To: Uniformity Standing Subcommittee

From: Helen Hecht, MTC Uniformity Counsel

Subject: Consideration of Possible Project –
Pass-Through Income and Potential Need for Uniform Approaches to Sourcing and Treatment

Date: November 17, 2020

At its November 5, 2020 meeting, the Uniformity Committee adopted a motion to have the standing subcommittee consider a possible project to address state taxation of pass-through income and the need for uniform approaches to particular issues. The motion asked the standing subcommittee to recommend a possible scope for the project, the particular issues to be addressed, the approach to be taken (study, white paper, model, or uniform regulations or legislation, etc.), and whether a work group should be formed. The goal is to provide these recommendations to the Uniformity Committee at its next meeting in April, 2021. The staff of the MTC are available to assist with this work at the direction of the subcommittee.

This Memo provides an introduction to this subject, a basic outline of general issues that might be considered, and a brief, simple example of some of those issues.

NOTE: States may have positions on the issues and questions presented in this memo, although in some cases there may be no explicit or clear written guidance as to the state's position. The fact that the memo presents an issue or question with possible alternative answers should not be taken to imply that there is not one best or proper answer—but only that that the issue or question is potentially unresolved.

Introduction to State Taxation of Pass-Through Income

State taxation of multistate businesses conducted in the form of pass-through entities, taxable as either S corporations or partnerships under federal tax law, present a number of issues state taxation of C corporations does not. This is chiefly because the income is taxed to the owners, rather than to the entity. In many ways, this makes the taxation of the income of the business much more complicated.

For purposes of this introduction, there are a few crucial elements of pass-through taxation that should be remembered. In general:

- The goal of pass-through taxation is to tax income only once, while retaining the requirements as to recognition, valuation, and characterization under the IRC.
- To achieve this goal, contributions and distributions of cash or assets are generally not taxable events (with some exceptions).
- A partner has tax basis in the partnership interest called "outside basis." Outside basis is generally increased by contributions and distributive shares of income and gains and is decreased by distributions to partners and the distributive shares of expense or loss.
- The recognition, valuation, and characterization of tax items (income, expense, gain, loss, etc.) under the IRC are determined at the entity level.
- Taxpayer owners (individuals, corporations, and certain estates and trusts) are taxed on these items of income as allocated.
- Under Subchapter K, partnership tax items can be allocated to owners in shares that do not match the ownership interest provided that they have substantial economic effect and otherwise comply with a number of specific rules for allocation of distributive shares, including anti-abuse rules.
- In a multi-tiered partnership structure, the recognition, valuation, and characterization of income is determined and then flows through each tier to the taxpayer owners.
- Certain tax items are "separately stated" by the partnership on the IRS 1065 return and schedule K-1s to the extent that the character would affect the tax calculation of the taxpayer owners. This preserves the federal treatment of different types of tax items (e.g. ordinary income, capital gains, etc.), and ensures that taxpayer owners will be treated the same whether they earned or incurred the tax item directly or in their capacity as partner.
- Partnerships, unlike S corporations, can exist in complex multi-tiered structures where partnerships own other partnerships ("tiered partners") and with hundreds or thousands of direct and indirect taxpayer partners.

Basic Outline of Issues

1) Nexus/jurisdiction – generally.
   a) Over the partnership (which may be essential to require withholding or composit returns or to comply with information requests).
      i) Whether a state has jurisdiction over a partnership if its only connection to the state is a partner, indirect partner, tiered partner, limited, or minority partner.
      ii) Whether any jurisdiction is somehow limited in a case where the partnership has only a minority, passive, indirect owner.
   b) Over the partners.
      i) Whether a state has jurisdiction, including taxing jurisdiction, over a partner because of the partnership's activities in the state, including where:
         (1) The partner is a limited, minority, or passive partner,
         (2) The partner is an indirect partner, or
         (3) The partner is a tiered partner.

2) Application of the unitary business principle.
   a) Can partners and partnerships (including tiered partners) be treated as a unitary business?
   b) If the unitary business principle is applied, how are minority partners treated?

3) Application of UDITPA.
   a) To operating income:
      i) Can UDITPA be generally applied to partnership income?
      ii) How should the determination of business/nonbusiness income be made?
         (1) At the level of the partnership that recognizes the tax item,
         (2) At the top level in a tiered structure—using the top tier entity's facts, or
         (3) At the taxpayer partner level.
      iii) How should nonbusiness income be allocated?
         (1) Based on facts at the level of the partnership that recognizes the tax item,

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

(3) Based on facts at the taxpayer partner level.

iv) How should apportionment be applied?

(1) Once at the level of the partnership that recognizes the tax items and then flowing through to the taxpayer partner,

(2) Successively at each entity-level in a tiered structure,

(3) At the top-tier or owner level using that entity or owner's factors,

(4) At the top-tier or owner level, combining a share of factors from lower tiers, etc.

v) Do the answers in iv) depend on whether the ultimate taxpayer owner is a C corporation?

b) To transactions between the partner and the partnership—do the answers in iv) above apply in the context of taxable transactions between the partner and the partnership, or if they vary, how do they vary?

c) To transactions between partners, including transfer of ownership interests—do the answers in iv) above apply in the context of the transfer of ownership interests or other transactions between partners, or if they vary, how do they vary?

4) Administration.

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

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

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

5) Other.

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

b) Should states conform to various aspects of federal law and if conformity creates issues for states how should those issues be addressed?

Simple Example

Assume State A, B, and C use a 3-factor UDIPTA formula for corporations and would exclude any factor that has a $0 denominator.

Year 1

- Partnership begins as the real estate business of Smith and Jones.
- Smith contributes vacant land (held as an investment) in State A worth $100,000 with a tax basis of $50,000 and Jones contributes $100,000 cash
- Both Smith and Jones are general partners, active in the business.
- Both Smith and Jones are residents of State A.
- Smith and Jones agree to split the partnership tax items 50/50.
- Smith and Jones each have an office in their homes and no other business property.
- Under federal law—neither Smith nor Jones is treated as an employee.

Year 2

At the beginning of the year, Partnership buys rental property in State B.

Question 1: How should Smith and Jones pay tax in States A and B?

- **Sub-question**: First, we have to know whether, if the Partnership uses apportionment—what should the value of the property in State A be (the value when contributed or the tax basis)?
- Assuming Partnership uses the value of the property in State A when contributed, factors in State A and State B would be:

	State A	State B	Total
Property	$ 100,000	$ 100,000	$ 200,000
Payroll	$ -	$ -	$ -
Receipts	$ -	$ 10,000	$ 10,000
Factor	25%	75%	

- Some states, however, do not clearly provide for the application of UDITPA to partnerships such as this. It may be unclear, therefore, whether Partnership should source 75% or 100% of its rental income to State B.

- This uncertainty can create problems in both State A and State B. If Partnership sources only 75% of the partnership income to State B, then Smith and Jones will each be entitled to a credit in State A for amount of tax actually paid in State B. If, later, State B were to audit Partnership and find that 100% of the partnership income should be sourced to State B, Smith and Jones would have to amend returns in State A, if they still can, and take additional credit for taxes paid.

Question 2: Assume Partnership were to sell the property in State A at the end of Year 2 for $100,000. Under federal partnership rules, the entire amount of built-in gain ($50,000) would be the distributive share allocated to Smith. Should part of this gain be apportioned to State B along with the rental income?

- It could be argued that the gain accrued while Smith held the property separately from the Partnership (which is also why the entire gain is Smith's distributive share) and should be allocated entirely to State A.

Year 3

Partnership takes on a new "silent" partner – Doe, also a resident of State A. Doe contributes a small amount money to Partnership and is entitled to receive 5% of the partnership income, but is not active in the business.

Question 3: Can State B impose tax on Doe?

- One theory is that State B lacks nexus over Doe. (But that is not the position most states would take.)
- Another theory is that Doe's share of the income of Partnership would be nonbusiness income to Doe, even though it is clearly business income in the hands of Partnership. But even then, there is an argument that as rental income, it should be sourced to State B.
- A third theory is that the income of Partnership is characterized for state purposes in the hands of the partnership and these characteristics (like the federal characteristics of partnership tax items) flow through to the partners. In this case, Doe's share of the partnership income would be business income (subject to treatment as such).
- Again—this may affect not only how much tax Doe pays in State B but how much tax he would owe in State A (because of the credit for taxes paid).

Year 4

Partnership has an opportunity to acquire profitable rental property in State C currently held by an LLC. Rather than buy the property, Partnership acquires a 50% interest in LLC, which will continue to hold the property.

Question 4: After Partnership acquires its interest in LLC, are Smith, Jones, and Doe required to file in State C?

- One theory is that State C lacks nexus over Partnership's partners because they are not direct partners in the LLC.
- Another theory is that Smith and Jones, as active in Partnership, are subject to tax in State C, but Doe is not.
- Another theory is that Doe is also subject to tax in State C since he can obtain information on the source of LLC income.
- Yet another theory is that it doesn't matter how many tiers the LLC income flows through, since it acquires its "state characteristics" (sourcing, business/nonbusiness, etc.) in the hands of the LLC and that information flows through with any allocation to upper tiers. So, another related question is whether it matters if the income is business or nonbusiness in the hands of the LLC.
- Again, the answer to these questions will affect whether Partnership partners pay tax in State C and also what amount of credit they can take for taxes paid in State A.

Question 5: Assuming that State C can impose tax on Smith, Jones, and Doe, how should the income from the rental property there be sourced?

- Assume Partnership has net income of $1,000 after expenses and LLC has net income of $2,000 after expenses. (Partnership's share of LLC income would be $1,000).
- Assume that Partnership and LLC entity-level factors are as follows:

Year 3				
Partnership:				
	State A	State B	State C	Total
Property	$ 100,000	$ 100,000	$ -	$ 200,000
Payroll	$ -	$ -	$ -	$ -
Receipts	$ -	$ 10,000	$ -	$ 10,000
Factor	25%	75%		
LLC:				
	State A	State B	State C	Total
Property	$ -	$ -	$ 200,000	$ -
Payroll	$ -	$ -	$ 10,000	$ -
Receipts	$ -	$ -	$ 20,000	$ -
Factor	0%	0%	100%	
Partnership With Inclusion of Share of LLC Factors:				
	State A	State B	State C	Total
Property	$ 100,000	$ 100,000	$ 100,000	$ 300,000
Payroll	$ -	$ -	$ 5,000	$ 5,000
Receipts	$ -	$ 10,000	$ 10,000	$ 20,000
Factor	11%	28%	61%	

- Assume State B apportions the income of Partnership and LLC at the entity level and this information then flows through to the partners. Partnership partners would have $750 of State B-sourced income from Partnership and $0 of State B-sourced income from LLC.
- Assume, instead, State B “combines” the share of LLC income and factors with the income and factors of Partnership. Partnership partners would then have $560 of combined Partnership/LLC income sourced to State B.

Year 5

Doe sells his interest in Partnership and recognizes a gain.

Question 6: Can states B and/or C tax any share of that gain. (See also the question in Year 3 above.)

- Assuming that State B (and State C) would answer the question regarding Year 3 (above) in a particular way, does the fact that this is the gain from the sale of the partnership interest, rather than income earned in that year by the partnership, make a difference?
- If the gain can be sourced to State B, presumably using apportionment, which factors are used (Partnership or Partnership with Share of LLC)?