MTC PROJECT – STATE TAXATION OF PARTNERSHIPS

ISSUE OUTLINE

Current as of August 10, 2021

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

**Introduction**

Most states conform to the federal partnership tax system. That system differs from the corporate tax system in three important ways.

* Partnerships are taxed on a passthrough basis. That means information essential to tax-reporting is split between the entity and its owners.
* Partners have flexibility that corporate shareholders generally lack—to share partnership items in proportions that differ from other items and from their ownership interests. IRC Subchapter K allows this flexibility as well.
* 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 Tax System***

By passing through the partnership’s tax items to the partners in a way that matches the true economic effects, the federal system attempts to ensure that the creation of a partnership cannot be used to alter the tax-effects of those items on the partners. Different tax items may have significant effects on the federal tax owed by different partners—especially given the differences in federal tax rates.

But these same attributes of the federal partnership tax system 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]](#footnote-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 resolve.

***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.

***Current State Approaches to Taxation of Partnership Income***

States currently tax partnership income in three ways:

1. On a passthrough basis with income sourced to residence or domicile of partners;
2. On a passthrough basis, using apportionment for corporate and nonresident partners and a credit system for resident partners;
3. On an entity basis, apportioned, with offsets for partners.

Method 1 is the method most states used for income of investment partnerships. Method 2 is the method generally used for operating partnerships. Method 3 is now being used for so-called SALT-cap workaround taxes.

***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.

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.

# General Terminology

NOTE: 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.

## Terms Describing Partnerships

### Partnership

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

### 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.

### Operating Partnership

A partnership other than an investment partnership.

### 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. ]

### 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.

### 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.

## Terms Describing Partners

### Partner

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

### Corporate Partner

A partner taxed under IRC Subchapter C.

### Individual Partner

A partner taxed as an individual under state law, including taxing on a residency basis.

### Resident and Nonresident Partners

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

### 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.]

### 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.

### Majority Partner

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

### Minority Partner

Any partner other than a majority partner.

### Taxpayer Partner

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

### Tiered Partner

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

## Other Terms

### Passthrough Entity

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

### Passthrough Taxation

The general method used under IRC Subchapter K 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.

### Allocate/Allocation

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

### 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.

### Partnership Return (1065)

The federal or state return filed by the entity in which it characterizes and determines the value of the partnership 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.

### 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.

### 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.

### Partnership Sourcing

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

### Situs

Sourcing income or other items based on specific rules for the particular income or item.

### Apportionment

Sourcing income or other items using apportionment factors.

# Taxation of Partnership Income and Items

## 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.

### Jurisdiction/Nexus Over Partnerships Doing Business in the State

#### 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.

### Jurisdiction to Require Reporting of Partnerships Not Doing Business in the State

The passthrough 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. As a result states may need to assert jurisdiction on the basis of resident partners—who are taxed on 100% of their income, wherever earned.

#### 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 doing business in the state. This primarily affects the ability of resident partners to properly calculate the state tax base (e.g. where the state requires adjustments to the federal tax base).

#### 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 partner is uncertain. Again, this primarily affects the ability of resident partners to properly calculate the state tax base.

### Factor-Presence Nexus Standards Applied to Partnerships

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

The MTC adopted a model factor presence nexus standard for partnerships 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.”

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

#### P.L. 86-272 generally applies to partnerships at the entity level.

The federal statutes 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.

### 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 passthrough 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.

#### 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.

#### Question – Does the nature of the partner affect the 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.

##### Authorities indicating the state does have nexus:

* See Hellerstein, Hellerstein & Swain, State Taxation ¶ 20.08[2][a][ii] Limited Partners.
* *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).

##### 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.

##### 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. 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 the past, it was true that 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, 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 investment partnerships to the partner’s residence or domicile. Investment partnerships will be discussed in the section on sourcing of partnership income, below.

#### General State-Law Exceptions to Tax Imposition

##### Whether or not 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 imposition provisions.

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 states was not, itself, doing business.

## Determining Tax Base

### Federal Conformity and State Adjustments

#### Federal Conformity – Generally

There are four main elements of federal conformity that apply to state taxation of partnerships: conformity to the definition of a partnership; conformity to rules for calculating partnership income and items; conformity to Subchapter K; and conformity to individual or corporate tax rules for determining a partner’s taxable income. Differences in state rules may require the partnership, the partners, or both to make adjustments for state tax purposes.

##### Conformity to the Definition of a Partnership

States generally conform to the federal definition of what is a partnership including IRC § 761 the check-the-box rules of Reg. § 301.7701. Under § 761, parties to certain agreements for co-investment or co-ownership may elect out of partnership treatment if they can calculate their income without resort to Subchapter K.

##### Conformity to Rules for Calculating Partnership Income and Items and Treatment of Transactions with Partners

At the federal level, partnership income and items are generally characterized and valued using the tax rules for individuals. See IRC § 703. And while distributions do not affect partnership income, payments to partners for goods and services will affect the calculation of that income. See IRC § 707.

Most states that tax partnership income on a pass-through basis generally conform to these rules, but may require certain adjustments be made for state purposes. For example, a state may require that certain deductible expenses for federal purposes be added back, or may subtract income subject to federal tax but not to state tax.

It appears these adjustments affect should only the calculation of partnership income subject to tax in the state, and perhaps the basis in partnership assets, and would not affect the basis of the partners in their partnership interests.

##### Subchapter K Conformity

Once partnership income and items are determined, the effect on the partners must also be determined. This is controlled by Subchapter K, which also controls the effects of other transactions between partners and the partnership. States generally conform to Subchapter K and its various rules for how partnership activities, income, and items will be reflected in the partners’ returns.

##### Conformity to Individual and Corporate Tax Rules for Determining Partners’ Taxable Income

Partnership items that pass through to partners are then subject to federal rules for calculating the tax of the individual or corporate partners. Again, while states generally conform to these federal rules, states may require that adjustments be made to calculate a partner’s state income subject to tax.

For example, net operating losses of partnerships flow through and may be used to offset gains or income from other sources to the extent not limited by federal passive or at-risk limitations. But states may also impose limitations on NOL carryovers not imposed at the federal level. These types of adjustments typically do not affect the partnership’s determination of its tax items.

### Intercompany Transactions, Add-Back Statutes and Transfer Pricing

#### Intercompany transactions may affect the partnership income and tax items.

Because partnerships may be related but generally do not file combined returns, intercompany transactions may affect the income of partnerships, and the state tax base. Partners’ transactions with the partnership will generally be treated as third-party transactions under Subchapter K whether done in the form of a third-party transaction under IRC § 707(a) or as a guaranteed payment to the partner under § 707(c). Indirect partners may also transact with partnerships in the same manner as third-parties.

#### IRC Sec. 482 which governs the transfer pricing of related-party transactions applies to partnerships.

To the extent related-party transactions occur between partnerships, those transactions, like transactions between related corporations, are subject to IRC § 482 and related regulations. These transactions may not receive much scrutiny at the federal level, other than in the international context, but states that conform to § 482 may need to rely on it to determine fair arm’s-length pricing when transactions might otherwise affect the amount of partnership income subject to tax. This is especially the case for partnerships since, unlike corporations, states using the passthrough system do not require combined filing of related partnerships.

#### Question: Do state add-back statutes for intercompany transactions apply to related partnerships and is guidance clear?

## Sourcing of Partnership Income

In general, there are different methods by which partnership income or items may be sourced. The method used may significantly change the result. Therefore, the effect of the method and its policy implications should be considered. Also, the method used may be subject to constitutional or practical constraints.

### Terms – Situs-Based and Apportionment-Based Sourcing

#### Situs-Based Sourcing

* The term “situs” or situs-based sourcing will be used here to refer generally to sourcing of items of income, most often to a particular geographic location. Under UDITPA, for example, so-called nonbusiness (or nonapportionable) income is sourced, or “allocated,” 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 the real property. See UDITPA, Art. IV Sec. 2.

#### Apportionment-Based Sourcing

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 divided between multiple locations. The term “apportionment” here is used broadly to encompass the use of the income-producer’s factors, the owner’s factors, or a combination of both.

### Differences Between Corporate and Individual Partners

### Methods of Sourcing Partnership Income - Generally

#### Situs-based sourcing – using partnership information.

#### Situs-based sourcing – using partner information.

#### Apportionment-based sourcing – using partnership information.

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

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

### Effect of Tiered Partnership Structures on Sourcing

#### Lower-tier passthrough sourcing.

#### Upper-tier sourcing.

#### Combination sourcing.

### Example – Differences in Results Between Methods Used

### Sourcing Methods - Constitutional Requirements

### Sourcing Methods – Policy and Other Considerations

### Application of UDITPA - Generally

### Sourcing of Guaranteed Payments.

## Credits for Taxes Paid

# Taxation of Gain (Loss) from Sales of Partnership Interest

## Jurisdiction and Nexus Issues

## Determination of Gain (Loss)

## Sourcing of Gain (Loss)

## Credits for Taxes Paid

# Administrative and Enforcement

## Information Reporting and Withholding

## Federal Procedural-Type Rules

## Composite and Entity-Level Taxes

1. The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 6th, Laura E. Cunningham and Noël B. Cunningham. [↑](#footnote-ref-1)