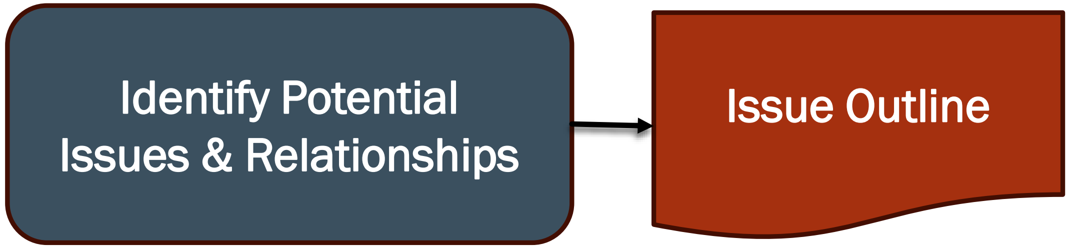
State Taxation of Partnerships – Work Group Report to the Uniformity Committee

MULTISTATE TAX COMMISSION

NOVEMBER 14, 2023

PROCESS

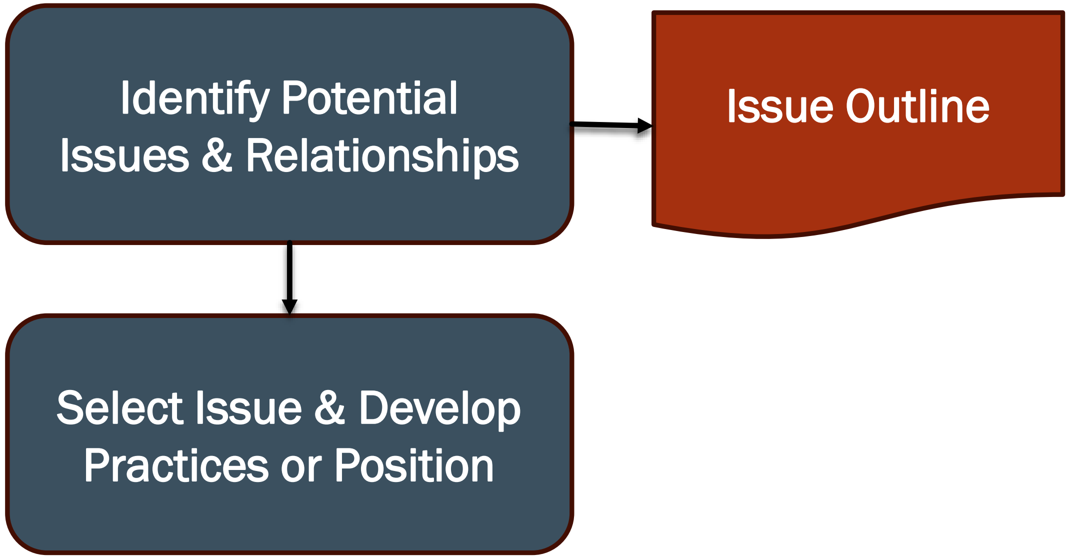
Identify Potential Issues & Relationships

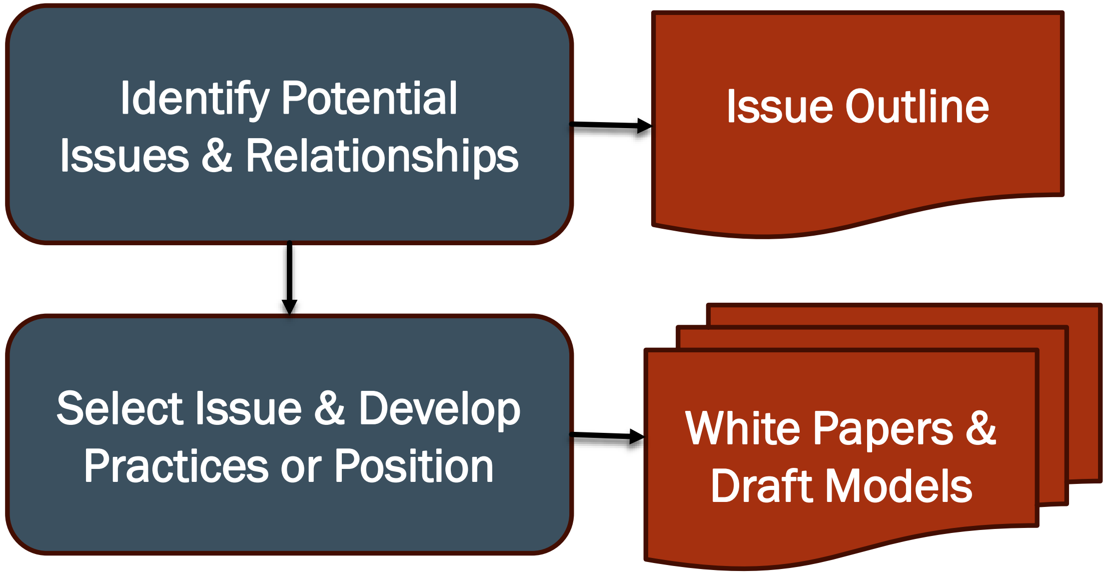

Identify Potential Issues & Relationships
Issue Outline

Identify Potential Issues & Relationships

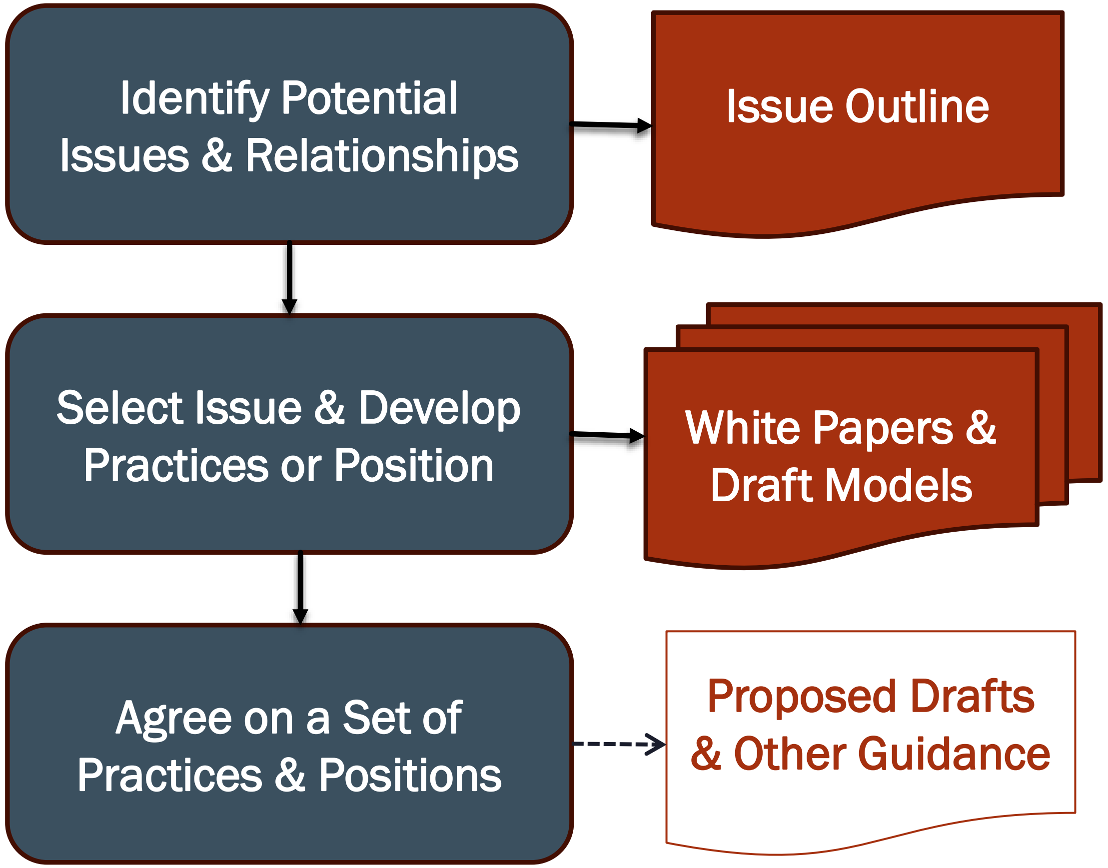
Issue Outline

- Jurisdiction & Nexus Issues
  - Jurisdiction to require filing of reports
  - Nexus over the partnership and partners, including limited, passive, and indirect
- Tax Base & Conformity Issues – State Adjustments
  - Adjustments to the base at the partnership level
  - Adjustments to the base at the partner level
- Sourcing – Operating Income & Gains from Interest Sales
  - Simple sourcing – partnership level
  - Issues – investment partnerships and other
  - Tiered sourcing and related party transactions
- PTE & Related Issues
- Administration & Enforcement
  - Withholding, etc.


Identify Potential Issues & Relationships
Issue Outline
Select Issue & Develop Practices or Position



- Sourcing –
  - Investment Partnerships
    - White Paper
    - Draft Model
  - Guaranteed Payments for Services
    - White Paper
    - Draft Model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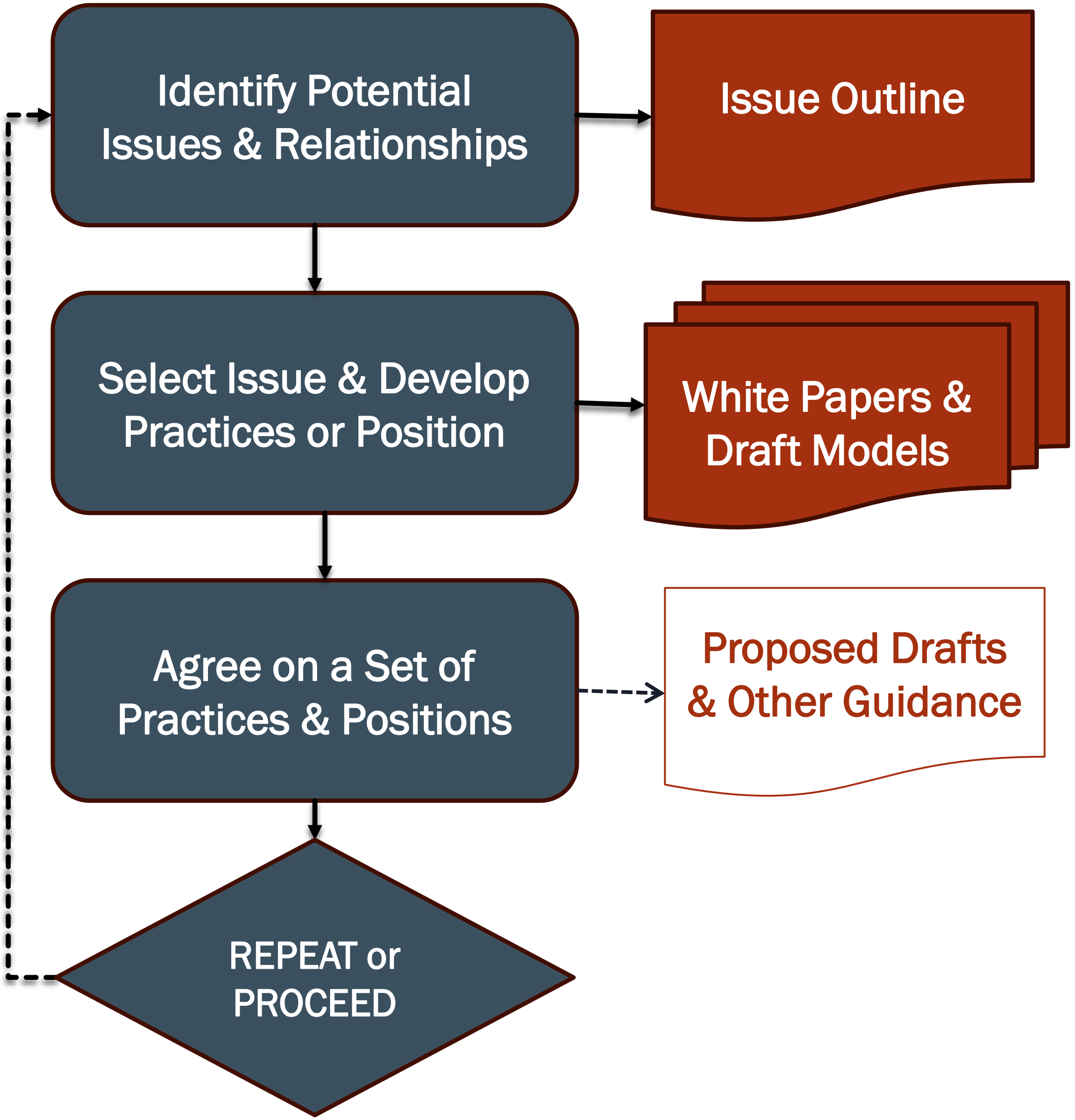
Agree on a Set of Practices & Positions
Proposed Drafts & Other Guidance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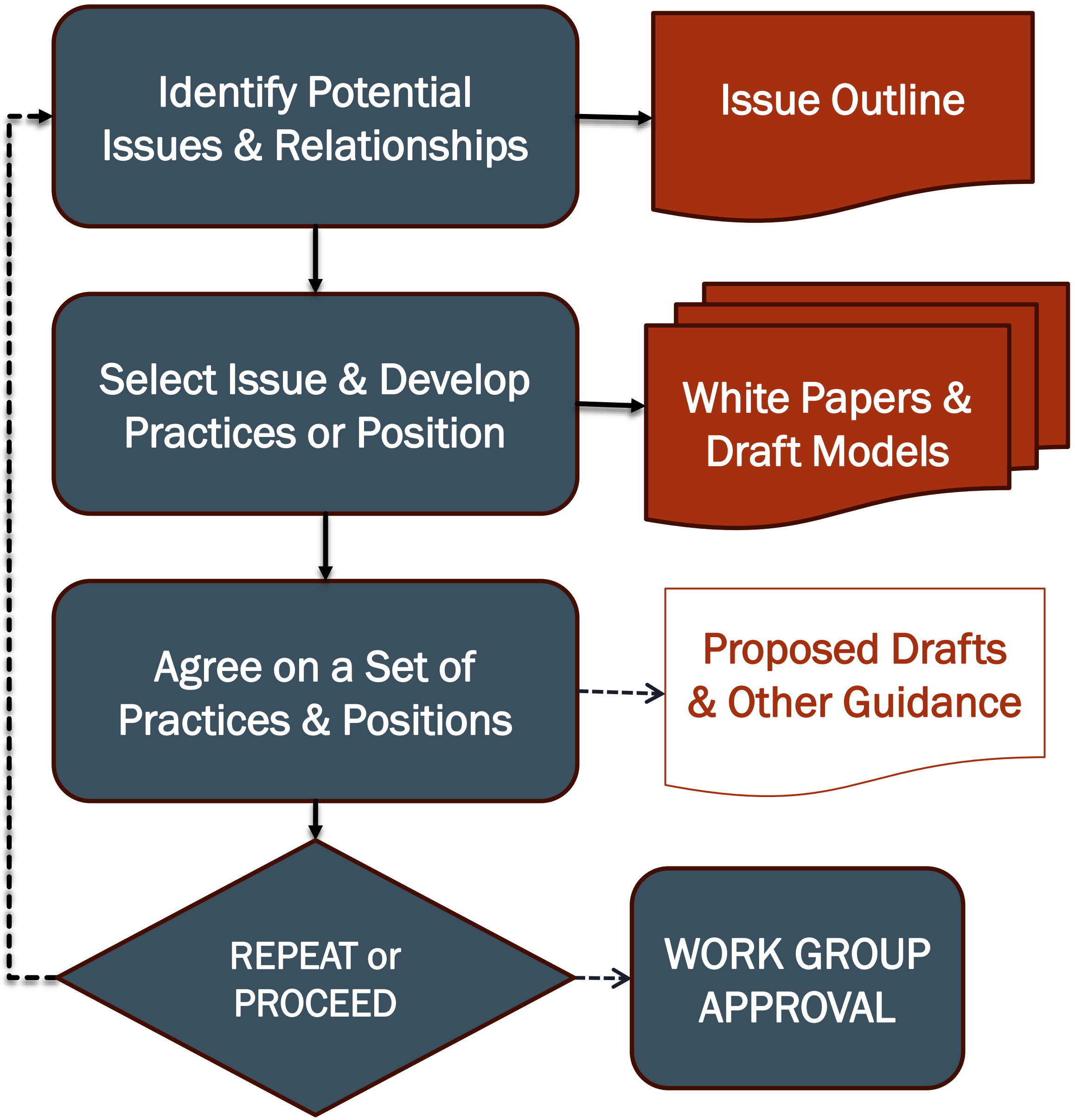

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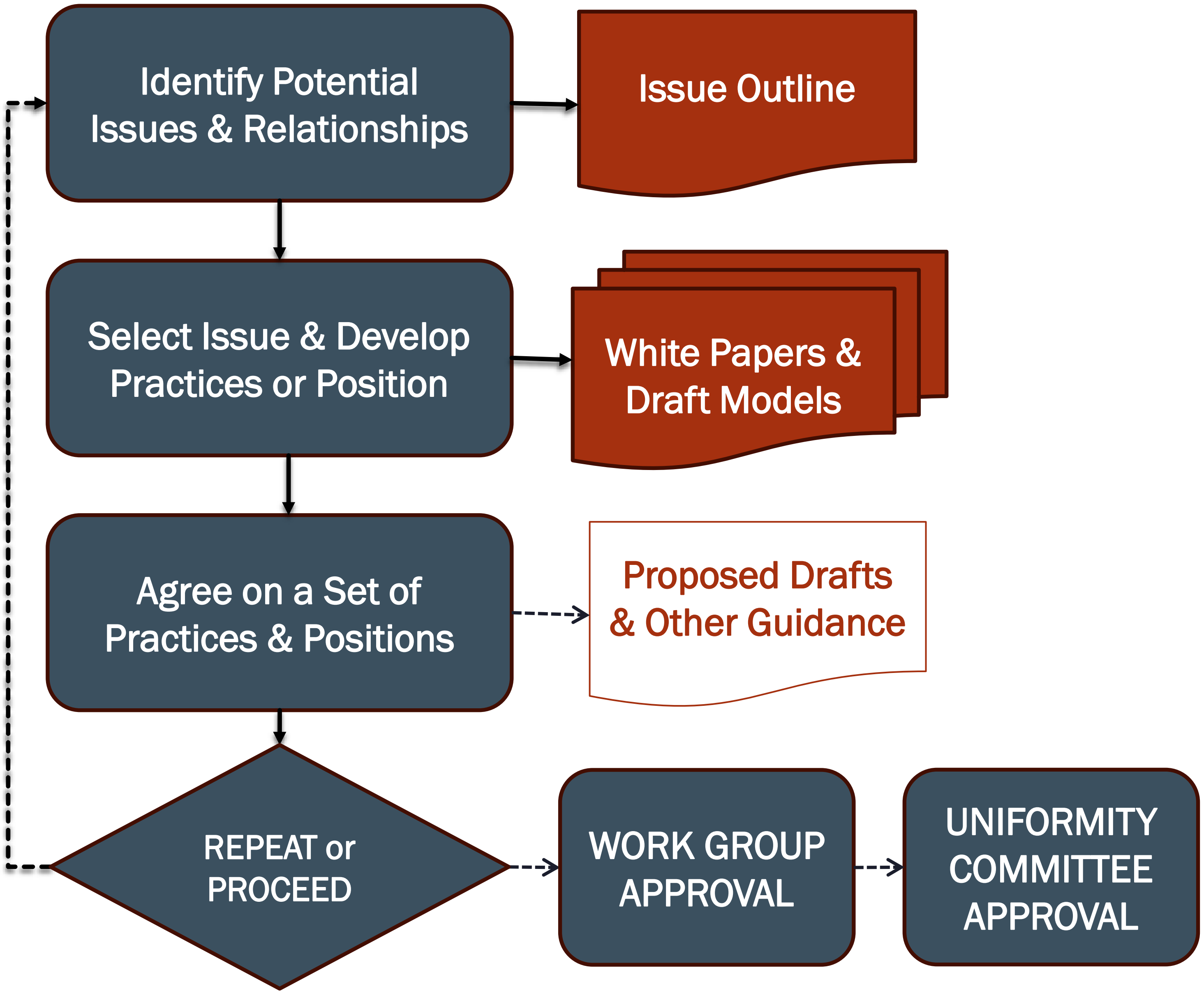
WORK GROUP APPROVAL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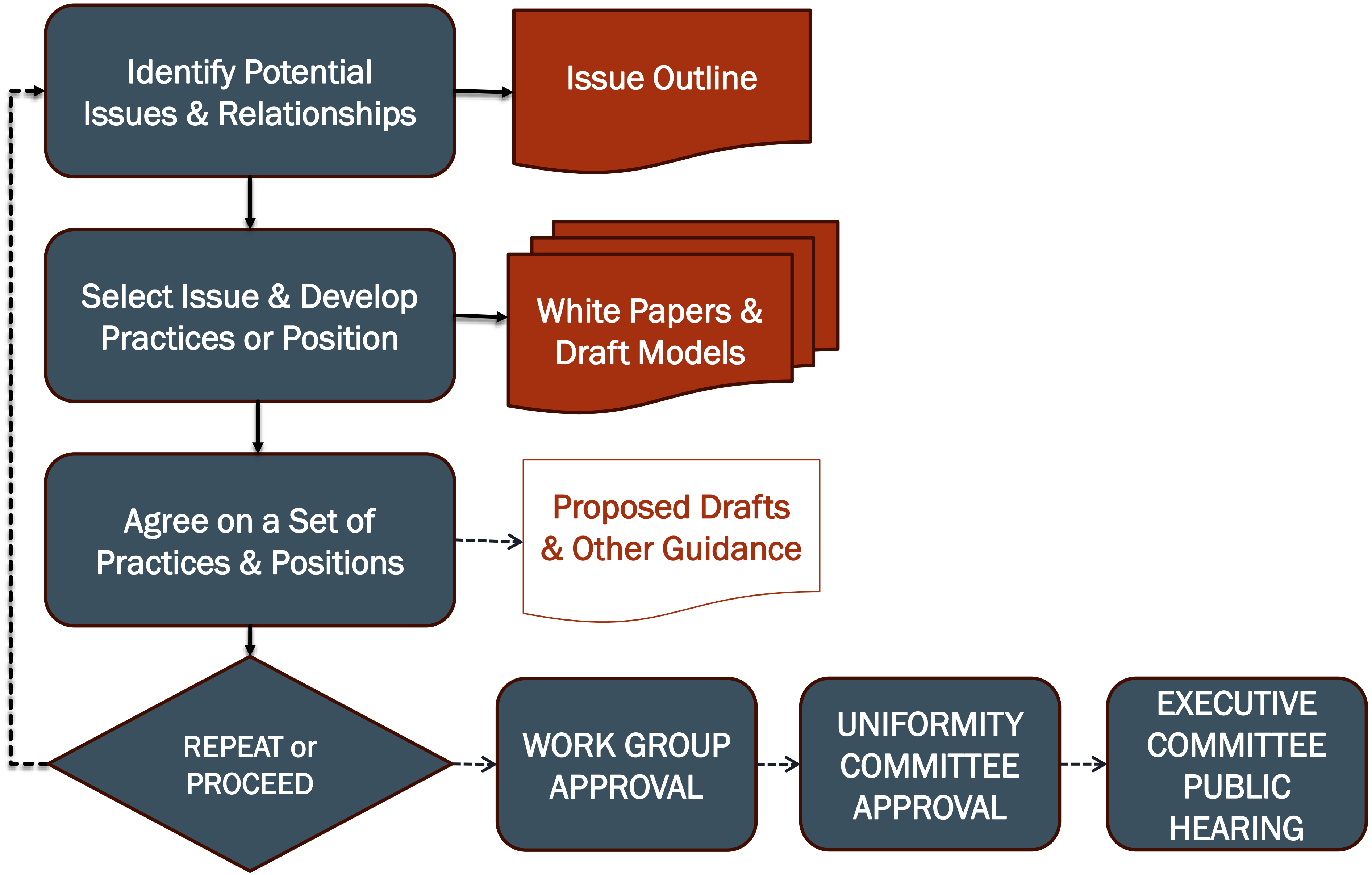
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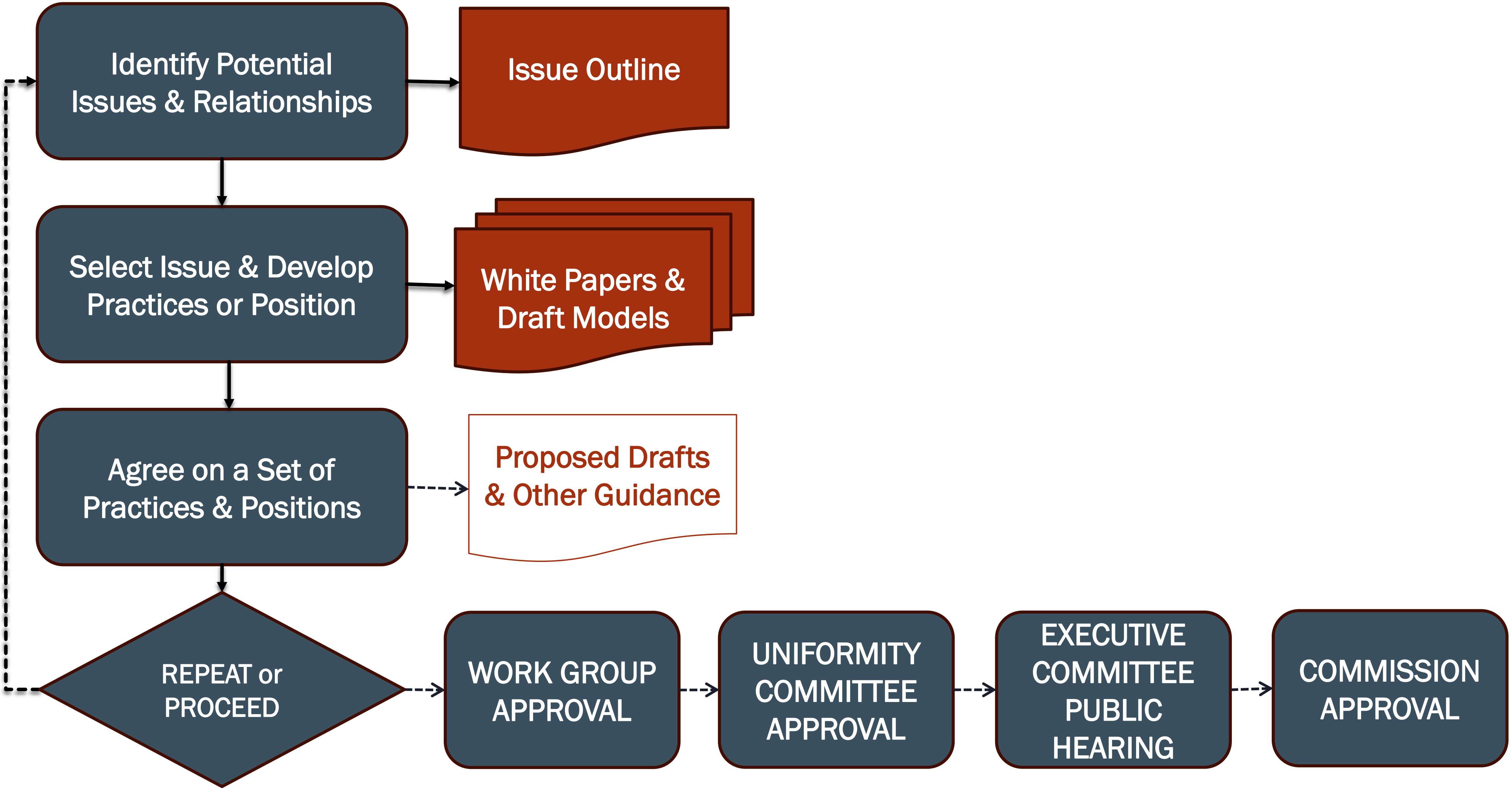
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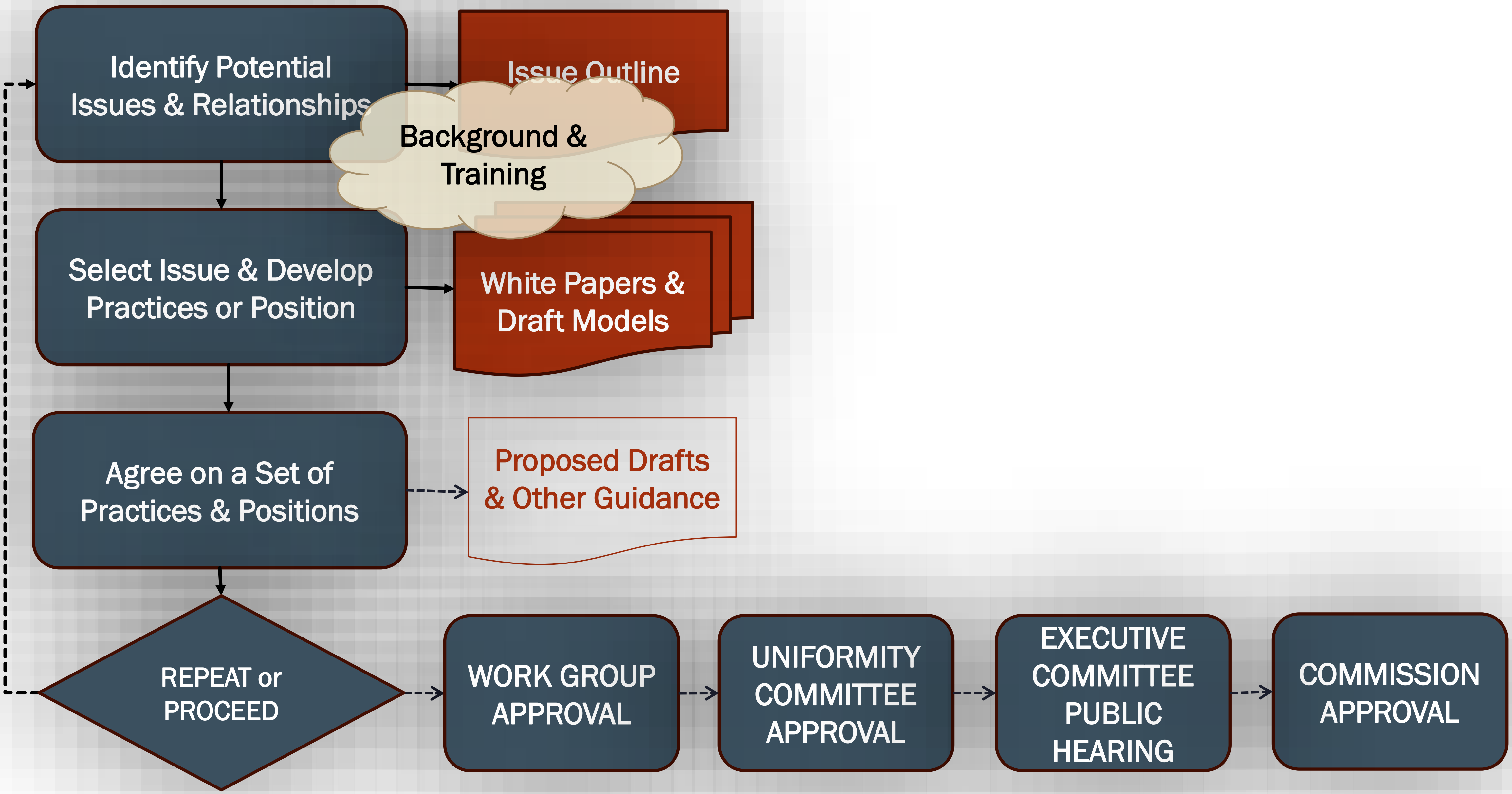
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Issue Outline
Background & Training
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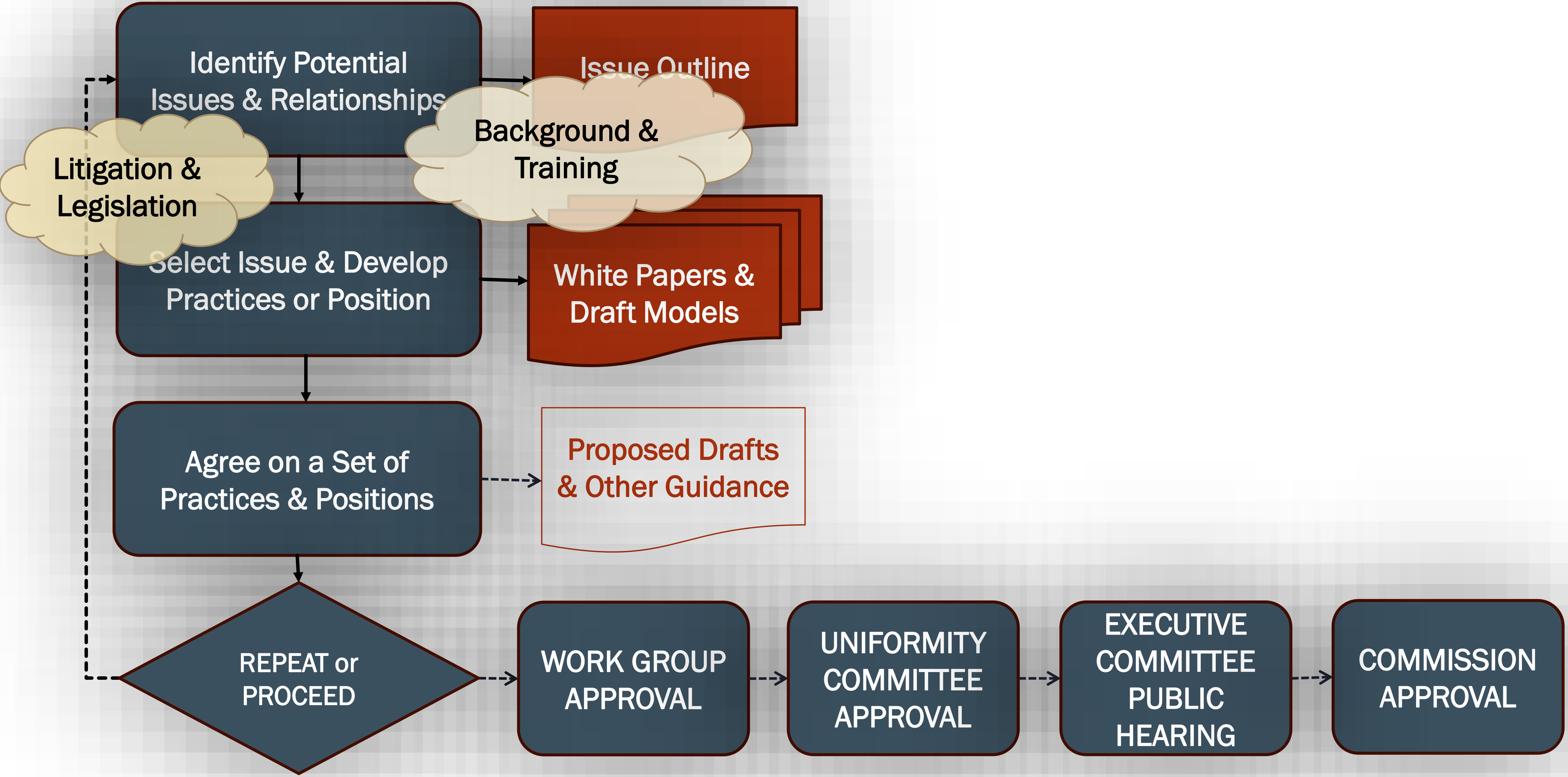
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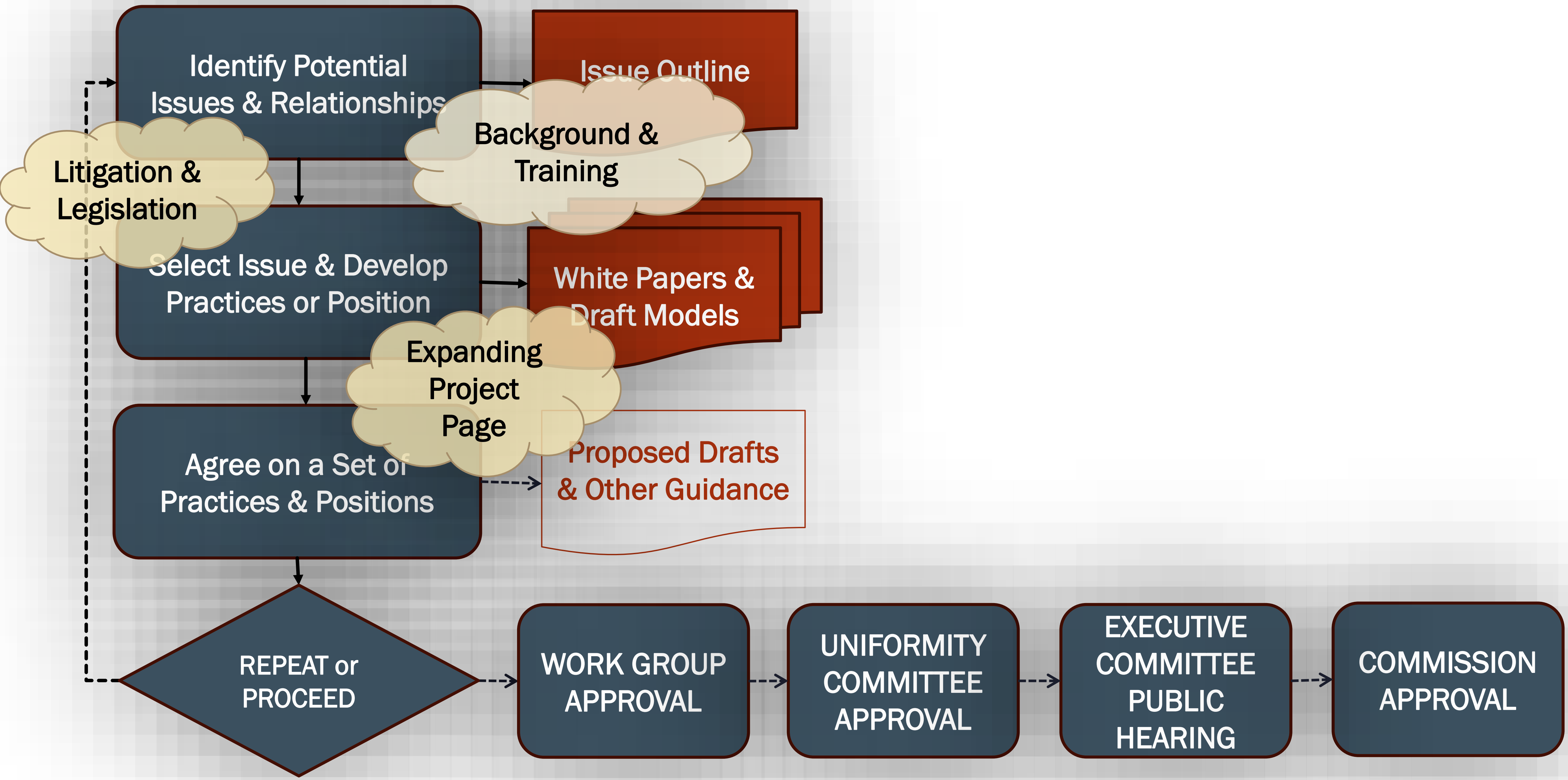
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Expanding Project Page
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COMMISSION APPROVAL

State Taxation of Partnerships

Project Description

At its meeting in April 2021, the Uniformity Committee took up a project on state taxation of partnerships based on the recommendations of the Standing Subcommittee that a work group be established to consider issues affecting:

- Sourcing of partnership operating income and partnership items for state tax purposes;
- Sourcing and taxation of gains and losses from the sale of partnership interests;
- Entity level taxation issues including transfer pricing or combined filing issues; and
- Other administrative and enforcement issues including information reporting and withholding.

On this project page, you will find:

- information about upcoming and past meetings
- whitepaper outline drafts
- written comments and feedback

Upcoming Meeting Notice

Agenda

Meetings are held each month on the third Wednesday at 3:00 p.m. Eastern

Next Meeting – Wednesday, October 18, 2023 – 3:00 p.m. Eastern

I. Initial Public Comment

II. Review of Sourcing of Guaranteed Payments for Services

– White Paper on Sourcing of Guaranteed Payments – October 12, 2023 (PDF)
– White Paper on Sourcing of Guaranteed Payments – October 12, 2023 (Word)
– Draft Models on Sourcing of Guaranteed Payments and Additional Credits (PDF)
– Draft Models on Sourcing of Guaranteed Payments and Additional Credits (Word)

III. Review of Investment Partnership Draft Model (Time Permitting)

– Current Version of Draft Investment Partnership Model – June 15, 2023 (See additional information below.)

IV. Proposal to Consider General Framework

– Discussion draft of Proposed General Framework (Word)
– Discussion draft of Proposed General Framework (PDF)

V. Wrap Up and Discussion of Uniformity Meeting – November 14th in Montclair, New Jersey

VI. Adjourn

Dial-in/Log-in Information

Join from your computer, tablet or smartphone.
https://www.gotomeet.me/LilaDisque/work-group—state-taxation-of-partnerships

You can also dial in using your phone.
United States: +1 (872) 240-3412
Access Code: 208-267-469

Telephone participants will be muted if their line causes interference with the call; to un-mute your line, please press *6.

If you experience any kind of difficulty participating in the meeting, please contact MTCVirtualSupport@mtc.gov.

Project Materials

Project Materials

Latest Documents – By Subject

- Partnership Issue Outline
- Subchapter K Training
- Investment Partnerships
- Guaranteed Payments

Additional Background Information

General Research and Analysis | Partnership Tax Reporting & Audit Rules | State Pass-Through Entity (PTE) Taxes

Prior Meeting Agendas, Materials, and Notes

Partnership Project Workgroup Agenda September 20, 2023

- Report to the Work Group – September 20, 2023

Status Report of the Work Group to the Uniformity Committee, July 25, 2023

Partnership Project Workgroup Agenda, July 19, 2023

- Report to the Work Group – July 19, 2023

Partnership Project Workgroup Agenda, June 21, 2023

- Report to the Work Group – June 21, 2023

Partnership Project Workgroup Agenda, May 24, 2023

- Report to the Work Group – May 24, 2023 (PDF)
- Report to the Work Group – May 24, 2023 (Slides)

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- Report to the Work Group – March 15, 2023 (Slides)

Partnership Project Workgroup Agenda, February 15, 2023

Project Materials

Latest Documents – By Subject

Partnership Issue Outline

The work group began this project by drafting a Partnership Issue Outline that identifies and generally describes a comprehensive list of potential issues an notes the relationships between those issues.

Current Version

- Partnership Issue Outline (Word) as of January 12, 2023
- Partnership Issue Outline (PDF) as of January 12, 2023

Past Versions (Word)

- Partnership Issue Outline as of August 22, 2022
- Partnership Issue Outline as of October 18, 2021
- Partnership Issue Outline as of October 2, 2021
- Partnership Issue Outline as of September 23, 2021
- Partnership Issue Outline as of August 26, 2021
- Partnership Issue Outline as of August 26, 2021
- Partnership Issue Outline as of August 10, 2021
- Partnership Issue Outline as of March 15, 2021

Subchapter K Training

Investment Partnerships

Guaranteed Payments

Additional Background Information

General Research and Analysis

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Partnership Project Workgroup Agenda, February 15, 2023

- Guaranteed Payments – Staff Presentation February 15, 2023 (Slides)
- Guaranteed Payments – Staff Presentation February 15, 2023 (Video)
- Internal Revenue Bulletin: 2015-32 (which contains a history of the federal treatment of guaranteed payments)

Partnership Project Workgroup Agenda, January 18, 2023

- Presentation Work Group Slides – January 18, 2023 (PowerPoint)

MTC
MULTISTATE TAX COMMISSION

An intergovernmental state tax agency whose mission is to promote uniform and consistent tax policy and administration among the states, assist taxpayers in achieving compliance with existing tax laws, and advocate for state and local sovereignty in the development of tax policy.

General Research & Analysis

Articles

- John A. Swain, "State Income Taxation of Out-of-State Corporate Partners," 18 Chap. L. Rev. 211 (2014).
- Walter Hellerstein, "Substance and Form in Jurisdictional Analysis: *Corrigan v. Testa*" (State Tax Notes) – June 13, 2016
- Helen Hecht and Lila Disque, "A State Tax Administrator's Perspective on Partnership Taxation" (Journal of Multistate Taxation and Incentives) – Aug. 2017
- Martin J. McMahon, Jr., "Rethinking Taxation of Privately Held Businesses," (ABA, The Tax Lawyer) – Winter 2016
- Andrea Monroe, "What We Talk About When We Talk About Tax Complexity," 5 Mich. Bus. & Entrepreneurial L. Rev. 193 (2016)
- Andrea Monroe, "Taxing Reality: Rethinking Partnership Distributions," 47 Loy. L.A. L. Rev. 657 (2014)
- Andrea Monroe, "Integrity in Taxation: Rethinking Partnership Tax," 64 Ala. Law Rev. 289 (2012)
- Andrea Monroe, "Too Big to Fail: The Problem of Partnership Allocations," 30 Va.Tax Rev. 465 (2011)
- Andrea Monroe, "What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?," 60 Case W. Res. L. Rev. 401 (2010)
- Tax Policy Center, "A New Analysis Shows How Much Business Income Goes Untaxed," Jan. 11, 2022

Prior MTC Projects on Partnerships

- Original Proposal to Adopt Uniform Composite & Withholding Provisions – 1992
- Final Model Reporting Options for Nonresdient Members of Pass-Through Entities with Withholding Requirement – 2003
- 2004 – MTC Pass-Through Entity Compliance Work Group Report and Proposed Initiatives

Back to the Partnership Project page.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Sourcing Issue:

Partnership income is generally sourced at the partnership level and that sourcing flows through to the partners. Should income of partnerships engaging primarily in investment activities be sourced differently, and if so, how?

- Example: Partnership X holds stock, interests in other partnerships, and certain real property as investments for its partners and the partnership does not take an active role in the management of the underlying businesses or use the assets in a business of its own.
- About half of the states have specifically addressed the issue—generally sourcing certain income to the partner's state of residence.
- Some appear to have treated it as a nexus or doing business issue, others appear to have treated it as nonbusiness or non-apportionable income.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Work Group Process to Date:

- Conducted discussions on the issue – starting in January, 2022 and ongoing.
- Issued a draft white paper analyzing the treatment – published in May, 2022.
- Circulated a draft model rule (statutory form) – in August, 2022.
- Took comments on model rule – summarized in April, 2023.
- Issued proposed revisions in response to comments – April, 2023
- Revised model rule into the form of a regulation – June, 2023.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Draft Model is Based on Certain Principles:

1. States conform to Subchapter K’s conduit approach.
2. States do not apply the federal sourcing rules to partnership items in the interstate context.
3. States generally source partnership income using an entity approach.
4. BUT - States source direct nonbusiness investment income of nonresidents using specific rules based on the type of income or asset.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Sourcing Based on the Asset Rather than the Partnership Applies If:

- The partner:
  - Is a nonresident individual (or taxed as a nonresident individual).
  - Does not engage in managing the investment partnership.
  - Is not a dealer in investments.
  - Does not hold the interest as part of the business of the partner.
- The investment partnership is not unitary with any other business.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Approach:

- The rule is NOT that a partners source all qualified investment partnership income to residence.
- The definition of "Qualified investment partnership" includes:
  - A general definition, and
  - A safe harbor – using the asset test.
- Examples are used to illustrate application.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

General Definition:

(c) "Qualified Investment Partnership."

A qualified investment partnership, as used in this regulation, means a partnership that:

(1) does not act as a dealer under 26 U.S.C. § 475(c);

(2) does not act as a financial institution as defined by [reference to state law]; and

(3) holds assets solely for investment purposes and:

(i) does not materially participate or otherwise actively engage in the activities of the businesses in which it holds interests;

(ii) is not unitary with a business in which it holds interests; and

(iii) does not use or employ assets in any way other than for investment.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

<u>Safe Harbor</u>:

(d) . . . no less than 90 percent of the cost of the partnership's total assets consists of the following:

(1) Common stock . . . and preferred stock, including debt securities convertible into preferred stock;

(2) Bonds, debentures, and other debt securities . . .;

(3) Deposits and any other obligations of banks and other financial institutions . . . and cash and cash equivalents, including foreign currencies;

(4) Corporate stock and bond index securities, future contracts, derivative securities, warrants or options on securities, and other similar financial securities and instruments available for sale or trade through public markets;

(5) Interests in partnerships or other pass-through entities but only if those partnerships or entities would meet the requirements of this safe harbor;

(6) Other similar or related financial or investments contracts, instruments, or securities; and

(7) Office facilities and other tangible and intangible personal property reasonably necessary to carry on its investment activities, including accounts receivable.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Examples:

General Assumptions: In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(1) Simple Example:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- X has dividends from corporate stock.

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from investment in corporate stock recognized by an individual would be sourced to the individual's state of residence. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Examples:

(2) Partnership X Meets General Criteria but not Safe Harbor:

- Smith meets the criteria of Section (b) of this regulation [nonresident and not active in any partnership management activities].
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has dividends from corporate stock.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from corporate stock recognized by an individual would be sourced to the individual's state of residence. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Examples:

(3) Partnership X has Gain from Sale of Real Property in this State:

- Partner Smith owns an interest in Partnership X.
- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has a capital gain from the sale of real property in this state.

. . . under state statutes and regulations, such capital gains from real property in the state that are recognized by an individual would be sourced to this state. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the capital gains is sourced to this state.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Examples:

If X were found *not* to meet the definition of a qualified investment partnership under Section (c), then X's activities in the state might affect the sourcing of the gain from the sale of real property. If the gain were determined to be part of X's unitary business, then the gain would be apportioned as part of X's business income using [reference to state's apportionment rules applied to partnerships]. If the gain were determined to be nonbusiness [or non-apportionable] income of X, then the gain would be allocated under [reference to state's rules for sourcing nonbusiness income].

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Examples:

(4) Partnership has in Distributive Share Income from Another Partnership:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has distributive share income from an interest in Partnership Y, doing business in this state.

. . . under state statutes and regulations, such distributive share income recognized by an individual would be sourced to this state based on the activities of Partnership Y. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the income of Partnership Y, flowing through Partnership X, is sourced to this state based on the activities of Partnership Y.

SOURCING – INCOME OF INVESTMENT PARTNERSHIPS

Status:

Awaiting any further comments – but also – will address other general sourcing issues before moving on to recommend the model to the uniformity committee.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

Sourcing Issue:

Should states source an individual partner’s guaranteed payments for services as distributive share or as compensation?

- About half the states have explicitly addressed the issue.
- Of those, the majority would source the guaranteed payments the same as other distributive share income. Other states would source as compensation, with certain limits.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

Work Group Process to Date:

- Began discussions in February, 2023.
- Published first draft of white paper in April, 2023.
- Published draft white paper with findings and recommendations in August, 2023.
- Drafted model using the same method as sourcing distributive share – October, 2023 – and including a credit provision to address multiple sourcing.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

Factors Favoring Sourcing the Same as Compensation:

- More consistent with the entity approach used under Subchapter K to account for and tax these payments.
- More consistent with the sourcing of payments to partners who perform services not acting in the capacity of partners.
- Generally consistent with the federal sourcing of such payments when partners perform services overseas.
- Since federal tax law gives these payments less favorable treatment than distributive share/distributions generally, this means that the risk that they would be used merely to alter the state sourcing result is somewhat reduced.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

Factors Favoring Sourcing the Same as Distributive Share:

- Guaranteed payments are simply a matter of agreement between partners and, in some cases, can lead to the same economic result for the partners as distributive share.
- Sourcing guaranteed payments for services as compensation requires distinguishing these them from special allocations and from payments for the use of capital.
- Sourcing the same as distributive share treats partners the same as owners of proprietorships who take draws.
- States that have PTE taxes and include guaranteed payments in the base will generally source that base using entity-level apportionment or allocation.
- Sourcing guaranteed payments differently than distributive share may also add administrative complexity.
- Sourcing guaranteed payments as distributive share is the approach used by the majority of states that have specifically addressed the issue.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

<u>Draft Models are Based on Certain Principles</u>:

1. States conform to Subchapter K's conduit approach.
2. States do not apply the federal sourcing rules to partnership items in the interstate context.
3. States generally source partnership income using an entity approach.
4. State sourcing of partnership income is attributed to the partners.
5. Multiple taxation should be reduced if possible.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

Approach:

- Model is drafted in part as a statute and in part as a regulation with examples.
- The model statute addresses the treatment of guaranteed payments to foreign partners and to domestic partners working abroad, where the federal sourcing treatment is based on location of performance.
- Addresses guaranteed payments to retired partners which states are preempted from taxing unless the partner is a resident.
- The additional credit recognizes that a minority of states have chosen to tax guaranteed payments for services to the location of the performance. The credit is drafted as a statute to be adopted by residency states that source guaranteed payments in the same way as distributive share.

SOURCING – GUARANTEED PAYMENTS FOR SERVICES

Status:

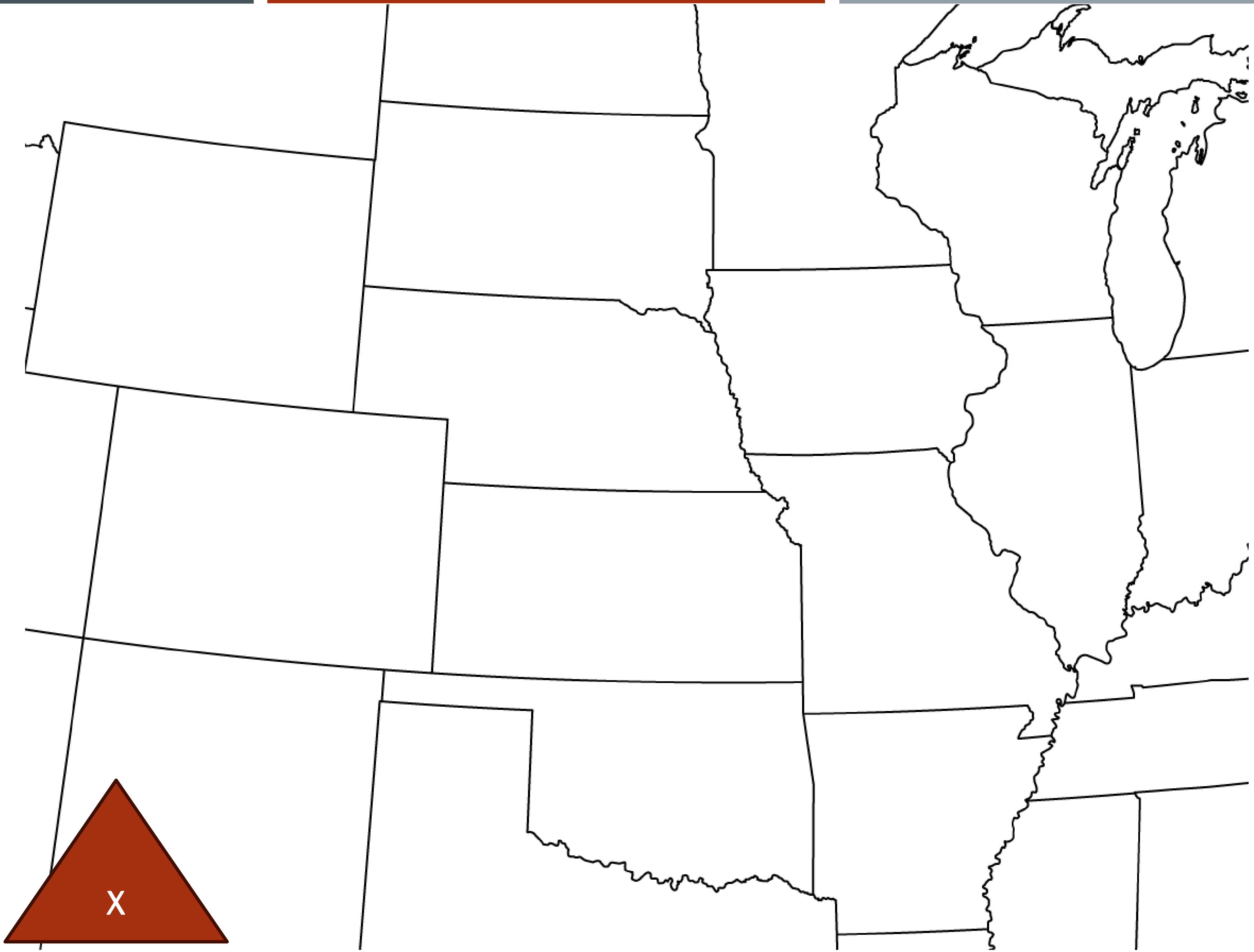
The work group is taking comments and input on the draft model as part of their discussions.

WHAT’S NEXT?

COMPLEX SOURCING ISSUES

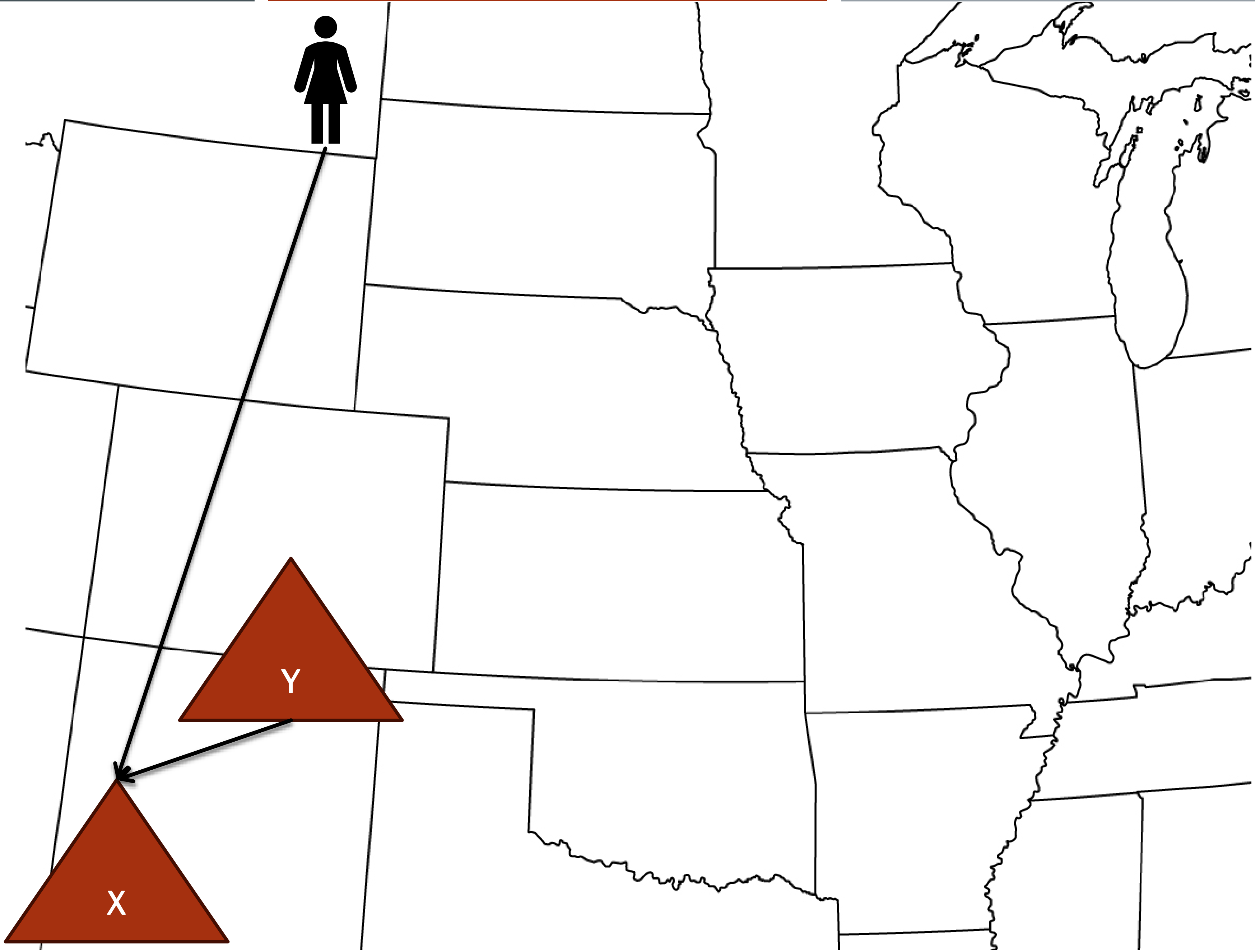
- Complex Tiered and Related Entity Structures
- Complex Special Allocations

SIMPLE EXAMPLE



SIMPLE EXAMPLE

Ownership



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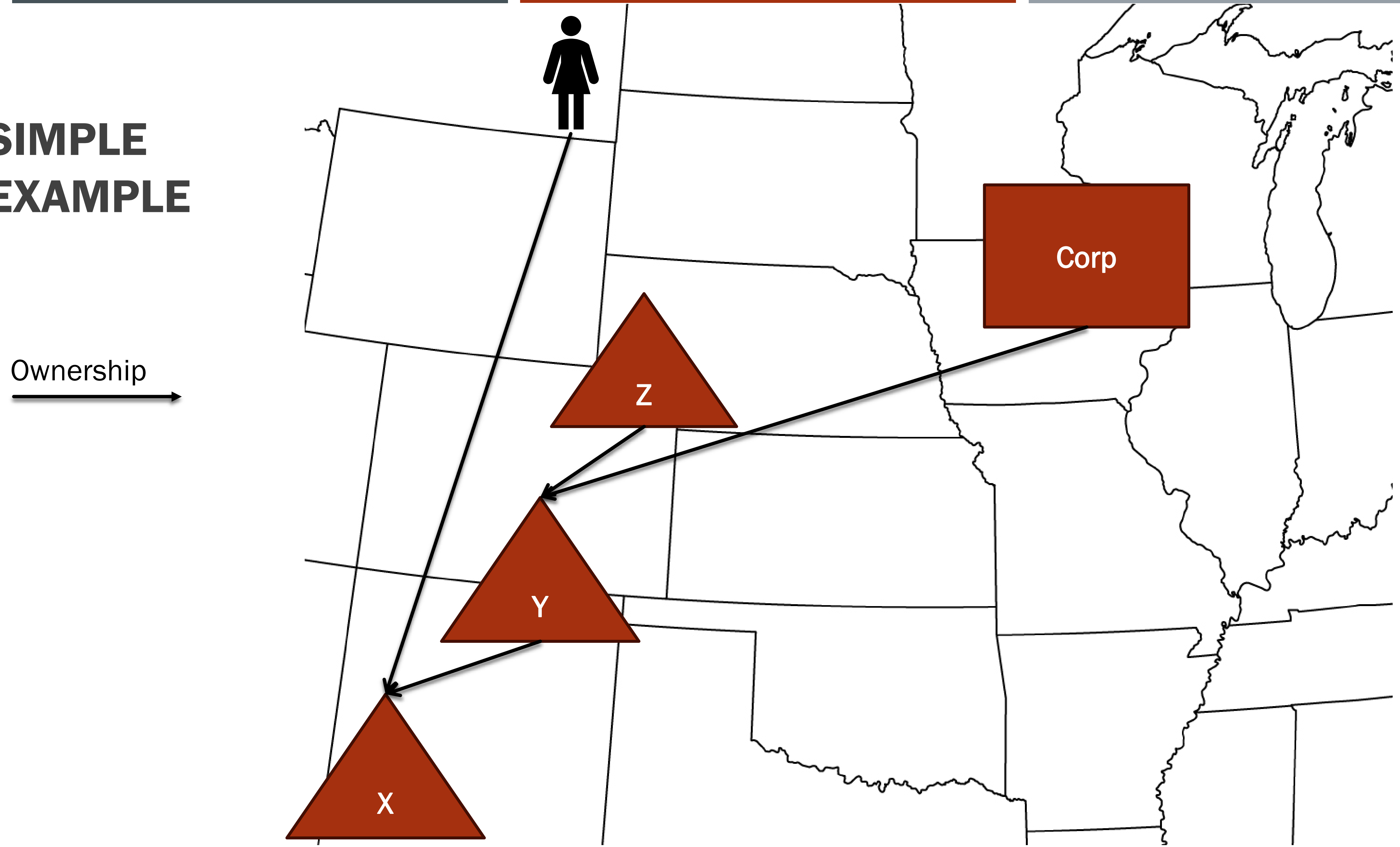

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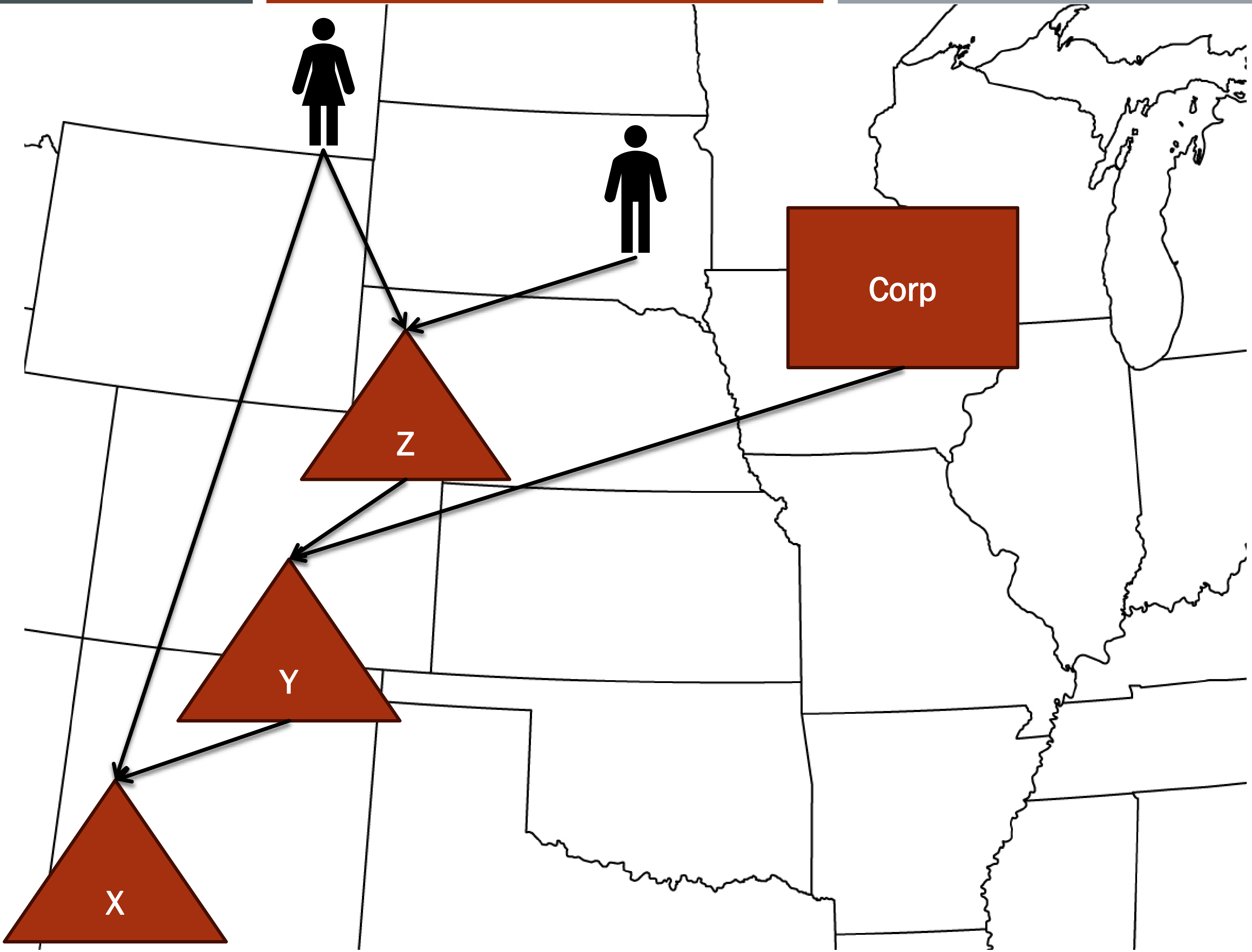

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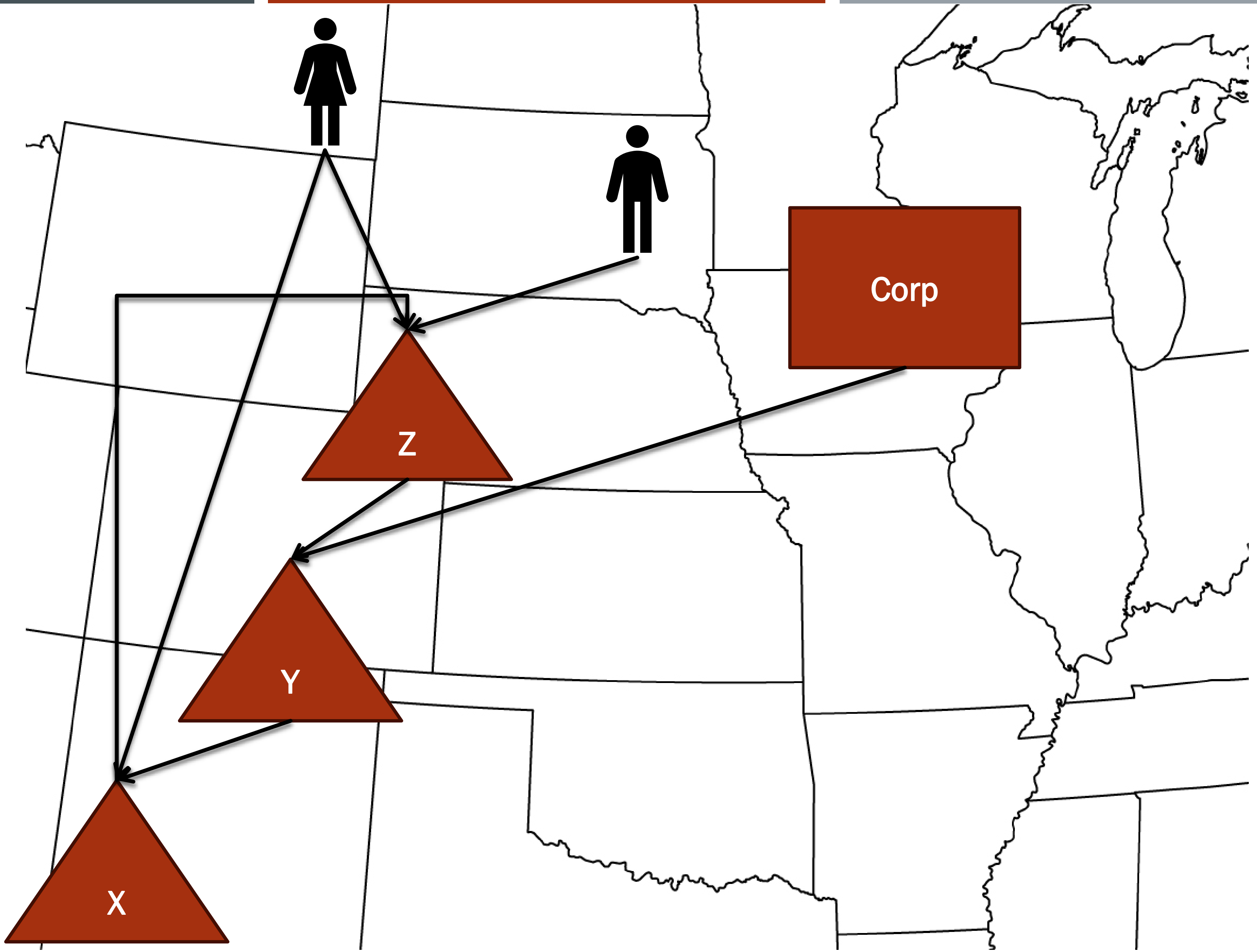
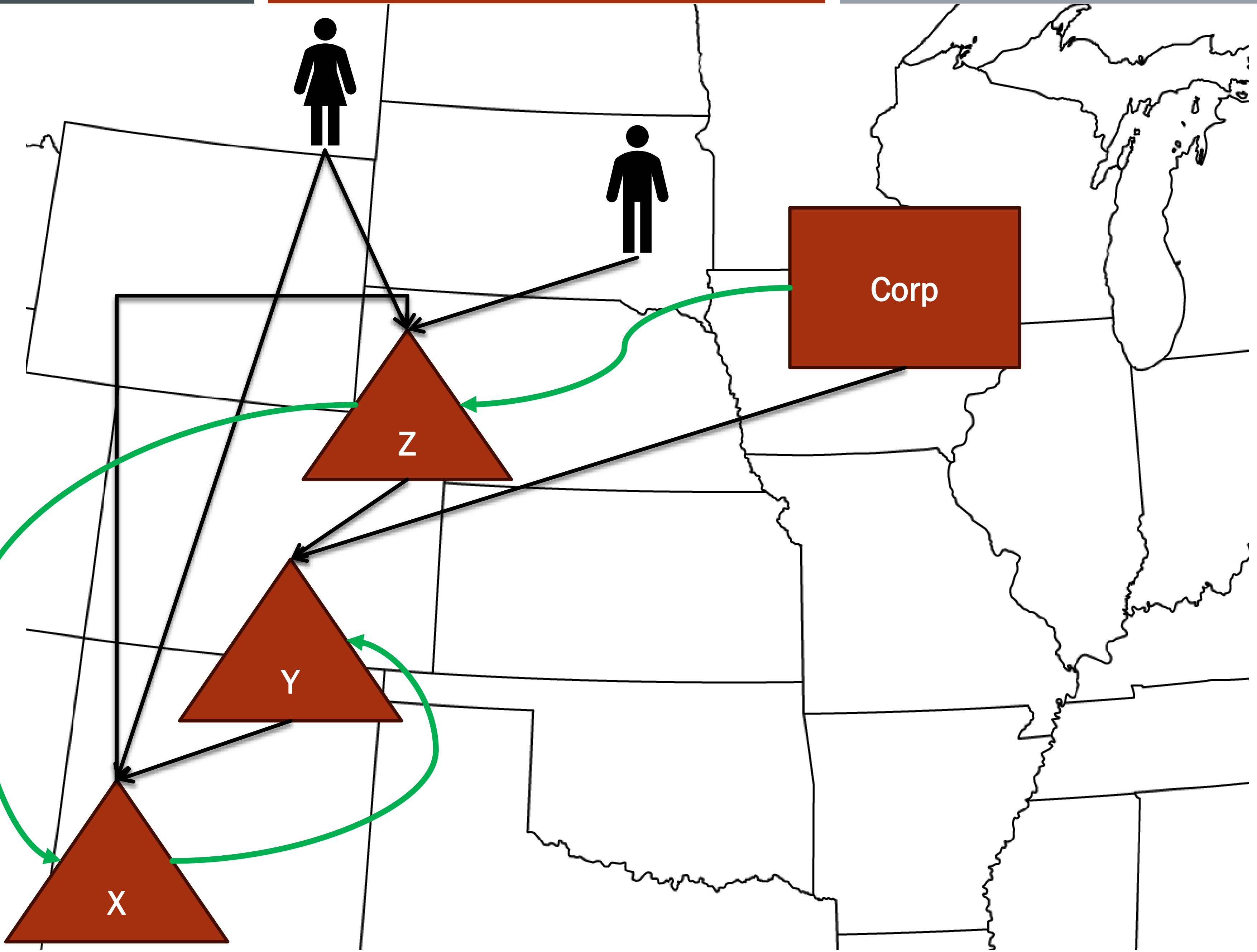


SIMPLE EXAMPLE

Ownership

Transactions

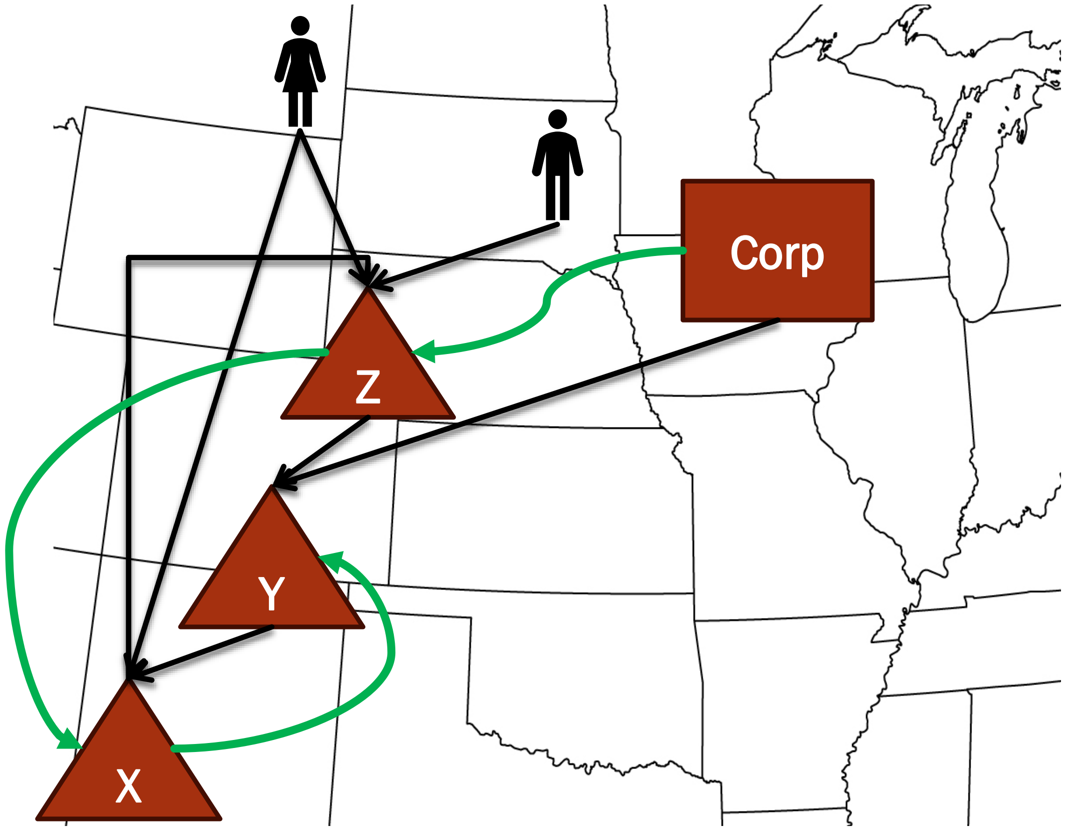


SIMPLE EXAMPLE

Do the activities of Partnership Z affect the sourcing of Bob's distributive share from Partnership Y?

Ownership

Transactions



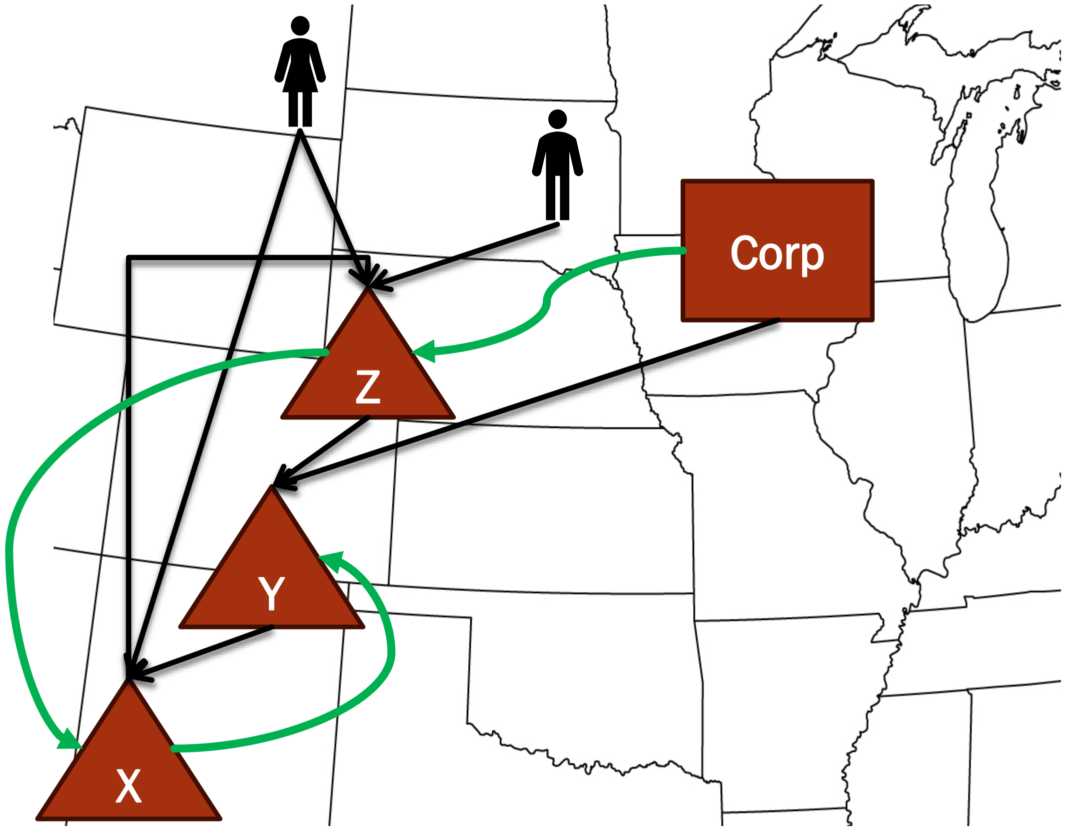
SIMPLE EXAMPLE

Do the activities of Partnership Z affect the sourcing of Bob's distributive share from Partnership Y?

Ownership

Transactions

Assume Partnerships Z and Y are part of a unitary business and Partner Bob is a majority, active partner in Partnership Z.

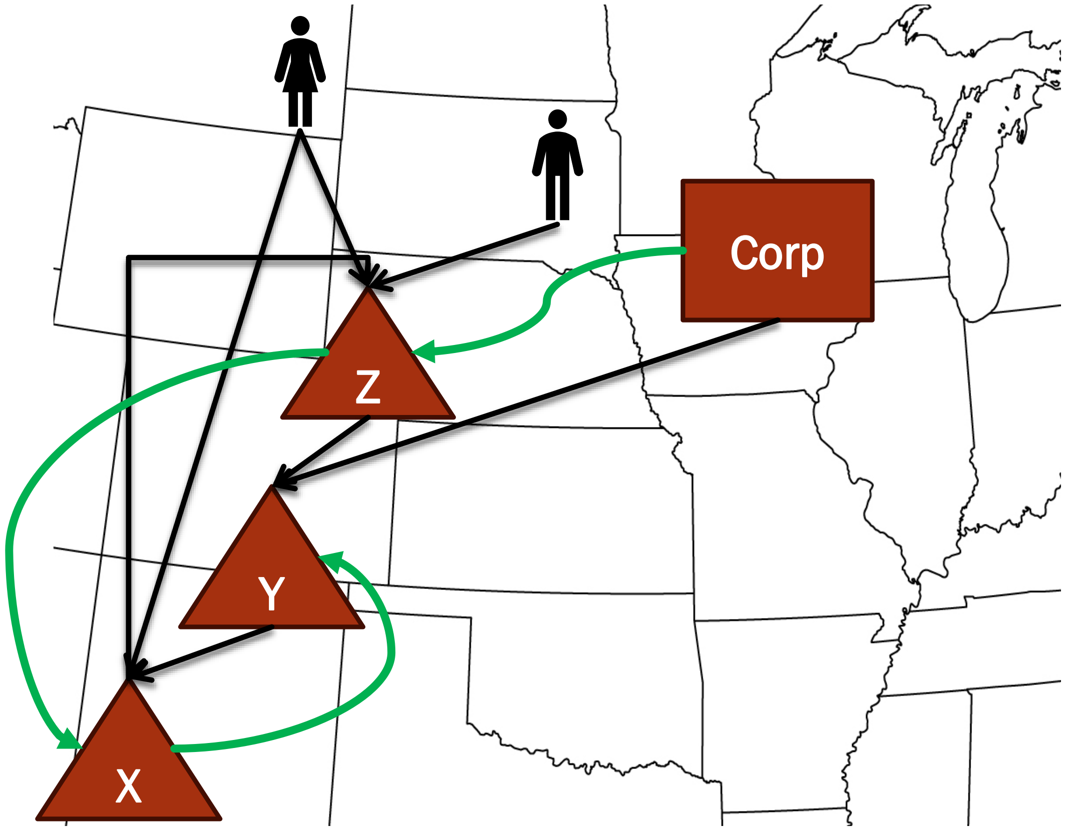


SIMPLE EXAMPLE

Do the activities of Partnership Z affect the sourcing Corp's distributive share from Partnership Y?

Ownership

Transactions



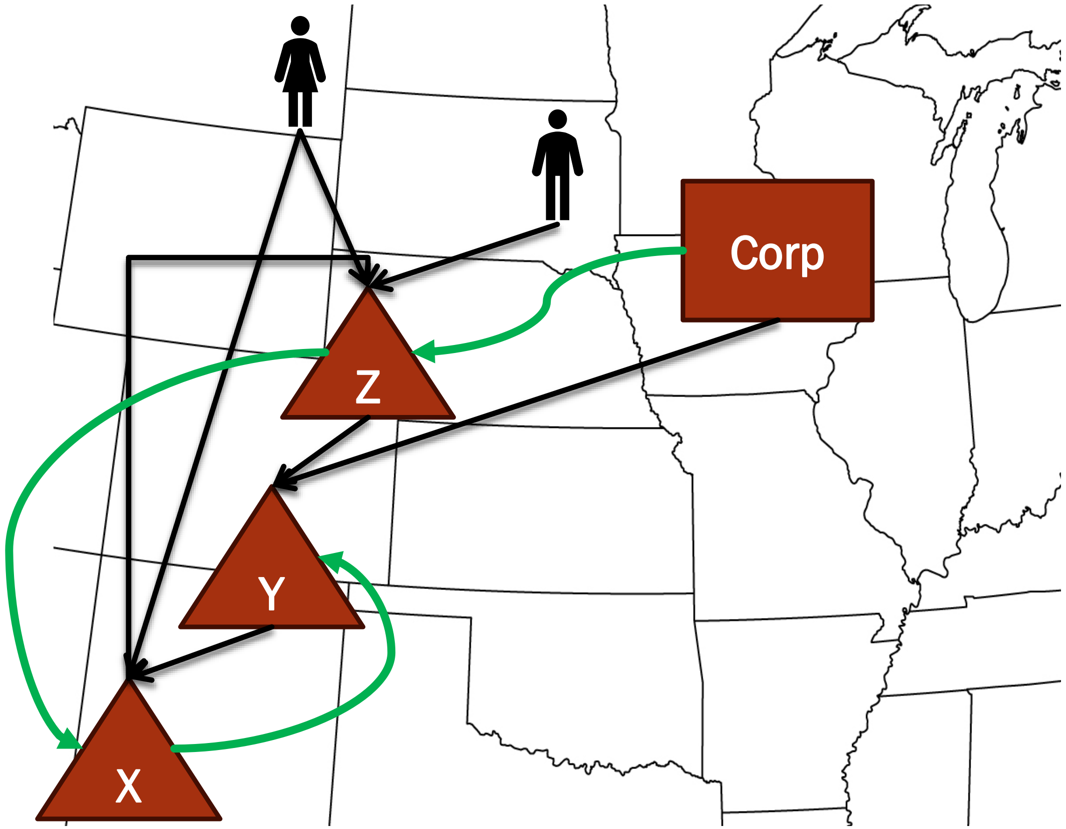
SIMPLE EXAMPLE

Do the activities of Partnership Z affect the sourcing Corp's distributive share from Partnership Y?

Ownership

Transactions

Assume Partnership Z and Partnership Y are part of a unitary business and Corp is a minority, passive partner in Partnership Y.



SIMPLE EXAMPLE

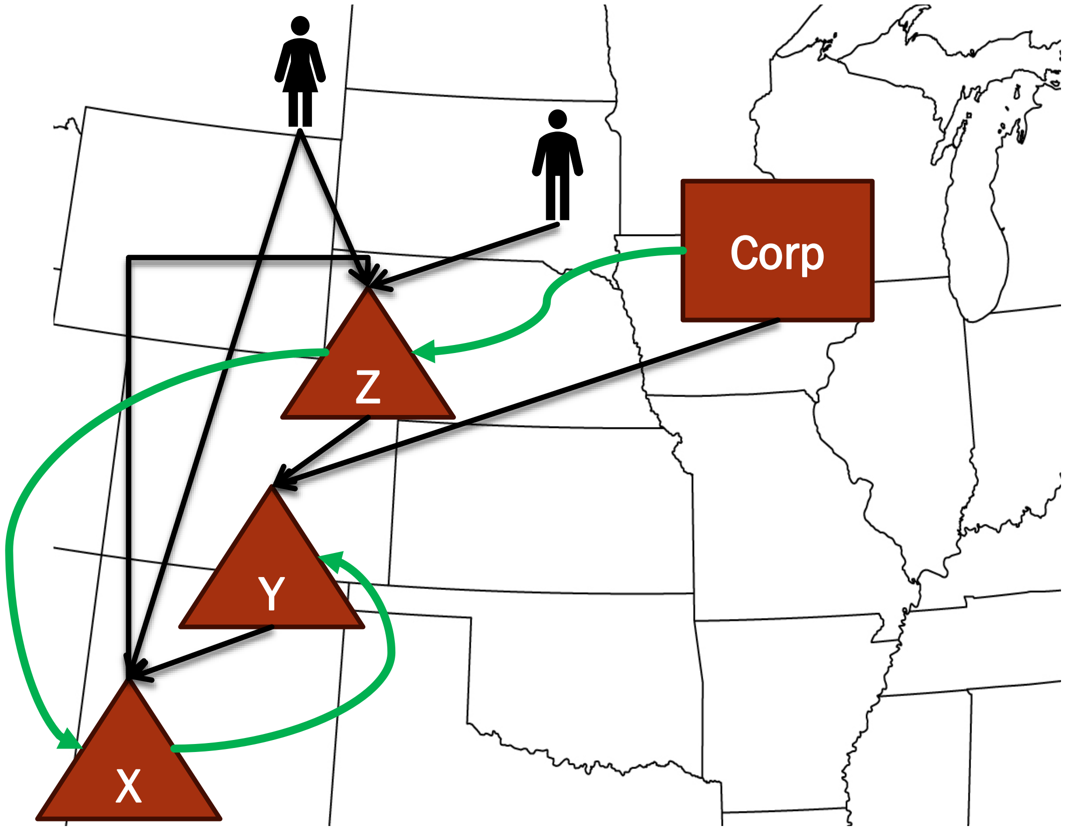
Assume Partnership Y and Partnership X are part of a unitary business.

How does this affect the sourcing of Partner Ann's partnership income?

Does it matter whether Ann is active in the business?

Ownership

Transactions



SIMPLE EXAMPLE

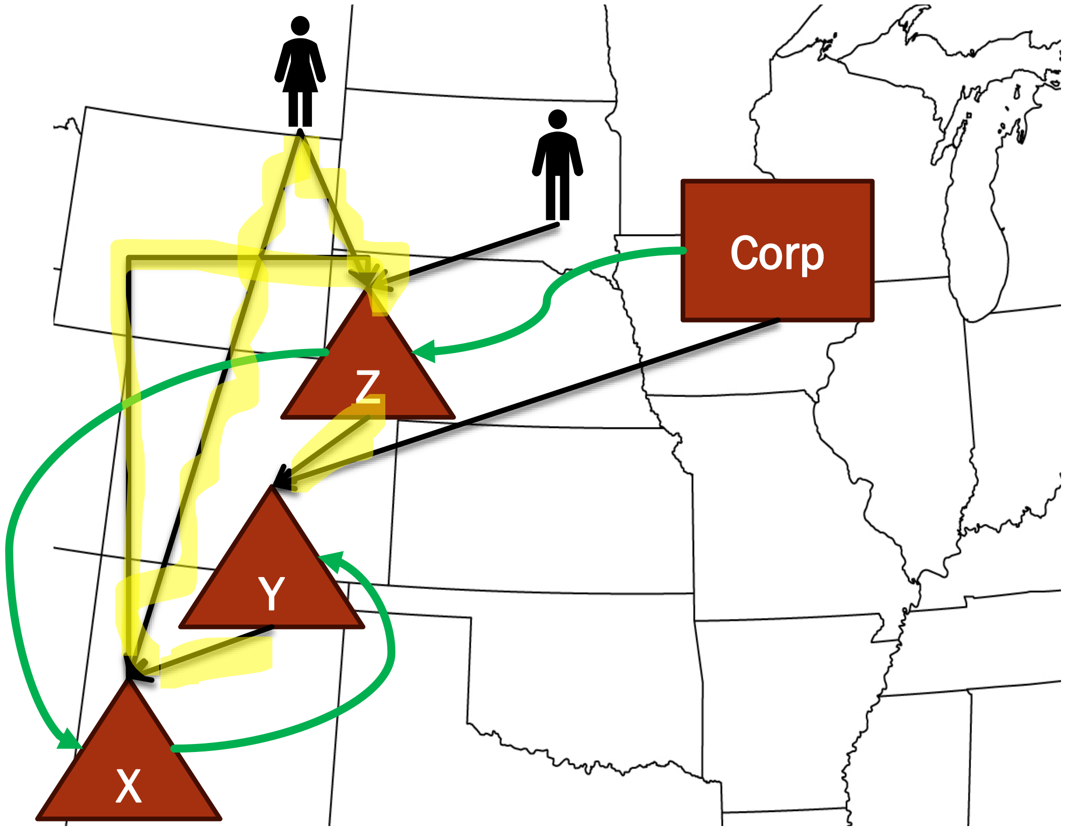
Assume Partnership Y and Partnership X are part of a unitary business.

How does this affect the sourcing of Partner Ann's partnership income?

Does it matter whether Ann is active in the business?

Ownership

Transactions

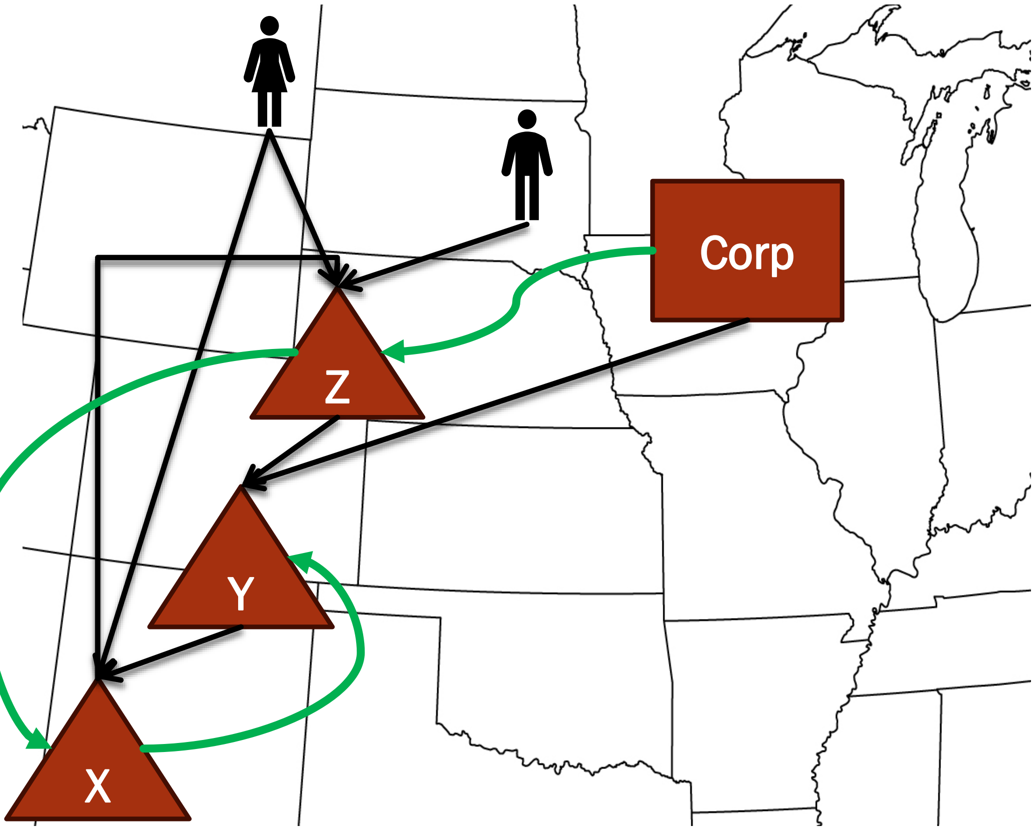


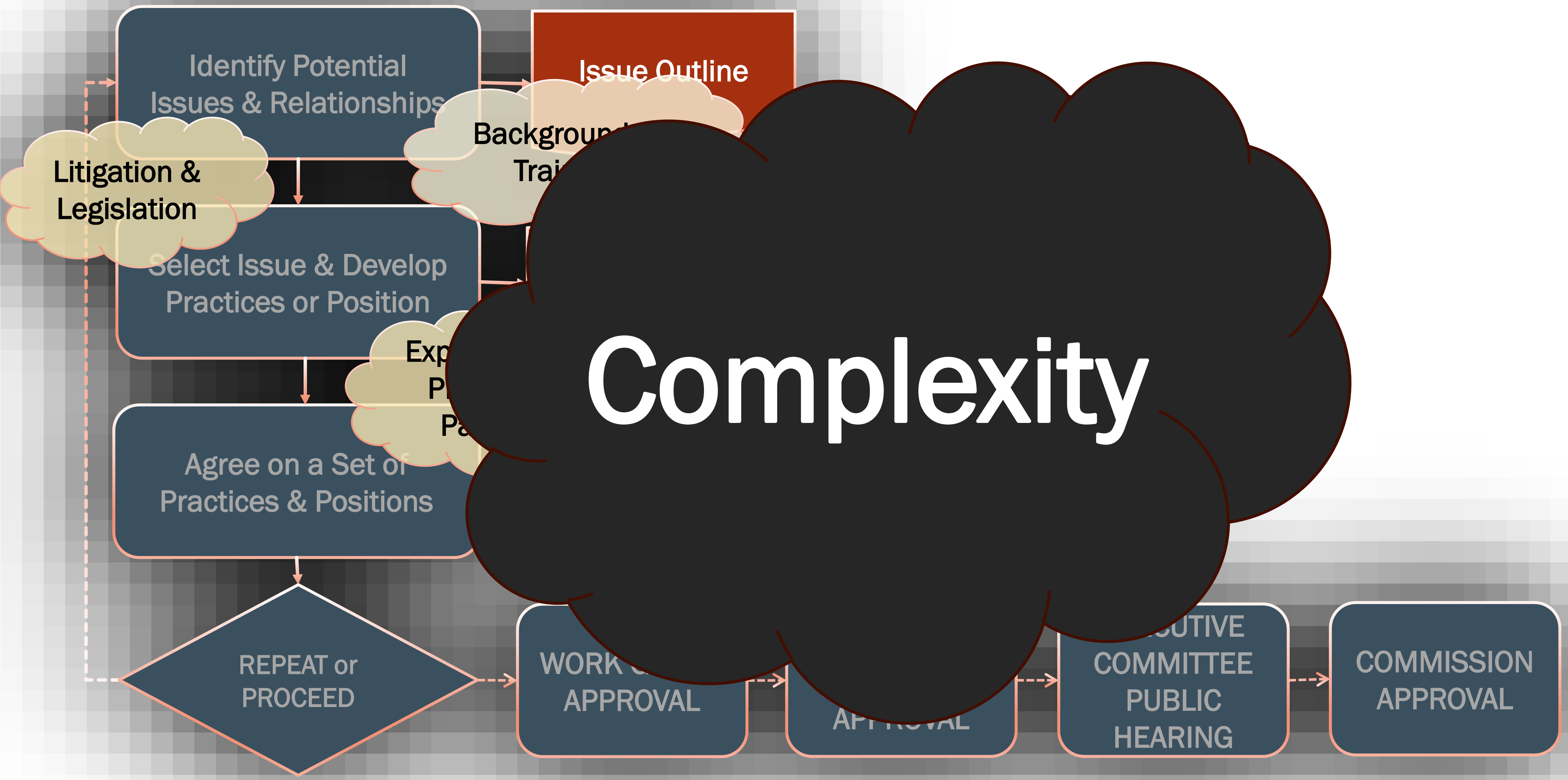
SIMPLE EXAMPLE

Assume Partner Ann receives a special allocation of income from Partnership X which is nonbusiness/ non-apportionable income to Partnership X.

Ownership

Transactions





Identify Potential Issues & Relationships
Issue Outline
Background Trai
Litigation & Legislation
Select Issue & Develop Practices or Position
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Agree on a Set of Practices & Positions
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COMMISSION APPROVAL
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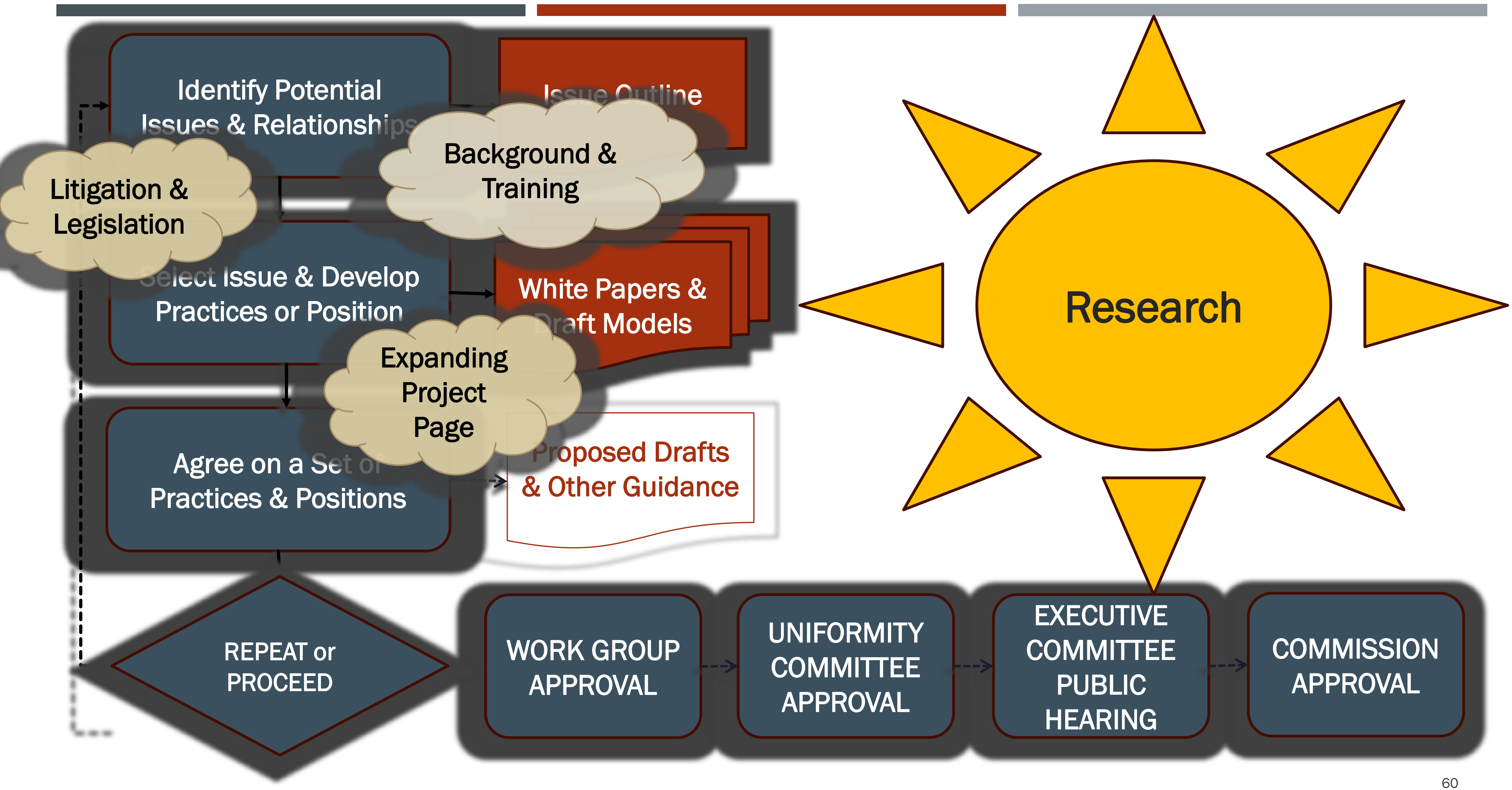
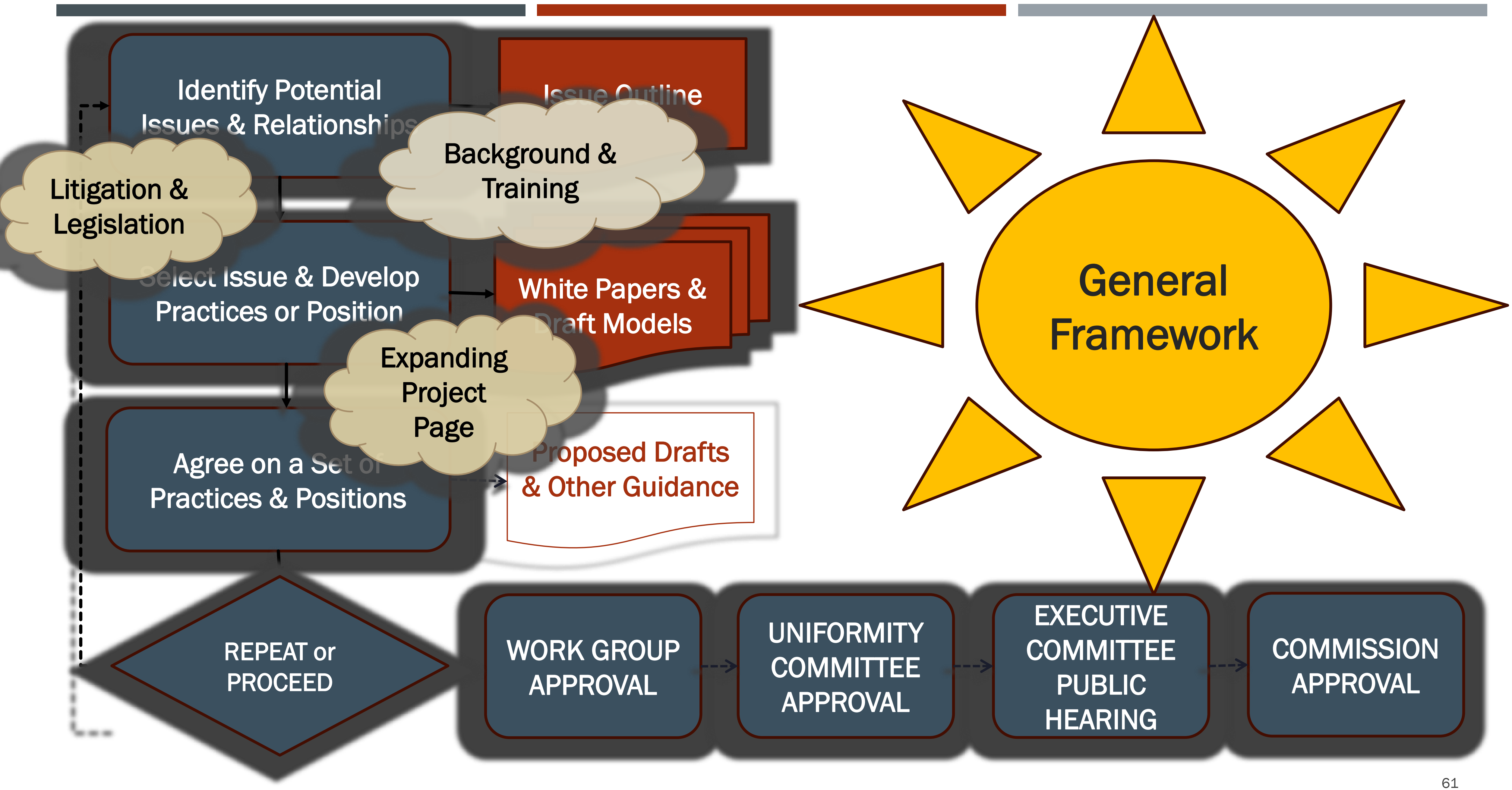

Identify Potential Issues & Relationships
Issue Outline
Litigation & Legislation
Background & Training
Select Issue & Develop Practices or Position
White Papers & Draft Models
Expanding Project Page
Agree on a Set of Practices & Positions
Proposed Drafts & Other Guidance
Research
REPEAT or PROCEED
WORK GROUP APPROVAL
UNIFORMITY COMMITTEE APPROVAL
EXECUTIVE COMMITTEE PUBLIC HEARING
COMMISSION APPROVAL



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Select Issue & Develop Practices or Position
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Agree on a Set of Practices & Positions
Proposed Drafts & Other Guidance
General Framework
REPEAT or PROCEED
WORK GROUP APPROVAL
UNIFORMITY COMMITTEE APPROVAL
EXECUTIVE COMMITTEE PUBLIC HEARING
COMMISSION APPROVAL

GENERAL FRAMEWORK

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.

GENERAL FRAMEWORK

General (cont'd) –

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)).

GENERAL FRAMEWORK

General (cont'd) –

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 FRAMEWORK

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:

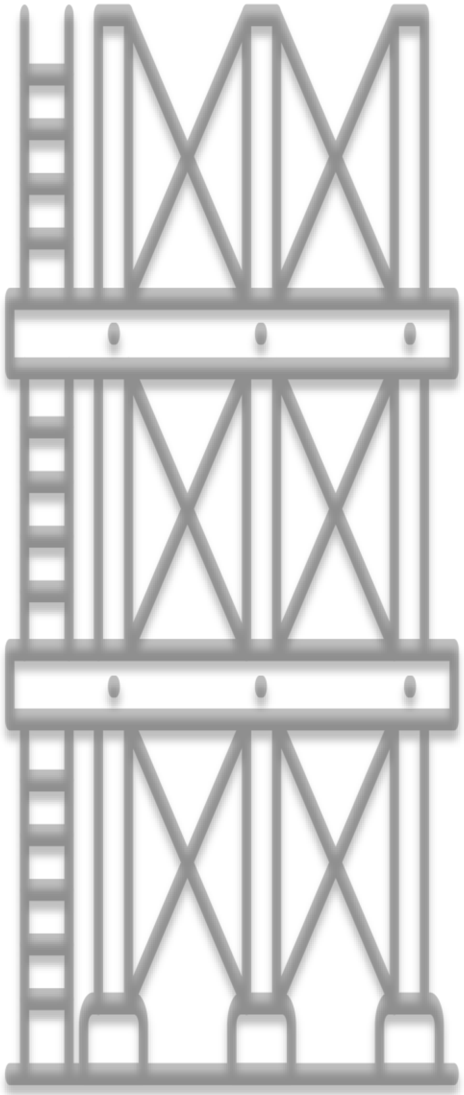
a. Requirements to register;

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.

GENERAL FRAMEWORK



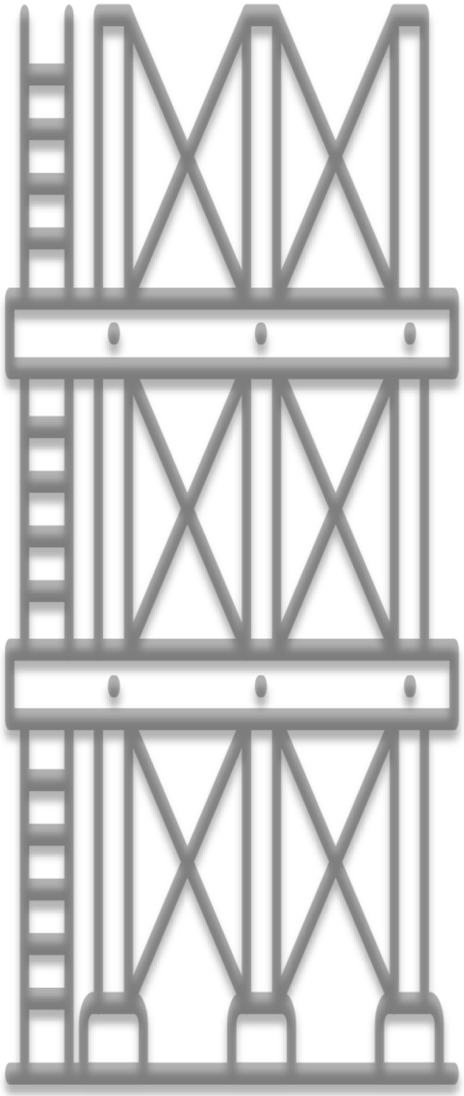
Constitutional Tax Nexus and State Doing Business Standards –

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.

GENERAL FRAMEWORK



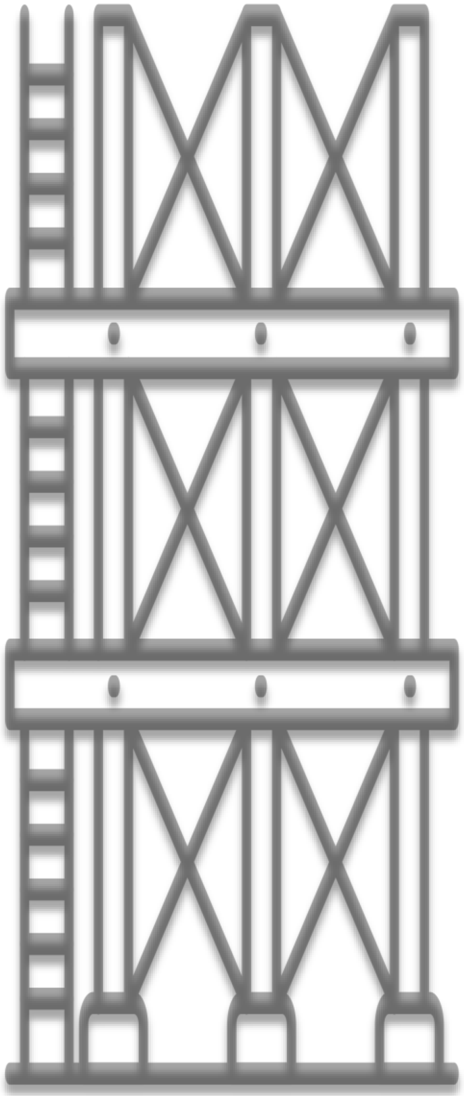
Constitutional Tax Nexus and State Doing Business Standards (cont'd) –

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.

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 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.

GENERAL FRAMEWORK



Sourcing –

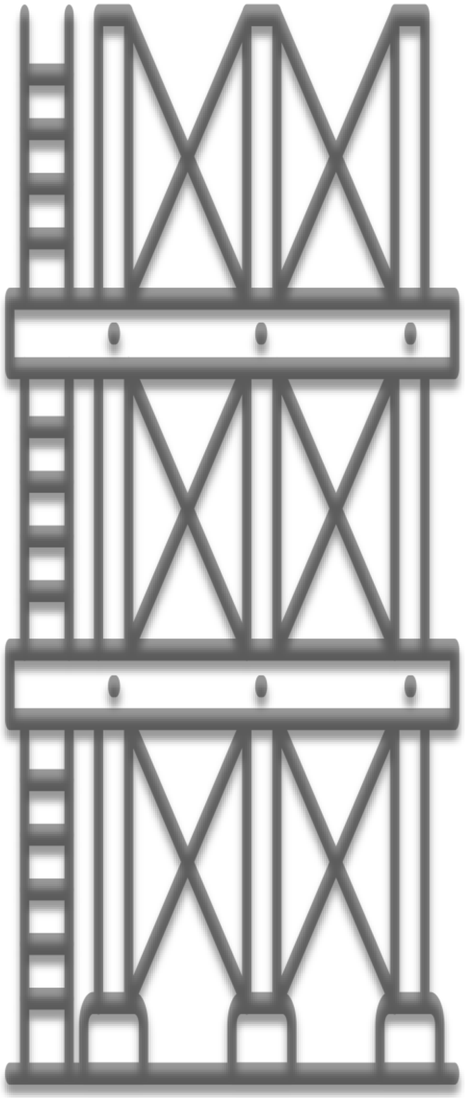
16. States generally conform to the federal rules for domestic sourcing of multinational income, but do not apply these federal rules to the sourcing of domestic income between the states.

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. Non-apportionable 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.

GENERAL FRAMEWORK



Sourcing (cont'd) –

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.

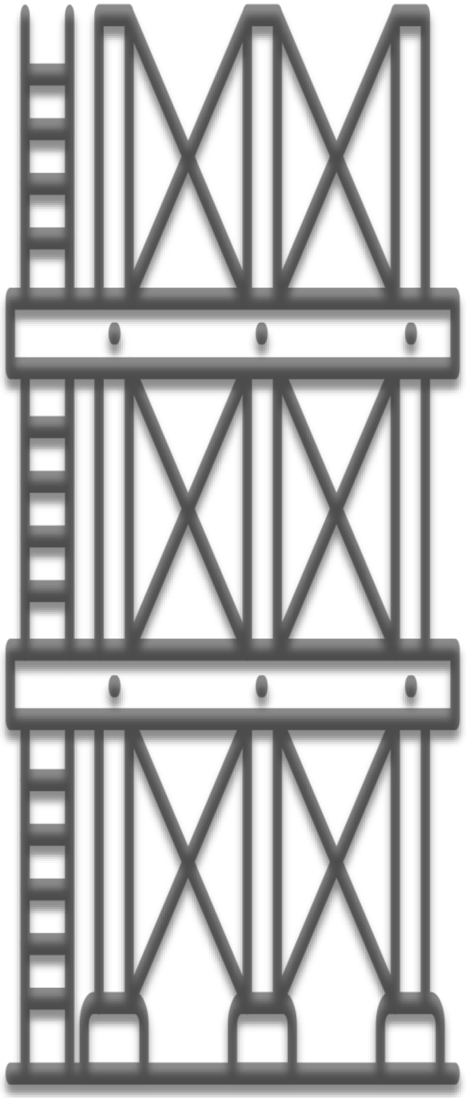
21. The sourcing of partnership income or items at the entity level can be attributed to any direct or indirect partner that receives a share of that income or items, regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control 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.

GENERAL FRAMEWORK



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.

QUESTIONS - COMMENTS