



# **GENERAL FRAMEWORK OF THE STATE PARTNERSHIP PASS-THROUGH TAX SYSTEM DISCUSSION DRAFT OCTOBER 13, 2023**

*Note: The terms used in this document have the specific meanings set out in the Appendix attached.*

## **Background**

In 2021, the MTC Uniformity Committee created a work group to study state taxation of partnerships and make recommendations. So far, it has produced a comprehensive outline, two white papers, and two draft models, one on sourcing of income from investment partnerships and one on sourcing guaranteed payments for services.<sup>1</sup> But, as expected, the work on these specific issues has raised some more fundamental questions about the pass-through tax system used by most states. As the work group's discussions proceed to other issues, it may be helpful for the participating states to adopt an agreed-upon framework to guide those discussions.

## **Elements of the Framework**

Tax systems are like buildings in that they are made up of different components, some of which are structural—that is, harder to change and more integral—and which, in turn, may dictate how the entire building, or system, can function. The elements of the state tax framework proposed here are similar in that they are either permanent or difficult to change and are integral to the system—that is, connected to or affecting multiple different issues. The framework includes elements of general state law, constitutional law, and federal tax law, as well as common provisions of state tax law. These elements are also necessary to make the system:

- Workable – creating a complete and consistent framework that can address issues arising under various facts and circumstances;
- Enforceable – with clear, specific rules that create filing obligations as well as workable enforcement mechanisms;
- Administrable – minimizing burdens on both states and taxpayers to the extent possible; and
- Equitable – treating similar income from similar activities the same, unless otherwise indicated by state policy choices.

Views about some of the essential elements of the state pass-through tax framework have evolved over time and the complexity of partnerships has also grown. So it is not always clear whether these essential elements can be relied on to make the system function in all circumstances. This uncertainty is another reason to review and consider this framework.

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<sup>1</sup> All of this information is available on the project webpage – here: <https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

## General Framework

The essential elements of this framework are listed here in summary form, noting any inherent uncertainty that may affect that element.

### General

1. State law governs the formation of different types of partnerships and the basic rights of partners, including any rights to:
  - a. Divest or transfer their interests;
  - b. Receive liquidating distributions; and
  - c. Alter certain legal and economic rights and relationships by agreement.
2. States allow entities formed in other jurisdictions to operate in the state, provided they comply with state regulatory requirements.
3. State income taxes generally conform to applicable federal substantive tax provisions for computing and characterizing items of income for individuals and corporations, and follow the IRS interpretation of those provisions.
4. State pass-through tax systems generally conform to the provisions of IRC Subchapter K and follow IRS interpretations of those provisions. The critical elements of Subchapter K include:
  - a. Partnership income is taxed when earned (IRC § 702 & 703).
  - b. Partners are required to report and pay tax on their shares of partnership items of income, expense, gain or loss, regardless of whether they receive any actual distribution (IRC § 704).
  - c. Distributions are not taxable to the extent they represent contributions by or income already recognized by the partner (IRC § 731).
  - d. Partners may agree to vary their shares of partnership items and change those shares over time and the tax result will reflect their agreement provided the allocations of items have substantial economic effect. (IRC § 704(b)).
5. The IRS has adopted certain anti-abuse rules deemed essential for the federal pass-through system to function properly but the application at the state level may be unclear.
6. Both general state law and Subchapter K allow partnerships to have partners that are corporations (whether taxed as C corporations or S corporations), individuals, trusts, and other partnerships.
7. Most states that impose tax on partnership income on a pass-through basis have also adopted elective pass-through entity taxes under which partnerships can report income and pay tax at the entity level in lieu of the tax on partners.

## General Regulatory Jurisdiction

8. Over the Entity: If a partnership has assets or activities with a sufficient connection to a state, the state may exercise general regulatory jurisdiction over that partnership, including:
  - a. Requirements to register;
  - b. Requirements to report activities in the state; and
  - c. Requirements to provide certain information about the partners regardless of a partner's control of or role in the partnership.
9. Over the Partners: If a state has general regulatory jurisdiction over the partnership, that jurisdiction generally extends to the partners in matters involving activities of the partnership, although there remains some uncertainty as to whether it extends to passive or indirect partners in all cases.

## Constitutional Tax Nexus and State Doing Business Standards

10. A business's choice of entity—sole proprietorship, partnership, corporation, etc.—does not affect constitutional limits on the state taxation of the business's income.
11. States have due process nexus to impose tax on the income of a business, including a partnership, to the extent there is a sufficient connection between the assets or activities giving rise to that income and the state.
12. States have commerce clause nexus to impose tax on the income of a business, including a partnership, to the extent the income or a share of it is fairly sourced (or "apportioned," as that term is used generally in Supreme Court precedent), the tax does not discriminate against interstate commerce, and the tax does not impose an undue burden on interstate commerce.
13. States that have due process and commerce clause nexus over the income of a partnership taxed on a pass-through basis also have due process and commerce clause nexus to apply the tax to partners generally. And while there have been some conflicting opinions in the past, this nexus extends to both direct and indirect partners and applies regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership, provided the state takes reasonable steps so as not to burden interstate commerce.
14. States' doing business or tax imposition statutes, as applied to partnerships, should be consistent with other businesses and may apply a factor-presence nexus standard or threshold at the entity level.<sup>2</sup>
15. As with nexus, if a partnership exceeds any doing business standard or threshold, then states should make clear that the standard or threshold is also met by any direct or

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<sup>2</sup> See the MTC Factor Presence Nexus Standard, here: <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/Factor-Presence.pdf>.

indirect partner, regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership.

### **Sourcing**

16. States generally conform to the federal rules for domestic sourcing of multinational income, but do not apply these federal rules to the sourcing of domestic income between the states.
17. States generally apply formulary apportionment and specific rules of assignment to source income of multistate businesses.
18. Under the dormant commerce clause, apportionable income is limited to income that has a sufficient connection to the apportionment formula and factors in the state, and it may include income that is part of a unitary business to which the factors relate.
19. Nonapportionable income can be sourced using state rules of assignment provided there is a sufficient connection between the basis for the rule and the income to be sourced.
20. Formulary apportionment and state rules of assignment can be properly applied to the partnership income or items at the entity level, based on the activities and assets of the partnership.
21. The sourcing of partnership income or items at the entity level can be attributed to any direct or indirect partner that receives a share of that income or items, regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership, unless the partner is separately engaged in a business and –
  - a. That business is unitary with the business conducted by the partnership, or
  - b. That partnership interest held by the partner serves a unitary purpose in that business.

In that case, the factors related to the partner's business may also be taken into account in sourcing the partner's share of the partnership income or items.

### **Withholding/Composite/PTE Tax**

22. States that tax partnership income on a pass-through basis may impose a requirement on partnerships to withhold tax on their partners distributive shares of that income, regardless of whether the partners receive any distributions.
23. States that allow partnerships to file a composite or PTE return and pay tax attributable to the shares of income or items of partners, and that also exempt partners with no other income in the state from requirements to file and report tax on that partnership income or items, have sufficiently reduced the burden that the tax might otherwise impose on interstate commerce.

## **Appendix - Important Terminology**

The terminology commonly used in state taxation generally and taxation of partnerships in particular can be confusing. For example, the term “apportion” may refer to a particular kind of state sourcing (using a formula made up of certain factors) or it may refer to multistate sourcing of income among the states generally. “Allocation” is sometimes used to describe state sourcing as well as the determination of partners’ distributive shares of partnership items.

To avoid confusion, this document uses terms as described below. All other terms have the same meaning as under Subchapter K.

<b>Term</b>	<b>Meaning</b>
Active Partner	A partner that takes some role in the partnership other than voting on certain issues as the applicable state law requires without exception.
Allocate or Allocation	Refers to the determination of partners’ distributive shares of the partnership’s income or items.
Apportionable Income	Income to which formulary apportionment is properly applied.
Assign	Sourcing items to a state using rules of assignment.
Attribute	The position of a taxpayer determined under federal tax rules that may be separate from, but have an effect on, taxation of an item. Example: A taxpayer’s NOL carryover is an attribute that may offset other ordinary income.
Character	Information about a particular tax item that determines its treatment for tax purposes. Example: The character of wages is that they are ordinary income.
Control of a Partnership	Refers to the ability of a partner through that partner’s interest or role in the partnership, or through the interest or role of other partners which can be attributed to that partner, directly or indirectly, to make certain decisions over the partnership’s business activities.
Direct Partner	A partner that holds an interest in a partnership.
Distribution	Payment of money or assets by a partnership to a partner.
Distributive Share	The partners’ share of items allocated each year, consistent with IRC § 704, including special allocations.
Formulary Apportionment	Sourcing net income from multistate business activities to a state using a formula or ratio consisting of factors representing the amount of related activity in the state (e.g., receipts, property, and/or payroll).
Guaranteed Payment	Payment made to a partner, acting as a partner, which is not dependent on the partnership’s income, consistent with IRC § 707(c).
Indirect Partner	A partner of a tiered partnership, with respect to a lower-tier partnership.

IRC	Internal Revenue Code.
Item	Income, expense, gain, or loss from a particular transaction or activity that has a particular character under federal substantive tax rules. Example: Rent from certain property would be considered an “item” of income, and depreciation of that property would be considered another “item.”
Lower-Tier Partnership	A partnership that has a partnership as a direct or indirect partner.
Net Income	An amount made up of netting various items of income, expense, gain, and/or loss, as determined under applicable tax rules.
Nexus	The connection between the thing or person to be taxed and the state imposing the tax. Nexus standards are derived from the U.S. Constitution, particularly the due process and dormant commerce clauses.
Nonapportionable Income	Income to which specific rules of assignment are properly applied.
Partner	A person properly treated as a partner under the rules of Subchapter K.
Partner Capital	The partnership share of partnership capital as determined under Subchapter K.
Partnership	An entity properly treated as a partnership under the rules of Subchapter K.
Partnership Capital	The capital (assets minus liabilities) of a partnership as determined under Subchapter K.
Partnership Item	An item that results from the activity of a partnership.
Passive Partner	A partner that is not an active partner.
Pass-Through Tax System	A system in which an owner’s share of items resulting from an entity’s activities pass through are treated as items recognized by that partner, retaining their character as determined at the entity level. (This is also sometimes referred to as the “conduit” approach.)
Rules of Assignment	Rules for attributing specific items, rather than net income, to a particular state, in whole or in part, using specific rules, including the application of certain ratios.
Tiered Partnerships	Partnerships that hold interests in other partnerships.
Unitary	A concept created by the U.S. Supreme Court to generally describe the relationship of one business to another business, or an asset to that business, that is sufficient to allow the net income from the business or the asset to be apportioned by combining that income and related factors with the income and factors of the other business.
Upper Tier Partnership	A partnership that is a direct or indirect partner in another partnership.

