State Taxation of Partnerships – Status Report

UNIFORMITY COMMITTEE
LITTLE ROCK, ARKANSAS
NOVEMBER 15, 2022

GENERAL APPROACH

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.

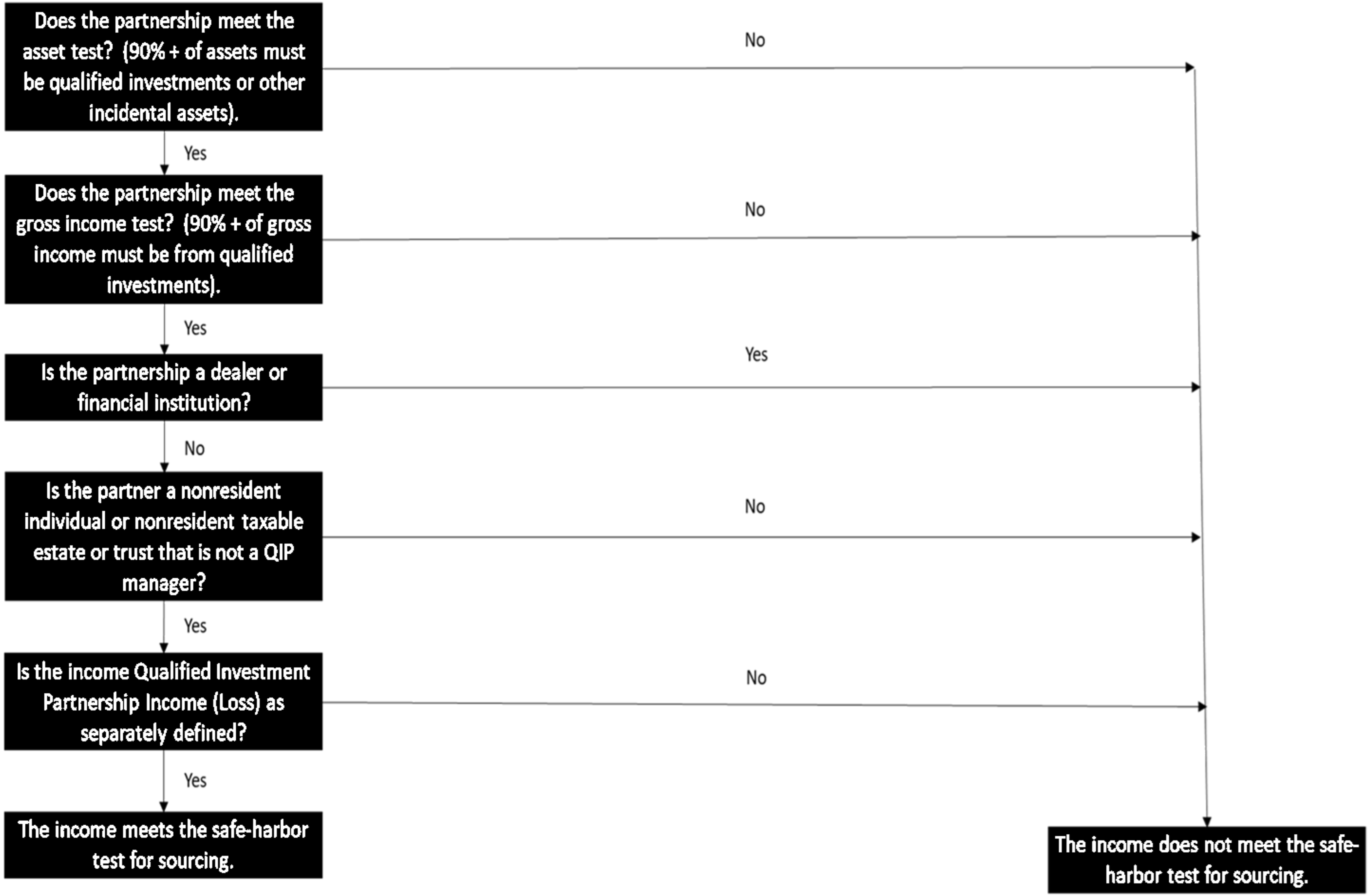
PROJECT TIMELINE & STATUS

Comprehensive Issue Outline - Ongoing
– Nexus and Jurisdiction
– Tax Base
– Sourcing
– Gain on Sale of Interest
– Administrative and Enforcement

Investment Partnerships
– White Paper
– Draft Model
– Awaiting Comments

General Sourcing Issues
– Request for Specific Examples
– Proposed General Sourcing Principles

DRAFT INVESTMENT PARTNERSHIP MODEL



GENERAL STATE SOURCING RULES

- Compact Art. II applies UDITPA to a “taxpayer” which is “any corporation, partnership, firm, association, governmental unit or agency or person acting as a business entity . . .”
- Original and MTC recommended versions of UDITPA – Sec. 1 – defines the terms “business income” or “apportionable income” based on the relationship between the transaction, activity, or property giving rise to the income and the taxpayer’s trade or business.

GENERAL STATE SOURCING RULES

- Business/apportionable income of the business is sourced using the business's general apportionment factors
- Non-business/non-apportionable income of the business is sourced using the situs of the related property giving rise to that income

PRINCIPLES – SUBCHAPTER K

- Liability for tax on partnership income is attributed to "persons carrying on business as partners." IRC §701 This liability for tax applies to limited, passive, and minority partners.

- Partnerships act primarily as "conduits" for tax items which are properly valued and characterized based on the partnership's actions undertaken to earn or incur those items. IRC §702 and 703.

- This conduit principle applies in tiered partnerships by maintaining the character of items as they flow through upper tiers.

- This "conduit" principle is applied to sourcing of domestic versus foreign income. See, for example, 26 CFR § 1.863-3.

PRINCIPLES – SUBCHAPTER K

- Partnerships do not allocate net income. They allocate partnership items making up net income. IRC §703.
- Partners have flexibility in allocating items, within limits, and allocations of certain items may not match other items or the partner's interest in the partnership. IRC §704
- Partners may derive different types of income allocations from partnerships:
  - Allocations made by agreement (IRC §704(b)
  - Allocations required by Subchapter K (IRC §704(c) and others)
  - Guaranteed payments (IRC §707(c)
  - Payments not as partners (IRC §707(a)

PRINCIPLES – SUBCHAPTER K

- The IRS has issued regulations to make explicit that Subchapter K's flexibility cannot be used to artificially avoid tax—particularly where the economic or legal substance of the transaction or structure does not match the tax result under Subchapter K.
- Examples of facts and circumstances where the tax result may be questioned:
  - Partners' aggregate tax liability over time is substantially less than had the partners owned the partnership's assets and conducted the same activities directly.
  - Partners who are necessary to achieve the claimed tax result either have a nominal interest or are substantially protected from any risk through distribution preferences, indemnity or other arrangements.
  - Substantially all the partners are related
  - Practical rights to property purportedly contributed or distributed do not actually transfer

PRINCIPLES AND APPLICATION TO STATE SOURCING OF PARTNERSHIP INCOME

- For purposes of state sourcing, it does not matter whether the partner is general, limited, active, passive, majority, or minority.
- The proper characterization of partnership items or income under Subchapter K should be taken into account when applying state sourcing rules.
- Sourcing will be determined based on the activities of the partnership that earned or incurred the income or expense.
- Items are not simply "re-sourced" when they pass through tiered partners.
- Only if the partner is also separately engaging in another trade or business, may the activities of that partner be considered in the sourcing of partnership income or items.
- If the partnership is not a bona fide partnership or the partner is not a bona fide partner, then the rules applicable to partnerships may be disregarded in determining the sourcing of partnership items.

EXAMPLES

- Individuals A and B form an equal general partnership, AB.
- AB operates, in part, in State X.
- A and B are both residents of State Z.
- At the end of year 1, AB has $10,000 of income from regular operations.
- AB properly sources half of its income to State X.

Assume A is a general partner and receives half of the income of AB. How much must A report to State X?

When poll is active, respond at **pollev.com/chrisbarber378**

Text **CHRISBARBER378** to **22333** once to join

Assume A is a limited partner. How much income does A have to report to State X?

$5,000, I don't care that it was wrong before.

$2,500

$0

Assume A is a limited partner, and receives 10% of the income of AB. How much income must A report to State X?

$1,000, this logic totally holds up.

$500

$0

Would your answer change if A and B had, instead, formed an LLC?

Yes

No

Would your answer to the previous question change if State X found that it did not have nexus over partner A?

Yes

No

WITHHOLDING!!!

EXAMPLES

- In year 2, AB purchases a 50% interest in CD, LLC.
- CD, LLC is taxed as a partnership.
- CD, LLC operates in State Y.
- CD, LLC has $10,000 of income in year 2.

How much income does A have to source to State Y in year 2 assuming A is a 50% partner of AB?

Does A now have nexus in State Y as a result of her indirect ownership in CD, LLC?

Would your answer change if the partnership AB only had a 10% interest in CD, LLC?

Yes

No

Would your answer change if the partnership AB only had a 1% interest in CD, LLC?

EXAMPLES

- A, B and C Corp form an equal general partnership, ABC.
- ABC operates in State X and State Y.
- C Corp is domiciled in State Z.
- ABC has $10,000 of business income.

Does the partner C Corp have nexus in State X and State Y by virtue of owning an interest in the partnership doing business in those states?

Yes

No

Will the $10,000 of business income remain business income once it is passed through to the partners?

Yes, for all partners.

Yes, but only for the individual partners.

Yes, but only for the corporate partner.

No, whether income is business or nonbusiness is always determined at the partner level.

It depends on the other activities of the partners.

RESIDENT CREDIT FOR TAXES PAID BY A PASS-THROUGH ENTITY

- This issue arises when:
  - A pass-through entity pays tax for a pass-through entity owner on a composite return in another state. Based on our research so far, 16 states have expressly addressed this issue.
  - A pass-through entity pays tax for a pass-through entity owner through nonresident withholding in another state. Based on our research so far, 7 states have expressly addressed this issue.
  - A pass-through entity pays a pass-through entity tax in another state. Based on our research so far, 31 states have expressly addressed this issue.

We are still awaiting responses from 14 states.
Comments can be sent to jstosberg@mtc.gov