unless the stock has acquired a business situs in this state. See section (1) of this rule.

(d) General Partnership Interests. A nonresident's gain or loss from the sale, exchange, or disposition of a general partnership interest in an Oregon partnership is attributable to a business carried on in Oregon and is Oregon source income. The gain or loss is allocated as provided in ORS 314.635 .

(e) Limited Partnership Interests. In general, a nonresident's gain or loss from the sale, exchange, or disposition of a limited partnership interest is not attributable to a business carried on in Oregon and is not Oregon source income. The gain or loss from the sale of the interest will not be used in the determination of Oregon taxable income unless the limited partnership interest has acquired a business situs in this state (see section (1) of this rule.).

(f) Limited Liability Company Interests. The taxation of a nonresident's gain or loss from the sale, exchange, or disposition of an interest in a limited liability company (LLC) operating in Oregon is Oregon source income and is taxed in the same manner as:

(A) The sale of a general partnership interest under subsection (2)(d) of this rule if the selling member is a member-manager of the LLC; or

(B) The sale of a limited partnership interest under subsection (2)(e) of this rule if the selling member is not a member-manager of the LLC.

(C) For purposes of this rule, a person is a "member-manager" of an LLC if that member has the right to participate in the management and conduct of the LLC's business. For an LLC that is designated as a member-managed LLC in its articles of organization, all members of the LLC will be member-managers. For an LLC that is designated as a manager-managed LLC in its articles of organization, only those persons who are both members of the LLC and are designated as a manager in the LLC's operating agreement (or elected as managers by the LLC members pursuant to the operating agreement) will be member-managers.

(g) Limited Liability Partnership Interests. A nonresident's gain or loss from the sale, exchange, or disposition of an interest in a limited liability partnership is taxed in the same manner as if it were a general partnership interest

- Ore. Rev. Stat. § 314.635(4) Gain or loss from the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of a partnership's assets consists of intangibles, gain or loss from the sale of the partnership interest shall be allocated to this state in accordance with the sales factor of the partnership for its first full tax year immediately preceding its tax year during which the partnership interest was sold.

3.2.1.3. New Jersey

N.J. Admin. Code tit. 18, § 35-1.3(d)(5) The allocation of gain or loss from a complete liquidation is determined as follows:

- i. The gain or loss from the sale of real and tangible assets located in New Jersey is sourced to New Jersey.
- ii. The gain or loss from the sale of motor vehicle equipment is sourced to the state where the vehicle is registered, unless the vehicle was used predominantly in another state.
- iii. The gain or loss from the sale of intangibles is allocated using the average of the business allocation used for the last three years, as defined in (d)4 above.

3.2.1.4. Idaho

Idaho Admin. Code r. 35.01.01.266.01(d). “Gains or losses from the sale or other disposition of a partnership interest or stock in an S corporation are sourced to Idaho by using the Idaho apportionment factor for the entity for the taxable year immediately preceding the year of the sale of the interest or stock.”

3.2.2. Federal Landscape

In 1991, the IRS published Rev. Rul. 91-32, which provided that when a foreign partner disposes of an interest in a U.S. partnership, the gain should be calculated by determining the gain if the partnership had disposed of the assets of the partnership. In *Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner*, 149 T.C. 63, 149 T.C. No. 3 (2017), the Tax Court refused to defer to Rev. Rul. 91-32. Instead, the court held that because Congress had not provided for a specific aggregate rule for determining the source and character of gain on the disposition of an interest in a partnership by a foreign partner, the general rule of section 741 should apply, and the gain should be sourced to the domicile of the foreign partner.

In response to the ruling in *Grecian*, Congress passed amendments to IRC § 864(c) as part of the Tax Cuts and Jobs Act that treats “gain or loss from the sale or exchange of a partnership interest as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as non-separately stated income and loss.” General Explanation of Public Law 115-97, 115th Congress, 2d Sess. 220 (2018).

Similar to some of the state statutes discussed earlier, the final regulations under section 864(c) source gain to the United States by looking back to the operations of the partnership in prior years.

3.2.3. Question: Can states require owners of pass-throughs to use the factors of the pass-through to apportion income from the sale of the owner’s interest?

As demonstrated above, the Ohio statute in *Corrigan*, the Massachusetts regulation in *VAS Holdings*, the California method, and the federal regulations concerning the sale of a partnership interest by a foreign partner all look to the previous activity of the partnership to determine how much of the gain should be apportioned to the state. The U.S. Supreme Court

declined to address the issue in *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 31, 128 (2008), and it has not addressed the issue since.

3.3. Credits for Taxes Paid

As discussed in section 2.4 of this outline, states that tax residents on 100% of their income and nonresidents based on the income derived within the state must generally give their residents a credit for taxes paid to other states on the same income. And since the credit is based on the internal consistency principle, states may limit the credit to the tax that a nonresident would pay in that state under the same circumstances. So, when a nonresident partner is taxed on the gain from the sale of a partnership interest, differences in the amount and source of the gain could affect the amount of the credit.

Additionally, some states do not allow nonresidents to take a credit when the tax is paid by the partnership. If the partnership is required to withhold and remit the tax on behalf of the selling partner, then the partner would likely not be able to take the credit in some circumstances.

4. Administrative and Enforcement

4.1. Information Reporting – Pass-through Taxation

4.1.1. Importance of Information Reporting – Pass-through Taxation

The pass-through tax system separates, to a large degree, the reporting of information necessary for the calculation of the tax (done by the partnership) from the calculating and reporting of that tax (done by the partners). So information-reporting requirements not only must serve to make sure that the state has information necessary to verify the tax calculation, but also to enable the partners to make that calculation.

This section will discuss the general information-reporting that is necessary under this pass-through system—broken down between information to enable the payment of tax on operating income and information to enable payment of tax on the sale of a partnership interest. The next section will address information reporting for sale of a partnership interest. A separate section below will address the type of reports used by states under the composite return or PTE tax rules.

4.1.1.1. IRS tax gap data shows that without sufficient information reporting, under-reported income is significant.

In general, partnerships can serve the role of other third parties (employers, third-party payors, etc.) in ensuring that taxpayers receiving income properly report that income. Whether current federal partnership reporting is effective is continually being studied.

- See, for example, the IRS Publication – Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013, p. 14, which describes a category of “income subject to some information reporting,” including partnership income—and estimates the gap in that category to be 17%--which is higher than compensation for which withholding is required, but lower than income on which little or no information reporting is required. Available here: <https://www.irs.gov/pub/irs-pdf/p1415.pdf>.
- See also John Guyton, Patrick Langetieg, Daniel Reck, Max Risch, Gabriel Zucman, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence,” National Bureau of Economic Research, March, 2021. The authors note that it is difficult to estimate the true extent of tax under-reporting in the partnership context because the IRS random audits—used to estimate under-reporting—have been unable to address complex partnerships. This paper also notes: “Partnerships create a specific additional challenge to the audit process, because partnerships can be owned by other entities, sometimes leading to complex ownership structures involving numerous partnerships, corporations, trusts, or other intermediaries.” Available here: https://www.nber.org/system/files/working_papers/w28542/w28542.pdf. Treasury Inspector General for Tax Administration (TIGTA), The Use of Schedule K-1 Data to Address Taxpayer Noncompliance Can Be Improved, September 27, 2019, Reference Number: 2019-30-078. In this partially redacted report, TIGTA found that improvements are needed with the IRS’s process design and collection of Schedule K-1 data to strengthen efforts to address the noncompliance of nonfilers

and under-reporters. <https://www.treasury.gov/tigta/auditreports/2019reports/201930078fr.pdf>

4.1.1.2. Data from the IRS shows that tiered partnership structures are common.

In the TIGTA report reference directly above, the IRS data shows the following breakdown of recipients of Schedule K-1s—individuals (1040's), tiered partners (1065's), and corporations (1120's):

CY	Number of K-1's Filed								
	With 1040s			With 1065s			With 1120s		
	Number	Paper	E-File	Number	Paper	E-File	Number	Paper	E-File
Actual									
2010	3,305,715	74%	26%	23,054,696	34%	66%	7,095,363	59%	41%
2011	3,272,177	46%	54%	22,851,661	26%	74%	6,950,935	45%	55%
2012	3,447,437	36%	64%	25,466,066	18%	82%	7,162,330	33%	67%
2013	3,360,025	30%	70%	26,947,888	15%	85%	7,226,768	27%	73%
2014	3,573,432	27%	73%	28,470,646	12%	88%	7,231,007	22%	78%
2015	3,403,736	22%	78%	29,931,317	9%	91%	7,431,895	18%	82%
2016	3,208,206	21%	79%	29,169,826	8%	92%	7,556,377	15%	85%
2017	3,379,324	18%	82%	28,321,164	7%	93%	7,609,741	13%	87%
IRS Estimates									
2018	3,137,100	18%	82%	30,239,400	5%	95%	7,795,000	11%	89%
2019	3,101,400	17%	83%	30,774,100	5%	96%	7,935,800	10%	90%
2020	3,065,800	16%	84%	31,308,900	4%	96%	8,076,700	8%	92%
2021	3,030,100	15%	85%	31,843,600	3%	97%	8,217,500	7%	93%
2022	2,994,500	14%	86%	32,378,400	3%	97%	8,358,300	6%	94%
2023	2,958,800	13%	87%	32,913,100	3%	97%	8,499,100	5%	95%
2024	2,923,200	12%	88%	33,447,800	2%	98%	8,639,900	4%	96%
2025	2,887,500	11%	89%	33,982,600	2%	98%	8,780,800	4%	96%

What this data also demonstrates is that there are currently about 32 million K-1s' issued to tiered partners compared to about 3 million provided to individuals (1040 returns) and 8 million provided to corporations (1120 returns). The unredacted information in this TIGTA report does not indicate what share of K-1s provided to individuals and corporations were from single tiered partnerships versus multi-tiered partnerships. In other words—some share of these K-1s to taxpaying partners likely also represent income that was passed through multi-tiered entity structures.

This prevalence of tiered partnerships is significant. As studies have shown, complex tiered partnerships, where much of the income from partnership businesses and investments is reported, make tracking and properly computing federal tax much more difficult. See, Martin J. McMahon, Jr., "Rethinking Taxation of Privately Held Businesses," University of Florida Levin College of Law, Legal Studies Research Paper Series Paper No. 16-38, Reprinted in ABA's, The Tax Lawyer, Winter 2016.

4.1.2. Federal Information Reporting

4.1.2.1. The federal rules require the partnership to report the recognition, valuation, and character of items on the IRS Form 1065.

The IRS Form 1065 includes information on partnership tax items as follows:

- Income and Deductions – Page 1 (with additional schedules if necessary)

- Schedule B – Other Information – Pages 2 and 3 – including certain ownership information, interests in other entities held by the partnership, and other information on activities of the partnership
- Schedule K – Partners’ Distributive Share Items – Pages 4 and 5 – including items that must be separately stated and an analysis of net income loss by type of partner
- Schedule K-2 is new for tax year 2021 and is an extension of Schedule K, used to report items of international tax relevance from the operation of a partnership—including GILTI and BEAT
- Schedule L – Balance Sheet per Books
- Schedule M-1 - Reconciliation of Income (Loss) per Books With Income (Loss) per Return
- Schedule M-2 – Analysis of Partners’ Capital Accounts

4.1.2.2. Federal rules require that partnerships report certain information to partners on Schedules K-1, K-2, and K-3.

Under current rules, the partnership must provide certain information to partners including:

- Schedule K-1 – including certain information on the partner’s share of liabilities and capital accounts, as well as the partner’s distributive share of partnership items
- Schedule K-3 – is new for tax year 2021 and is used to report to partners their share of items now required to be reported on Schedule K-2, part of the 1065, reflecting certain foreign activities

4.1.2.3. Note: Partnerships must now report partners’ capital accounts using a particular method called the tax basis method. (See IRS Notice 2020-43.)

Information reporting by large partnerships also now requires that partnerships track and report partners’ capital accounts using a particular method, referred to as the “tax basis method.” While this method will not necessarily match a partner’s determination of outside basis in the partner’s partnership interest, it will often get close. The purpose of having the partnership report the partners’ capital accounts using tax basis is likely to help identify negative capital account balances. If a partner has a negative capital account balance, it may signify that any sale of the interest will have a gain exceeding the proceeds. It may also affect the reporting of other issues. The new guidance is just now being implemented and it remains to be seen how much value the IRS will get from having this information.

4.1.2.4. The IRS imposes accuracy related penalties for failing to properly report information as required on partnership returns.

Federal law imposes penalties for failing to properly and timely file information returns and accurately report necessary information by partnerships. See IRC Sections 6698, 6031, 6721, and 6722.

4.1.3. State Information Reporting – Operating Income

Information reporting is critical in the partnership context but is also largely dependent upon the particular rules that the state adopts. As at the federal level, information reporting serves to show both the character and value of partnership items (the base) but also the distributive share of items to the partners.

4.1.3.1. State information reporting should address state adjustments to partnership operating income – whether reported at partnership or partner level.

To the extent a state may make no significant adjustments to federal taxable income reported by partnerships or partners, the state might rely substantially on the IRS Form 1065 and the federal Schedule K-1s. Most states, however, also have their own state form used for reporting partnership income and any state adjustments necessary as well as forms similar to federal Schedule K-1s for reporting this state-specific information to partners.

To the extent that state law adjusts items reported at the federal level, for any reason, there must be a reporting mechanism to show that such adjustments have been made. Some adjustments can, practically, only be made at the partnership level (on the state partnership return). Others can only be made on the partner's own state tax return. See the discussion of federal conformity above in this outline, as well.

Examples of state adjustments and the factors that might lead to reporting at the partnership or partner level include:

- Adjustments that can be made and reported at the partnership level:
 - Subtraction for certain federal taxable income not subject to state tax.
 - Additions for certain deductible federal expenses not deductible for state tax.
 - Adjustments involving depreciation and the tracking of state-tax basis in partnership assets.
 - Add-backs for related entity charges if applicable.
- Adjustments that can be made and reported at the partner level:
 - Limitations on the use of NOL or capital loss carryovers and their use.
 - Credits against tax under state law—if applicable.

4.1.3.2. State information reporting, unlike federal reporting generally, must also address the sourcing of partnership income.

As with reporting of partnership income and state adjustments, the reporting of sourcing information used by a particular state is dependent upon the specific sourcing rules used. It would be possible, for example, for a state to require sourcing of partnership income entirely at the recognizing-partnership level, requiring that all partners then report their share of that same state-sourced income consistently regardless of

their own status (individual or corporate, direct or indirect) or other partner-related information (business or nonbusiness income).

But while this is often the approach used when the partners are individual direct non-resident partners, if the partnership has corporate or tiered partners, the sourcing rules may require use of combined partnership/partner factors—which would, in turn, require that the partnership do more than simply report the sourcing result—that is—the state share of its partnership items or income using its own factors.

Therefore, most states need to provide that partnerships must report not only the partnership income, as determined under federal and state rules, and its source—but also the information to be used in that sourcing, including:

- Any income or partnership items determined to be nonbusiness and not sourced using formulary apportionment under state rules.
- Any other information necessary for determining whether to use situs-based or apportionment-based sourcing.
- The partnership’s apportionment factors for each state under those states’ rules.
- Each partner’s share of the partnership factors.

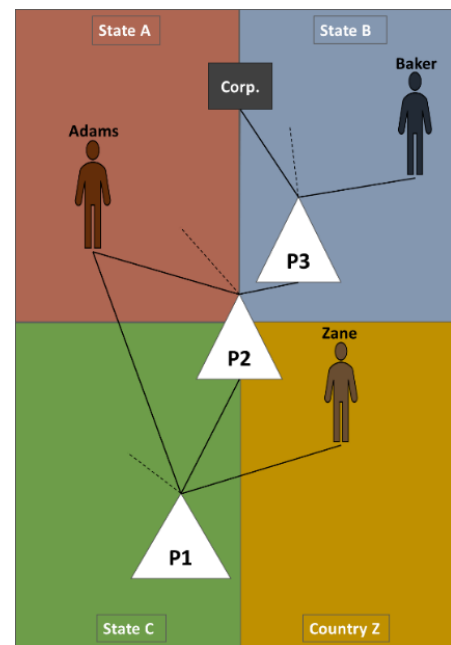
This last point is critical. To the extent that the state were to make a distinction in the sourcing of particular partnership items because of the way in which they are allocated to the partners or their nature, the partner may need to be able to separately calculate an apportionment formula for such income.

4.1.3.3. Complications when tiered partner sourcing information is used.

Even when the recognizing partnership reports detailed information to allow partners to determine the proper state sourcing of that partnership’s income, the existence of tiered partners may complicate the application of state rules as well as the information reporting required.

Example: Assume the following about the diagram shown here:

- P2 holds an 60% interest in P1 and its operations are closely integrated with the operations of P1.
- State A requires that the income of P1 be sourced at that recognizing partnership level (P1) with the sourcing information for that P1 income flowing through to the ultimate tax-paying partners.
- State B, in contrast, requires that, under the circumstances, P2 should re-determine the sourcing of the income from P1, using its share of P1 factors, along with its own related



factors, for apportioning that income for its partners, including P3.

Note that Adams is both a direct partner in P1 and an indirect partner (through P2). Therefore, when determining whether any portion of his ultimate share of P1 income is sourced to State B, it will depend on whether that income flows through P2, or not. (In the case of State A, which uses recognizing-partnership factors only, it will not matter.)

Not only will State A and State B get different results (as the more detailed example in the section on sourcing above demonstrates), but State B will have to provide for a different method of information reporting than State A in order to implement its rule. And P3 will also need to report this information received from P2 through to its own partners – Corp and Baker.

4.1.4. Information Reporting – Sale of a Partnership Interest

Information reporting is also critical for tax on sale of a partnership interest. In this area, the federal government has implemented new requirements for sale of a partnership interest by a foreign partner.

4.1.4.1. Reporting is required when partnership interests are transferred by foreign partners.

The TCJA added IRC section 1446(f) applicable to transfers of partnership interests by foreign partners after January 1, 2018. Under that section, a transferee of an interest in a partnership must withhold 10% of the amount realized on the disposition if the partnership has effectively connected business in the U.S. under IRC section 864(c)(8) (discussed in the section on sale of partnership interests above). If the transferee fails to withhold, the partnership must deduct and withhold from distributions to the transferee the amount the transferee failed to withhold (plus interest).

These provisions require that the transferee, transferor, and partnership comply with certain information reporting requirements as well. See further information on the IRS website – here: <https://www.irs.gov/individuals/international-taxpayers/partnership-withholding>. These withholding requirements are also discussed below.

4.1.4.2. States may need to consider information reporting for sale of partnership interests.

Most states do not appear to have specific information reporting for sale of partnership interests—either by the transferee or the partnership.

4.1.5. Requirement for Consistency in Reporting

IRC § 6222 provides that, for federal purposes, a partner must treat any partnership-related item consistently with the treatment of such item on the partnership return unless the partner notifies the IRS properly of the inconsistency. An unexplained difference in reporting may be treated as a math error (and any additional tax summarily assessed). This type of consistency provision is extremely important, and it would be difficult to administer a pass-through system without it.

4.1.5.1. States may need to consider having a separate consistency provision applicable to state information—including sourcing information.

The federal consistency provision is part of IRC Subtitle F – Procedure and Administration. Therefore, it may be that even states that conform to the IRC through use as AGI or net income would not consider this federal requirement to apply where the particular reporting issue affects only the state taxation of the partnership income.

4.2. Withholding

4.2.1. Operating Income

Both the federal government and most states have withholding requirements for foreign or nonresident partners.

4.2.1.1. Partnerships must withhold on U.S. income allocated under IRC § 704 to foreign partners.

Federal law does not require withholding on operating income except in the case of foreign partners. See IRC §1446. Federal Reg. §1.1446-5 provides for withholding in the case of tiered partners who themselves have foreign partners as well. See also IRS information - Helpful Hints for Partnerships With Foreign Partners, available here: <https://www.irs.gov/individuals/international-taxpayers/helpful-hints-for-partnerships-with-foreign-partners>.

4.2.1.2. The majority of states require partnerships to withhold on the share of partnership income allocated to nonresident partners.

4.2.1.2.1. The MTC has a model law whose provisions may need updating.

Since 2003, the MTC has had a model statute titled: Reporting Options for Nonresident Members of Pass-through Entities with Withholding Requirement. The statute provides for withholding on “nonresidents” (both individuals and corporations not resident or domiciled in the state) on amounts distributed. The model statute briefly describes how withholding works in a multi-tiered structure and provides that the partnership must provide for the ability of partners to take credit for the amounts withheld. Otherwise the model refers to “the manner prescribed by the [tax agency]” for computing the amount to be withheld—presumably including the sourcing of the distributions. This model also contains a composite return provision (discussed further below).

It appears this model may need updating. Possible issues to address are whether withholding should be computed on distributive share rather than actual distributions, when waivers of the withholding requirement may be granted, how withholding, composite returns, and PTE tax provisions should be coordinated, etc.

4.2.1.2.2. Withholding requirements adopted by states have some variations.

The majority of states have withholding requirements for partnerships. Most of these states compute withholding on the basis of distributive share of income or partnership items and may require that the amounts be paid periodically as estimated payments. There are variations, however, including:

- A minority of the states with withholding requirements do not apply them to corporate partners.
- Some states also apply a di minimis standard (typically \$1,000-\$2,000).

- Most, but not all, states also have an exception to the withholding requirement for those partners that file a written consent to be taxed.
- Like the MTC model, most states also do not apply withholding to publicly traded partnerships.
- States that allow or require a composite return also typically exempt partners filing that return from any withholding.
- States that do not tax the income of nonresidents from investment partnerships also typically exempt the partnership from any duty to withhold.
- A handful of states specifically address withholding on guaranteed payments in addition to partnership income.

4.2.2. Sale of a Partnership Interest

4.2.2.1. Federal law now requires withholding on proceeds paid for a partnership interest to a foreign transferor.

As discussed above, federal law now clearly imposes tax on the sale of a domestic partnership by a foreign partner, generally to the extent of domestic assets, and IRC § 1446(f) imposes a withholding requirement as well, unless certain exceptions apply. For future transfers, the transferee is generally required to withhold a tax equal to 10% of the amount realized on any transfer of a partnership interest (other than certain PTP interests). Transferees must obtain certification or other documentation that an exception to withholding applies. The transferee must also notify the partnership that withholding has been made on the transfer. If the transferee fails to do so and withhold any required amount, the partnership must deduct and withhold from distributions to the transferee the amount that the transferee failed to withhold.

The IRS will use Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, and Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests, for reporting and paying the withholding. See also IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities—available here: <https://www.irs.gov/forms-pubs/about-publication-515>.

4.2.2.2. States that source gains from sales of partnership interests on an apportionment basis may wish to consider withholding requirements.

States that impose withholding requirements typically do so in the context of distributive share (operating) income and perhaps guaranteed payments—but not in the case of the sale of a partnership interest. There may, however, be a handful of states that would impose such requirements on the sale of a partnership interest.

- See, for example, Maryland Administrative Release No. 6, p. 2 – “Tax Base” includes: “any income derived from the sale or other disposition of an ownership interest in a pass-through entity where the pass-through entity owns real or personal property in Maryland or conducts a business in Maryland.”

4.3. Composite and Entity-Level Taxes

4.3.1. Suggestions for Federal Entity-Level Tax

While the federal pass-through system is the only system used for reporting tax on partnership income, a number of experts have, over the years, proposed different forms of entity-level taxes instead. These would be single-level taxes, with credits or offsets for partners.

4.3.1.1. A paper on “Rethinking the Taxation of Privately Held Businesses” proposes a simpler approach that would also address abusive tax strategies.

One such tax that would apply to all pass-through entities (including Subchapter S corporations) was proposed by Martin J. McMahon, Jr., professor of law at Florida Levin College of Law, and published in the ABA Journal, *The Tax Lawyer* (a link is available on the project page for this project). In that paper cited above, Professor McMahon lists other proposed entity-level taxes that have been discussed and how his proposal would differ. Under his proposal, pass-through entities would be taxed under rules similar to corporations, including consolidated filing for related entities. When distributions are actually made, partners (including un-consolidated tiered partners) would receive a tax credit—which could be geared to the partner’s effective tax rate or its marginal tax rate—depending on the policy of lawmakers.

Also, under the proposal, partners would no longer be allowed to use losses from one pass-through entity to offset gains or income from other entities (unless those entities are related). This, in turn, would greatly simplify the loss-limitation rules under federal law as well as limit losses created using debt. Professor McMahon notes that it is the ability of partners to create current losses by taking on more debt (and obtaining current year deductions such as interest and accelerated depreciation) that have been the focus of many abusive federal tax planning strategies over the years.

4.3.1.2. While the federal government is unlikely to enact an entity-level tax, the various proposals demonstrate that it is possible to impose such a tax and retain the single tax imposed on pass-through income.

The federal entity level taxes proposed in recent years demonstrate that it is possible to retain the policy of imposing only a single tax on pass-through income while greatly simplifying the tax. To achieve this simplicity, these approaches may sacrifice the ability to apply progressive federal tax rates on partnership income earned by high-income individuals, at least in the current tax years. They have the advantage of being much more transparent so that tracing income and determining that tax has been paid is much easier.

4.3.2. History of Composite and Entity-Level Taxes Generally

NOTE: Unlike federal proposals to tax pass-through income at the entity level (discussed briefly above), state entity level taxes may have a distinct advantage. Because pass-through income would still be reported on federal tax returns under the pass-through system, it is possible for states to gear the credit or offset mechanism to that income, recognized in the current year.

4.3.2.1. States looked to composite returns to help with compliance and enforcement.

As discussed elsewhere in this outline, the federal pass-through system, which most states follow, embodies two policies: (1) that the income be taxed only once (when earned), and (2) that the tax be computed as though the tax items were earned or incurred directly—that is—by taking into account the specific tax attributes of the partners (e.g. tax brackets, passive/active status, income or gains and losses from other sources, etc.). This pass-through system has made both enforcement and compliance difficult, at both the federal and state level. In the 1980's, states began to consider composite returns—under which partnerships would pay tax on behalf of partners in some circumstances. The difficulty with such returns is it may be necessary to sacrifice the principle (using partner attributes to compute tax).

4.3.2.2. The MTC engaged to try to reach a uniform approach.

As states were considering a composite return approach, the MTC staff also began work on a model statute (with an elective composite return option and a withholding requirement, discussed above). There was concerted opposition by some in industry to this model which slowed the MTC's process. By the time the MTC issued its initial proposal, over a dozen states had already adopted some form of elective composite return for nonresident partners.

The MTC's original proposal, issued in 1992 as a comprehensive and detailed draft model statute, attempted to balance the principle of using some partner attributes to compute the tax—with the need to provide an easier partnership-level tax computation. The original model treated the tax computed and paid by the entity as a credit for taxes owed by individual partners. The original model also contained withholding provisions which applied in some cases—including where a composite return was not filed.

For over a decade, no version of the model was adopted. Finally, a scaled down version was adopted in 2003 after two years' of hearings. That simplified version included both withholding and elective composite return provisions. By that time, a number of additional states had enacted withholding and/or composite return statutes or regulations.

4.3.2.3. The TCJA's limitation on the SALT deduction prompted states to adopt PTE taxes as workarounds.

In 2017, the Tax Cuts and Jobs Act limited the deduction for state and local taxes for individuals. As a partial workaround, states began to offer elective in-lieu-of taxes on partnership income at the entity level, giving a credit or exclusion for the tax or income for the partners. The IRS, Notice 2020-75, has indicated that it will respect this entity level tax/deduction for these in-lieu-of taxes—generally referred to as “PTE taxes.” (The TCJA limitation is set to expire in 2025 and Congress has debated repealing it sooner.)

4.3.3. Variations in Composite and Entity-Level Tax Regimes Adopted by States

There are many variations in partnership-level taxes on income. Most of these taxes imposed at the entity level will offset or are imposed in-lieu-of taxes otherwise due from partners. A few states have also enacted non-offset taxes, which are imposed at the entity level instead of or in addition to taxes imposed on the partners. The Texas “margin” tax and taxes in the District of Columbia and New York City are examples of taxes imposed in addition to or instead of taxes on the partners.

4.3.3.1. There are a number of variations in how state composite or PTE taxes work.

In general, the PTE taxes are imposed on income derived within the state (whether the partners are resident or nonresident) as sourced under general state sourcing rules applied at the entity level. But there are many differences in the way the PTE taxes have been implemented.

Examples of important differences in recently enacted PTE taxes include:

- Whether the tax is elective or mandatory. (So far, all states except Connecticut have elective taxes.)
- Whether resident or corporate partners are included in the PTE calculation. (States vary considerably.)
- How the partners' taxes are offset. Some approaches use a credit mechanism (common in composite return filing) but others use a simple exclusion (or some percentage exclusion) of partnership income.
- Whether residents may obtain a tax-paid credit for PTE taxes paid to another state. (States vary and some states may not have addressed the issue explicitly since the tax is imposed only on income derived within the state.)
- Whether partners are jointly and severally liable for the tax (States vary and some states laws are silent.)
- Tiered partners may be generally included—in which case there may be some complications in computing the tax and the offsets that states will need to address.

4.3.4. Audit Procedures and Administrative Adjustment Requests

For years, various studies showed that federal audit coverage of partnerships had declined, in large part because partnership structures have grown in terms of size and complexity. This led to Congress passing the Bipartisan Budget Act of 2015, which gave the IRS authority to audit large partnerships and make adjustments and assess tax at the partnership level.

4.3.4.1. The IRS has begun implementation of the new federal centralized partnership audit and adjustment regime for large partnerships.

The new federal centralized partnership audit provisions are effective for tax years beginning in 2018. The MTC conducted a project to draft provisions for having partnerships report and provide for the payment of state taxes, including an election for the partnership to pay the tax. Information on that project, including information on the IRS centralized audit regime, is available here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>.

4.3.4.2. States may want to consider partnership-level audits for state issues.

States have similar (and perhaps even larger) problems auditing complex partnerships and may wish to consider provisions that would allow auditing and assessment at the partnership level.

See, for example:

- Georgia’s new audit provisions modeled on the federal regime – DOR regulations available here: https://dor.georgia.gov/sites/dor.georgia.gov/files/related_files/document/LATP/Regulation/Rule%20560-7-3-.11%20Partnership%20and%20Pass-Through%20Entity%20Audits.pdf
- Before the BBA, Pennsylvania’s legislature instituted entity-level assessments with Act 52 of 2013. State law 72 P.S. §7306.2 imposes tax at the partnership level if the amount of underreporting of income by more than \$1 million and applies to with 11 or more individual partners or partnerships that have at least one partner that is a corporation, LLC, partnership or trust.