MTC PROJECT – STATE TAXATION OF PARTNERSHIPS

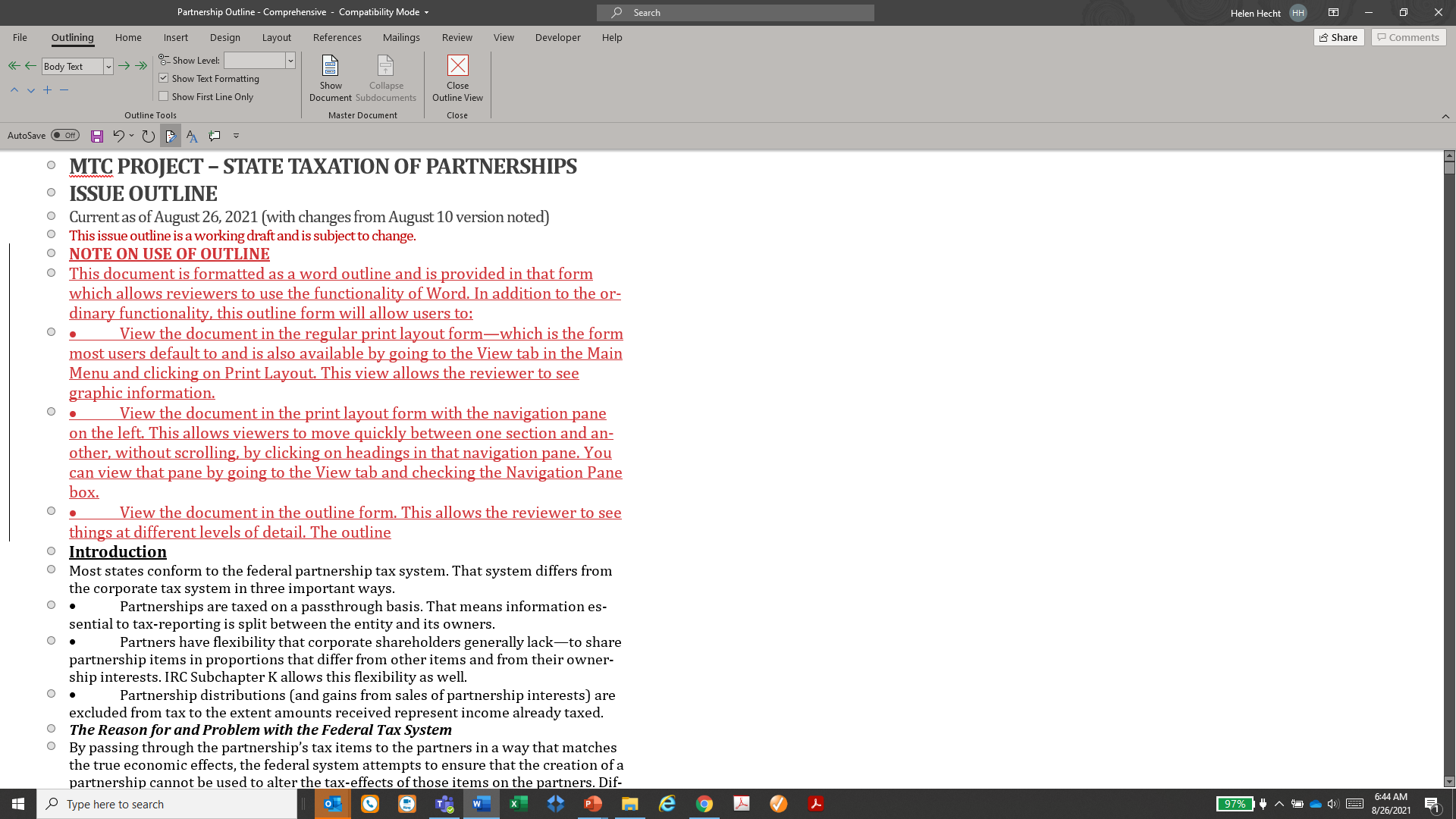
ISSUE OUTLINE

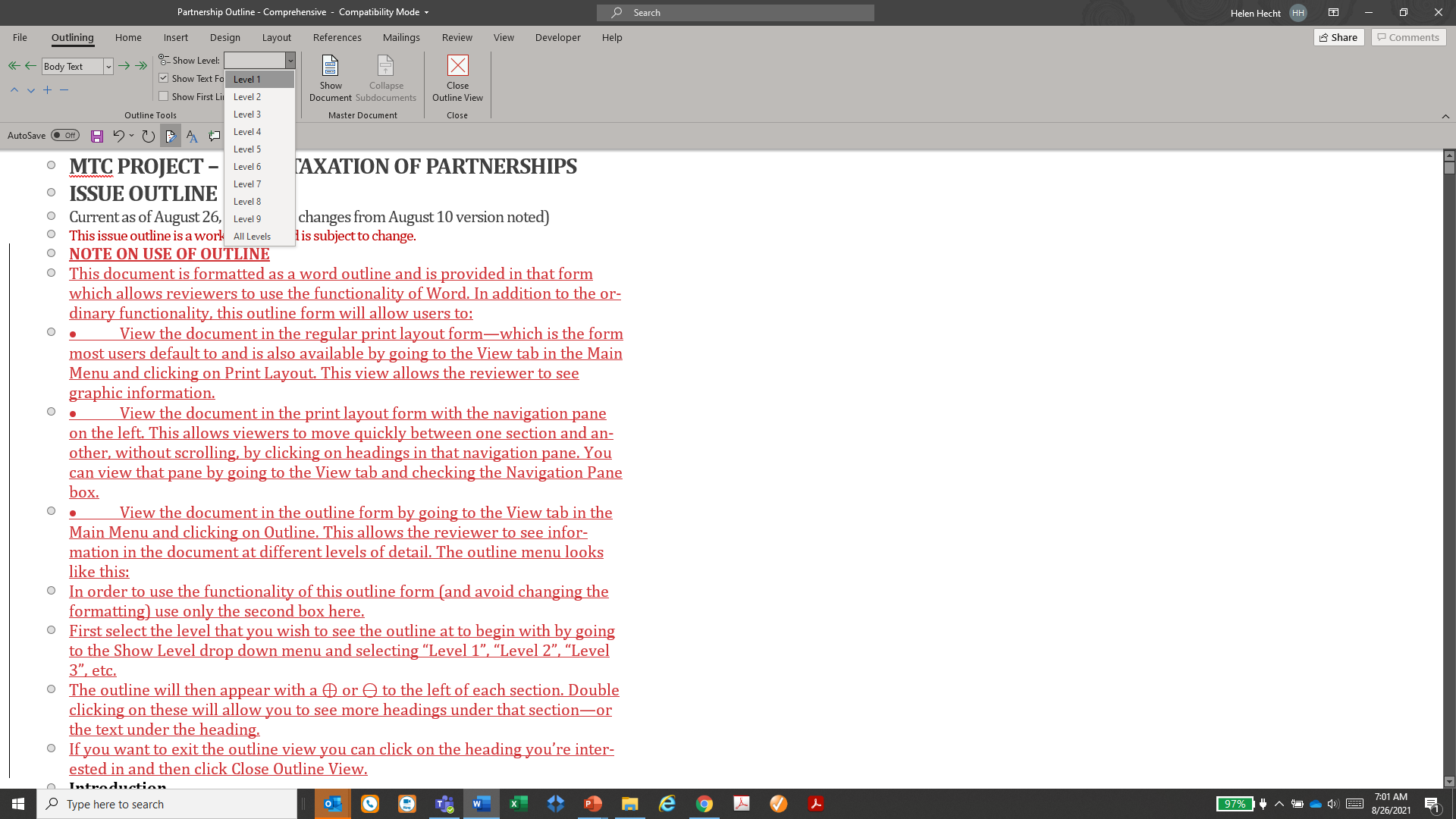
Current as of September 23, 2021 (with significant changes from September 8 version highlighted).

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

**NOTE ON USE OF OUTLINE**

This document is formatted as a word outline and is provided in that form which allows reviewers to use the functionality of Word, which includes the ability to:

* View the document in the regular print layout form—which is the form most users default to and is also available by going to the View tab in the Main Menu and clicking on Print Layout. This view allows the reviewer to see graphic information.
* View the document in the print layout form with the navigation pane on the left. This allows viewers to move quickly between one section and another, without scrolling, by clicking on headings in that navigation pane. You can view that pane by going to the View tab and checking the Navigation Pane box.
* View the document in the outline form by going to the View tab in the Main Menu and clicking on Outline. This allows the reviewer to see information in the document at different levels of detail. The outline menu looks like this:

In order to use the functionality of this outline form (and avoid changing the formatting) use only the second box here.

First select the level at which you wish to view the outline to begin with by going to the Show Level drop down menu and selecting “Level 1”, “Level 2”, “Level 3”, etc.

The outline will then appear with a ⊕ or ⊖ to the left of each heading or subheading. Double clicking on one of these will allow you to see more or less detail in that section including the subheadings or text under the heading.

If you want to exit the outline view you can move to the heading you’re interested in and then click Close Outline View and you will return to the print view.

**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?

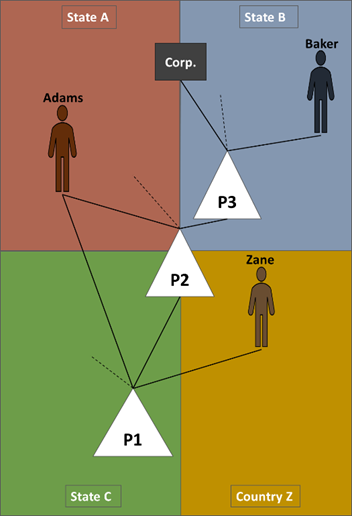
***Approach to the Project***

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.

### 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.

### 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—including any add-back adjustments for intercompany transactions that may apply. 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. 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.

#### 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.
* 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.

##### 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 tax 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.

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.

One exception to this rule is state treatment of investment partnerships and partners generally. Many states tax the income of investment partnerships only on a domicile or residency basis and so would not assert the authority to tax a non-resident investment partner on that partner’s share of the partnership income.

## Determining Tax Base

This section addresses issues affecting the determination of operating income for state purposes. A later section of this outline addresses issues affecting the determination of gain or loss from the sale of a partnership interest.

### 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, other 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. (Also, see below for exceptions made for certain items treated under IRC § 707(c),) 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 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’ income 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.

### Conformity Implications and Questions

Some aspects of federal conformity are fairly straightforward and raise few questions in the state context. But others carry implications for states or raise questions that may not be fully addressed by the states. In large part, this is because states may only tax a portion of the income of multistate partnerships and because, under the passthrough system, it is not feasible to require related partnerships to file combined returns (discussed further below).

The following section touches on some of the most important implications of federal conformity in this state tax context and notes questions raised that states may need to further consider. Note that in some cases, it is the relationship between multiple aspects of federal conformity (e.g. the treatment of guaranteed payments combined with the ability of partners to offset income and loss from different sources) that is critical.

This section cannot hope to provide an exhaustive analysis of these implications and questions, but those summarized here should serve to illustrate why states may need more detailed rules addressing federal conformity in particular instances.

#### Guaranteed Payments to Partners Treated as Deductible Expense

##### State rules and guidance often focus on distributive shares of partnership income allocated to the partners each year and not on guaranteed payments to partners, which are treated differently under Subchapter K.

##### There is a fundamental difference between distributive shares and guaranteed payments. Distributive shares are allocations *of* partnership income, whereas guaranteed payments are generally reductions *from* partnership income. This difference may matter for purposes of how guaranteed payments affect state taxes.

Guaranteed payments are governed by IRC § 707 which defines these payments as those made by a partnership to a partner for services or for the use of capital to the extent such payments are determined without regard to the income of the partnership. Guaranteed payments can, in fact, create losses for the partnership.

Guaranteed payments are characterized and otherwise treated by the partnership as if they were transactions with a person who is not a partner. This means the partnership will generally recognize deductible expense or, if the payment is for property conveyed by the partner, a capital asset.

##### Question: Should guaranteed payments be sourced separately from distributive shares?

Assume that Partnership X does business mainly in State 1. One of Partnership X’s partners provides services entirely from her home state, State 2, for which she receives a guaranteed payment, and also receives a distributive share of partnership income. Should the guaranteed payment be sourced on the same basis as the distributive share (e.g. using Partnership X’s apportionment formula).

##### Question: Should guaranteed payments be subject to state anti-income shifting or other limitations?

It appears guaranteed payments can be used for state income shifting—as could transactions between related partnerships (see further discussion below). States may need to consider this possibility and rules that would limit abuse.

#### Special Allocations Allowed

##### State rules often assume that partners’ distributive shares will be in accordance with their interest in the partnership, but this may not be the case.

##### Under IRC Sec. 704(b), partners may agree to allocate items of partnership income, gain, loss, and expense in proportions that differ from the partners’ interests in the partnership. Provided that these “special allocations” have substantial economic effect and do not violate anti-abuse provisions, as further defined by IRS regulations, they will be allowed. The requirement for substantial economic effect generally prohibits partners from using special allocations to artificially lower partners’ combined federal income tax liability while having no other economic effect on the partners. This requirement extends not just to the tax year in which the allocations are made, but over time, and prohibits shifting allocations that are used to lower total combined federal tax over extended periods.

##### The particular treatment of these special allocations under state law may not be entirely clear.

##### Question: Are there circumstances in which special allocations should be sourced differently than allocations made in accordance with the partners’ interest in the partnership?

In general, it appears that special allocations are subject to the same unitary principles underlying state sourcing of income generally and the special allocations would would not affect sourcing. But this may not be entirely clear under state guidance.

For example, assume Partners A and B form a partnership. Each contribute the same cash to fund the partnership. The partners agree that Partner A will oversee the business operations in State 1, while Partner B will be in charge of expanding the business into State 2. They also agree that Partner A will receive 90% of the income from operations in State 1, while Partner B will receive 90% of the income from operations in State 2. Unless the state makes clear that these special allocations are apportioned at the partnership level in the same manner (e.g. using all the partnership’s factors), the partners might take the position that their income would be sourced to State A or State B, respectively.

There may be other circumstances, as well, that raise similar issues.

##### Question: Are there circumstances in which special allocations would have substantial economic effect for federal purposes but arguably not for state purposes and, if so, may states apply the same limitations as under federal rules?

It appears this is hypothetically possible, in particular with so-called “shifting” allocations over time. However, the circumstances in which this may happen would likely involve complex structures and may be difficult to identify.

#### Built-In Gain or Loss on Contributed Property Allocated Back to Contributing Partner

##### Under IRC § 721, property contributed to a partnership by a partner will generally not trigger gain or loss, but under IRC § 704(c) and related regulations, if the partnership exchanges or transfers the property then it must generally allocate the built-in gain or loss back to the contributing partner.

IRC § 704(c) generally prevents accrued gains and losses from being shifted by a person, through the use of a partnership, to other persons. Built-in gains in contributed depreciable property can also affect how depreciation is allocated among the partners..

##### Question: Should these built-in gains and losses be sourced differently by the affected partner?

For example, assume Corp. X, which operates mainly in State A, contributes to a partnership operating mainly in State B a capital asset with a $1 million built-in gain. The asset is eventually sold by the partnership and $1 million of the resulting gain is properly allocated back to Corp. X as built-in gain, along with X’s share of the remainder of the post-contribution gain. Should the $1 million of built-in gain now realized be sourced in the same way as the post-contribution gain?

#### Partners May Offset Income and Loss from Different Partnerships or Other Sources

##### Federal tax law generally allows individuals and corporations to offset ordinary income and loss or capital gains and capital losses from different sources. So a partner may offset a loss from one partnership against income or gain from another, subject only to other general limitations under federal law.

At the federal level, allowing partners to offset income, gains, and losses from different sources may not, by itself, change the ultimate tax result, even where the items being offset result from related entity charges (e.g. where a lower-tier partnership makes a guaranteed payment for services to an upper-tier partnership). However, this appears to be more likely to affect state taxes where partnerships operate in multiple states.

##### Question: Are there cases involving related-company income or gains and losses where states may need to limit partners ability to offset those items.

See further discussion of intercompany transactions below.

#### Conformity to Federal Anti-Abuse Rules

##### The federal tax law also contains a number of anti-abuse rules, including rules that are specific to partnerships. See, for example:

* + IRC § 751(b) – which prohibits partnerships attempting to shift ordinary and capital income through disproportionate distributions;
  + IRC § 707(a)(2)(B) – which addresses so-called “disguised sales” of property through contribution of assets to a partnership followed by a distribution; and
  + Reg. § 1.701-2(b) – which allows the IRS to recharacterize partnership tax items where the taxpayer’s characterization results in reductions in tax “inconsistent with the intent of subchapter K.”

##### Question: As in other areas, the intersection of state and federal tax rules may create a number of questions as to how federal rules, like these anti-abuse rules, will apply at the state level, including:

* + Questions concerning whether federal statutory and regulatory rules created for one set of circumstances will apply in analogous circumstances involving state taxes. 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 IRC § 482 meant that the state should follow federal regulations in a situation the proper determination of state income).
  + Questions concerning how conflicts between state and federal tax rules should be resolved. See, for example, *Parker v. Idaho State Tax Comm'n*, 230 P.3d 734, 741 (Idaho 2010)(where the court noted, “we have made clear that the [state] statute [incorporates] . . . federal tax provisions where Idaho law is silent, but has declined to adopt the federal tax code when it conflicts with Idaho law).
  + Questions concerning the extent to which federal tax principles should be employed in interpreting state tax statutes tied to federal statutes. See, for example, *Mid City Bank, Inc. v. Douglas Cty. Bd. of Equalization*, 616 N.W.2d 341(Neb. 2000)( applying the step transaction doctrine in a case involving the valuation of property acquired by merger).

This topic is also addressed further in the following section.

#### Other General Federal Anti-Abuse Rules

##### The IRS has authority under § 6011 and related regulations to require certain transactions to be reported and to classify transactions as “listed transactions” when the IRS has determined they are done for tax avoidance purposes.

##### Partnerships, in particular, have been used in certain reported or listed transactions over the years. For example, so-called “Son of Boss” schemes created artificial losses to offset (real) gains by using obscure rules involving futures contracts and allocation of partnership liabilities to increase the basis a partner has in the partnership interest so that it could later be sold at a “loss” while having no economic effect. The “Son of BOSS” schemes were reported to have cost the federal government over $6 billion in taxes.

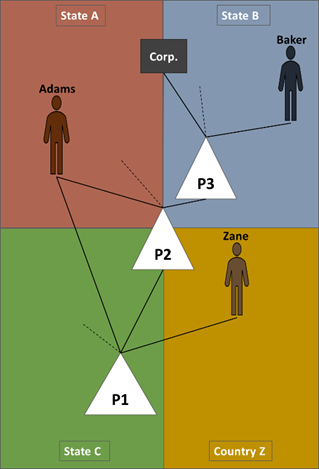
##### Question: Can such federal rules be used to address potential state tax avoidance strategies?

It appears that most states would not consider their law to include the authority provided to the IRS to create reportable or listed transactions undertaken solely for state tax avoidance—but other doctrines such as economic substance may apply.

The MTC has a Model Statute on Disclosure of Reportable Transactions which would apply to partnerships. See that model here: <https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Final%20-%20Reportable%20Transactions%20Statute.pdf>.

### State Approaches to Intercompany Transactions, Transfer Pricing and Add-Back Statutes, and Other State Anti-Abuse Provisions

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

Because partnerships may be related but generally do not file combined returns (see note on combination below), intercompany transactions may affect the income of partnerships, and the state tax base. As noted above, 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.

For example—using the diagram, assume the following:

* P3 owns 80% of P2 and P2 owns 80% of P1.
* State C, where P1 does business, imposes an income tax but State B, where P3 does business, does not.
* P3 charges P1 interest on an intercompany loan. P1, therefore, will have a deductible expense which will lower its net income potentially subject to sourcing to State C.

Unless State C taxes P3’s interest income from P1 (e.g. by using market sourcing to source the interest receipts to State C), this may result in artificial income shifting affecting all the partners of P1, indirect partners such as P3.

Of course, this is a simple example. In large, complex partnership structures, it may not even be possible to clearly ascertain the effect of intercompany transactions on state taxes.

NOTE ON COMBINATION: Because P1, P2, and P3 are taxed on a passthrough basis and have minority partners, they must each determine their own partners’ distributive shares of their own incomes. Therefore, it is not feasible for the three entities to file a simple combined return in the same way that taxable corporate entities may file such a return—computing one amount of income for the group and eliminating all intercompany transactions.

##### Question: Does IRC § 482, which governs the transfer pricing of related-party transactions, apply 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: Does IRC § 482 apply when the transaction is between an individual partner and a partnership?

IRC § 482 applies to “organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated).” Nevertheless, it has been interpreted and applied broadly by federal courts to include individual partners when dealing with their partnership. See *Aladdin Indus., Inc. v. Commissioner*, 41 T.C.M. (CCH) 1515, 1519 (1981)(noting that “[e]ven individuals have been held to be covered by section 482” and citing other holdings).

#### State Add-Back Statutes

A few states appear to have specifically applied their add-back statutes or other types of add-back provisions to partnerships. See, for example:

* Alabama - Ala. Code § 40-18-24(b) (applying the general add-back rules to related partnerships)
* Connecticut - CT: Conn. Gen. Stat. § 12-699(c) (requiring the add-back of certain guaranteed payments in computing the income of the partnership)
* Georgia - GA: ¶59,511 2020 Form 700 (IT 711 Booklet) Instructions—Partnership Tax Return (requiring add back of intangible, interest, and REIT expense)
* Illinois - ILCS Chapter 35 §5/203(d)(2)(C) (requiring the add back of certain guaranteed payments in computing the income of the partnership)
* *See* also Mo. Rev. Stat. § 143.411(3) and N.Y. Tax Law § 617(c).

In most cases, it appears that add-back statutes do not specifically or explicitly apply to related partnerships where the income is taxed on a passthrough basis.

## 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 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 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 that 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 (or investee’s) factors, the owner’s factors, or a combination of both.

### Differences Between Corporate and Individual Partners

#### States typically tax corporate income based on the source of the income.

Because states tax corporate income based on the source of the income, and because corporations also have their apportionment factors, states may use the corporate partner’s apportionment factors, the partnership’s factors, or a combination.

#### States typically use a hybrid method to tax income of individual partners.

Most states apply tax nonresident individual partners on a source basis and 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.

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

Even when states tax nonresident individual partners on a source 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.

### 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 passthrough 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.)

#### 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.

#### 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.

#### 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.

#### 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.

#### 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 factors is included in the calculation as the share of income or other items the partner recognizes.

### Effect of Tiered Partnership Structures on Sourcing

In addition to the five primary ways of sourcing partnership income (above), a tiered partner might also affect the sourcing of income or items of a lower-tier (recognizing) partnership.

#### Lower-tier passthrough 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.

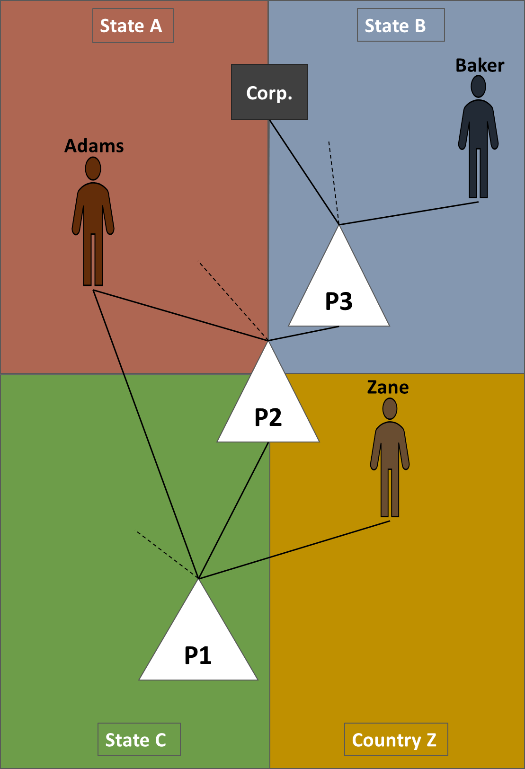
#### Upper-tier sourcing.

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

#### 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.

### Example – Differences in Results Between Methods Used

Assume that P1 has an amount of income that will be allocated to its partners (and their partners) through the structure shown in the diagram.

#### Situs-Based Sourcing

The income might be sourced to a situs (including domicile or residence). But the result will differ depending on whether this is done depending on which of the methods is used:

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

**All partners would source their share of P1 income to the same location.**

##### Situs determined at the partner level.

**Partners would source income to different locations.**

#### Apportionment-Based Sourcing

Even though the diagram shows a structure which is not particularly complicated, the result of apportionment 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 about 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.

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.

### 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 passthrough basis. A few cases have touched on the subject, particularly *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542 (2015), in which the state (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” Generally Means 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, “apportionment” may encompass what this outline refers to as situs-based or apportionment-based sourcing.

#### 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 next section.

* + 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).

#### 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 passthrough 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 souring 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).

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 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. See *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 173 (1983).

* + 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.

* + 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 income is not from a *separate unitary business that could be separately apportioned* to the state under a separate formula*.*

* + 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)(whichcites *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”).

### 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 apportionment and allocation rules which may be based on UDITPA) applies to partnership income generally—or may apply to certain kinds of partnership income.

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 to the state.
  + Kansas Form 120S – Partnership or S Corporation Income Tax Return Instructions - which provide instructions on apportioning and allocating 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 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 passthrough context, therefore, there are gaps that are not explicitly addressed.

* Business (Apportionable) Versus 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” 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 passthrough taxation. So, for example, UDITPA does not address how to source the distributive share of partnership income, assuming it is “nonbusiness” income to the taxpayer.

### 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.

### 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):

* + “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.I. 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 passthrough 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 – discussed below.)
  + 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. (c) 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.

### 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 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) and 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 passthrough 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 recognizes and pays tax on a share of the items making up that partnership income—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.

### Questions and Issues – Applying Sourcing Principles and Methods to Passthrough Taxation

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 answers and also notes how the principles discussed and general sourcing methods used might be adapted to fit sourcing of passthrough income.

#### Note on Use of Partnership versus Partner Information to Source Income and Differences Between Corporate and Individual Partners

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.

* + 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.

* + Sourcing of Nonbusiness Income:
    - 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 property giving rise to the income or the partnership’s 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.
  + Sourcing of Business Income – Formulary Apportionment:
    - Partnership-Level Information – 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.)

Because of these 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.

#### Note on the Roles or Status of Partners in the Partnership – Effect on 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, t 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 in-vesting 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

#### Note on Operating versus Investment Partnerships

The majority of states recognize such partnerships, to some extent, and provide that the income is essentially treated as nonbusiness income in the hands of nonresident partners, so that it 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 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:

1. 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.

#### Questions and Issues -Souring Partnership Operating Income

The matrix on the following page illustrates how the nature of the partnership and the role and status of partners may relate and how, in each category, the principles and methods discussed above might apply differently.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Distributive Share of Partnership Income (not including Built-In Gains/Losses on Contributed Property)** | | | | | | | | | | | | | | | |
|  | Nature of the Partnership | | Business or Nonbusiness Determination | | | | Type of Partner | | Role or Status of Partner in the Partnership | | | | | | |
|  | Operating or Investment Partnership | | Partnership Level | | Partner Level | | Individual or Corporate Partner | | Majority or Minority | | Active or Passive | | Direct or Indirect | | Other |
|  | Operating Partnership | Investment Partnerships | Business | Nonbusiness | Business | Nonbusiness | Individual | Corporate | Majority | Minority | Active | Passive | Direct | In-direct |  |
| Partnership Income or Item – Shared According to Partnership Interest |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Partnership Income or Item – Special Allocation |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

In addition to the sourcing of distributive share income covered in the matrix on the prior page, state rules may also need to address the specifics of sourcing:

* Guaranteed Payments
* Built-In Gain/Loss (Recognized) on Contributed Property

### When Situs-Based Rather than Apportionment-Based Sourcing Has Been Used [New Material from Here]

As discussed above, there are two main methods of apportionment—situs-based and apportionment-based. As the terms are used here, situs-based sourcing is the attribution of income to a state based on rules for the particular income, whereas apportionment-based sourcing is the use of a formula to divide income between jurisdictions and includes the use of the taxpayer’s factors, the investee’s factors, or both.

All of the different attributes of partnerships, partners, and types of income, as outlined in the matrix above, may serve to determine whether situs-based or apportionment-based sourcing will be used under particular state rules. As the prior sections 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 formulary apportionment may be applied to specific types of income.

#### Rationales for Situs-Based Sourcing

* Business-Nonbusiness Determination at Partnership Level – Situs-based sourcing can be applied at the partnership level to types of income. So, for example, under rules similar to those used for sourcing corporate income, a state may determine that the income is nonbusiness income at the partnership level and should be sourced based on the type of income and specific rules for sourcing the income to a particular jurisdiction—rather than by formulary apportionment.
* Other Rationales – Situs-based sourcing can also be applied to source the income to the partner’s residence or domicile. The rationale used by states that prescribe this treatment is sometimes unclear, but may include the following:
  + A determination that the state lacks nexus over the partner;
  + A determination that the state lacks nexus over the income;
  + A determination that the income is nonbusiness income in the hands of the partner;
  + Other considerations—such as ease of administration.

#### The Role of 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.

#### Income Determined to be Nonbusiness and Sourced Using Situs at Partnership Level

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 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.

#### Nature of the Partnership – Investment Versus Operating

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, 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.
* Whereas, 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 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 nonresident individuals, trusts and estates.
* Illinois - IL: 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) .

#### 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 nonbusiness 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.

#### Nature of the Partner – Direct Versus Indirect

A 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. States that have explicitly addressed the sourcing of income of indirect partners have generally 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 be the basis for sourcing the income in the hands of the partners as well.

### Apportionment-Based Sourcing – As Applied in Different Circumstances

#### Individual Versus 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.

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.

#### Tiered Entities

As noted in sections above, tiered entities present a question similar to the one faced when using formular 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.

#### Different Types of Partner Income – Effects on the Apportionment Formula

Even where it is determined that formulary apportion 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 the partnership X. If the partners agreed, Partner Adams might receive:

1. 10% of the partnership income.
2. 15% of the partnership income.
3. The first $10,000 of partnership income and 5% of the remainder.
4. 20% of capital gains or losses from sale of certain partnership assets and 5% of other partnership income.
5. $50,000, regardless of partnership income, and 5% of the partnership income.
6. 5% of the amount that Adams contributed, regardless of income, plus 5% of partnership income.
7. 5% of the amount Adams contributed, plus a guarantee of the return of that capital over time.

#### Category of Partner Allocation – 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) – Exampled 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.

#### Sourcing of Distributive Share (Not Including Guaranteed Payments)

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.

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.

#### Sourcing of Guaranteed Payments

Based on a survey of authorities – the states are split. 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 nonresident 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 soured 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.

#### Effect of Special Rules for Built-In Gains and Losses on Contributed Property – IRC § 704(c)

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 states have explicitly addressed this issue.

#### Sourcing of Gains on Liquidating Distributions

If a partner receives a distribution that terminates the partner’s interest in the partnership, it is considered a liquidating distribution. Liquidating distributions have attributes that are similar to gains on sale of partnership interests, discussed in the next section. The amounts received in excess of the partner’s basis will be considered capital gains, with exceptions for amounts representing the partners 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 discussed further in the following sections on sale of partnership interests.)

### Sourcing Applied to Taxes Paid by the Partnership

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

## Credits for Taxes Paid – Resident Individuals

### 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 above).

#### The Credit may be Affected by the Crediting 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 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.

#### PTE, Withholding, and Composite Return Taxes

Passthrough entity taxes (PTE taxes) and partnership withholding and composite returns 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.

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

## Jurisdiction and Nexus Issues

### 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 is state-sourced income 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 individual on the sale of a partnership interest. This section analyzes notable cases:

#### 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 here 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).

#### Other Important Cases

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 at 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.
* A number of cases have looked to state definitions of business income and the unitary business principle to determine whether a corporate partner is subject to tax on the gain resulting from the disposition of a partnership interest in the state.
  + In *BIS LP, Inc. v. Dir., Div. of Taxation*, 26 N.J. Tax 489 (App. Div. 2011), Superior Court, Appellate Division, held that a holding company whose “only or most substantial asset” was a ninety-nine percent interest in an operating partnership was not involved in a single enterprise or line of business, and therefore, was not unitary with that partnership. Similarly, 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 nondomicilary holding company’s sale of a majority interest in a pass-through entity operating in Idaho.
  + 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. And 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 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.
  + These cases have turned 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.

### Taxes on Exchange of Partnership Interests - Generally

### Effect of State Adjustments on Basis

### Distributions in Excess of Outside Basis

### Reorganization

## Sourcing of Gain (Loss)

**NOTE:** 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 allocate nonbusiness/investment gains and losses.

But even in the corporate tax context, the rules for how 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 allocated to domicile.

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

* IDAPA 35.01.01.266.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.”
* Me. Rev. Stat. Ann. tit. 36, § 5211(16-A)(F) – “Gross receipts on the sale of a partnership interest must be sourced to this State in an amount equal to the gross receipts multiplied by the ratio obtained by dividing the original cost of partnership tangible property located in Maine by the original cost of partnership tangible property everywhere, determined at the time of the sale.”
* 1708 Mass. Regs. Code tit. 830, § 62.5A.1(3)(b)(8)—A gain/loss that is “business income” would be subject to apportionment over the period during which the interest was held.

## Credits for Taxes Paid

## 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)