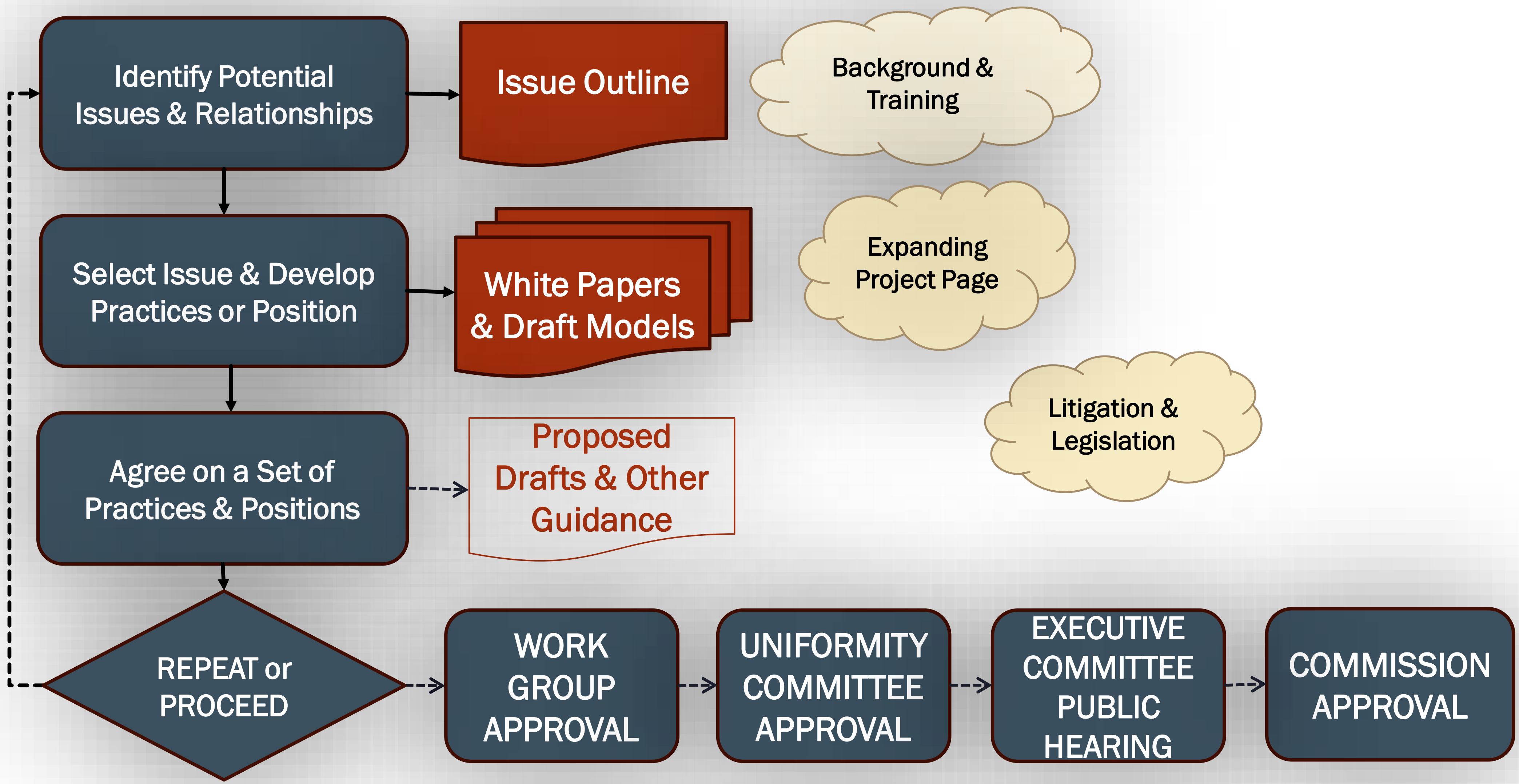
State Taxation of Partnerships – Status Report and Next Steps

MARCH 20, 2024

General Work Group Process



WORK TO DATE

Issue Outline

- Comprehensive list of the state tax issues raised by the pass-through tax system that states must address including:
  - Nexus
  - Tax base .
  - Sourcing
  - Administrative
  - Etc.

Sourcing of Income from Investment Partnerships

- White Paper and Draft Model –
  - If the partnership meets the definition of an investment partnership,
  - Then nonresident partners not involved in the partnership activities would source that partnership's income by looking through to the underlying assets and activities.

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  - A credit for tax paid is provided if a resident is subject to tax in another state on the basis of where services are performed.

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Overview of State Tax Guidance on Sourcing in Tiered Partnership Structures

- We researched to see what states have done to address the sourcing of partnership income in tiered structures generally.
- We looked in state tax statutes, regulations, guidance, tax form instructions, and case law.
- We compiled this research into a draft document containing examples of state tax sourcing rules, pass-through entity tax rules, and withholding/composite return tax rules relevant to tiered partnerships.
- If we have missed anything in our research, please contact Jenn Stosberg at jstosberg@mtc.gov

**Our research should not be relied on as tax advice. For specific questions, please contact your state department of revenue and/or tax advisor.*

State Rules on Tiered Partnerships

This document draft sets forth examples of state sourcing, withholding/return, and PTE tax rules relevant to tiered partnerships. This information comes from state statutes, regulations, cases, form instructions, and guidance as of the date of this draft. This information should not be relied on as tax advice. For specific questions, taxpayers should contact the applicable state department of revenue or their tax advisor. If you have any updates or changes for your state to the information listed below, please contact Jenn Stosberg at jstosberg@mtc.gov

Alabama

Ala. Admin Code r. 810-27-1-.09(3) *Sourcing*

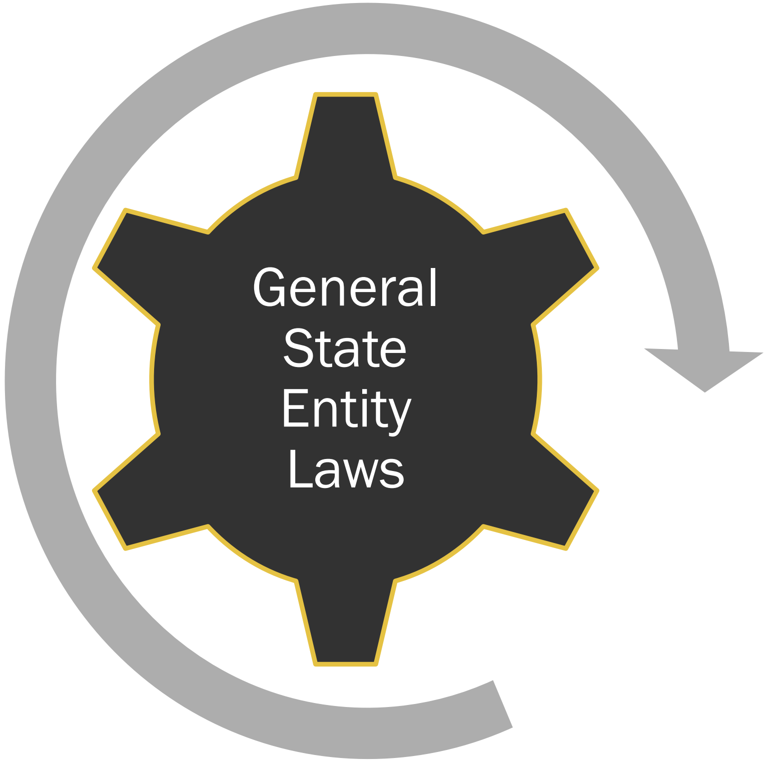
> For taxpayers with a business interest in an unincorporated entity (e.g., partnership, unincorporated joint-venture, limited liability company taxed as a partnership, etc.), the apportionment formula shall include the pro rata share of the unincorporated entity's factor data.

THINKING ABOUT NEXT STEPS

Reviewing the research to determine if there are consistencies in state tax treatment.

For this, it's necessary to first agree on consistent terminology.

CONTEXT FOR STATE PARTNERSHIP SOURCING RULES



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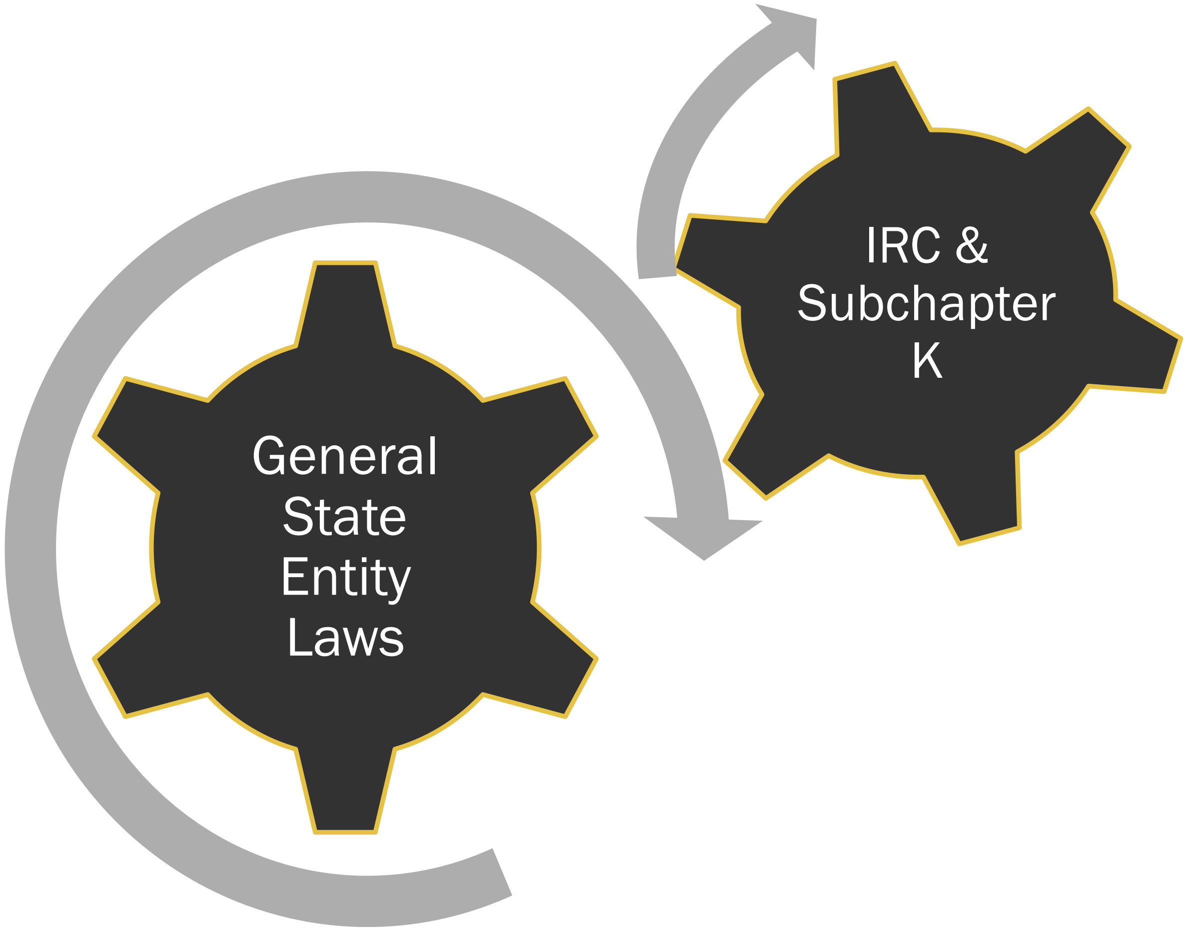

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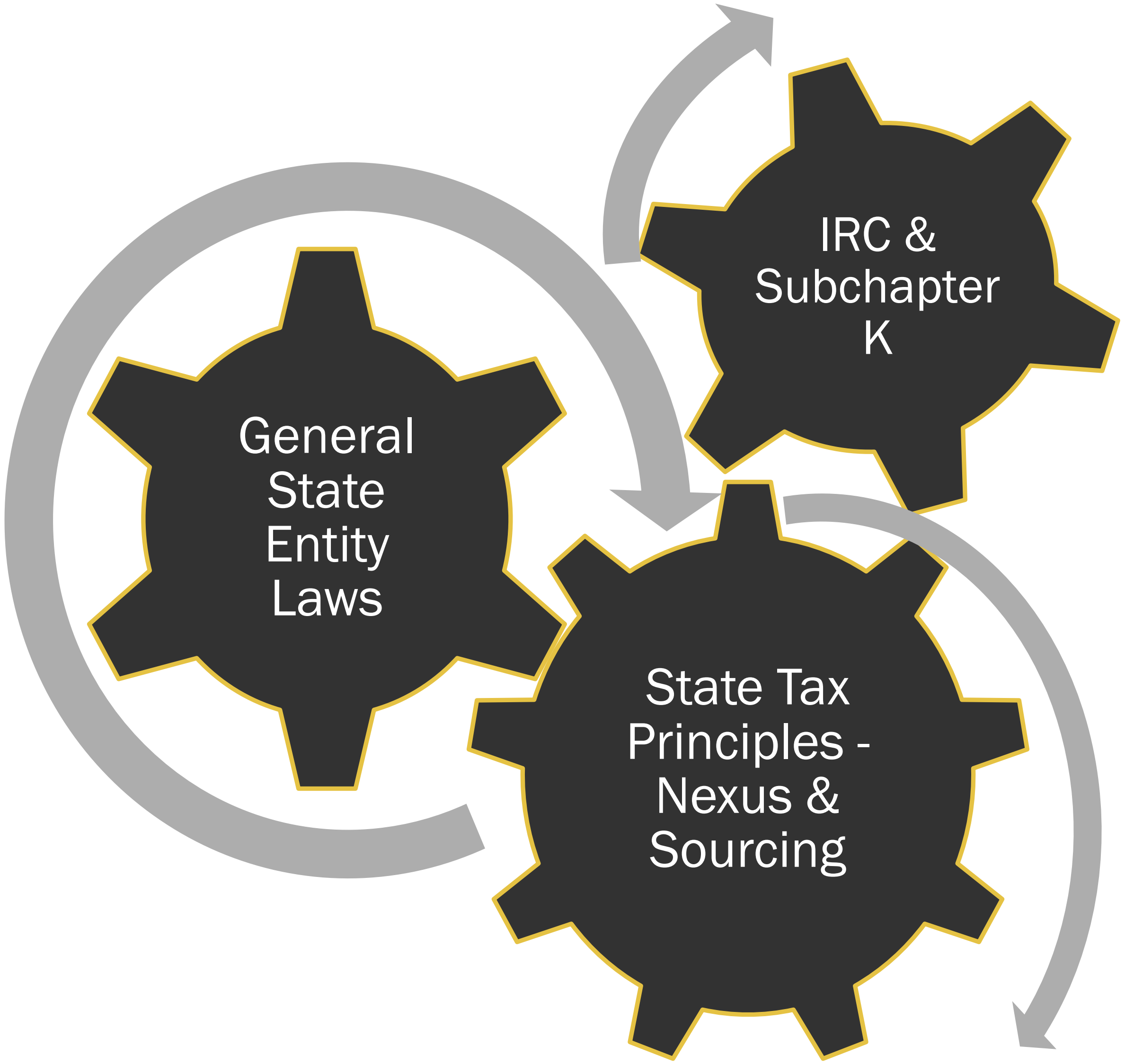

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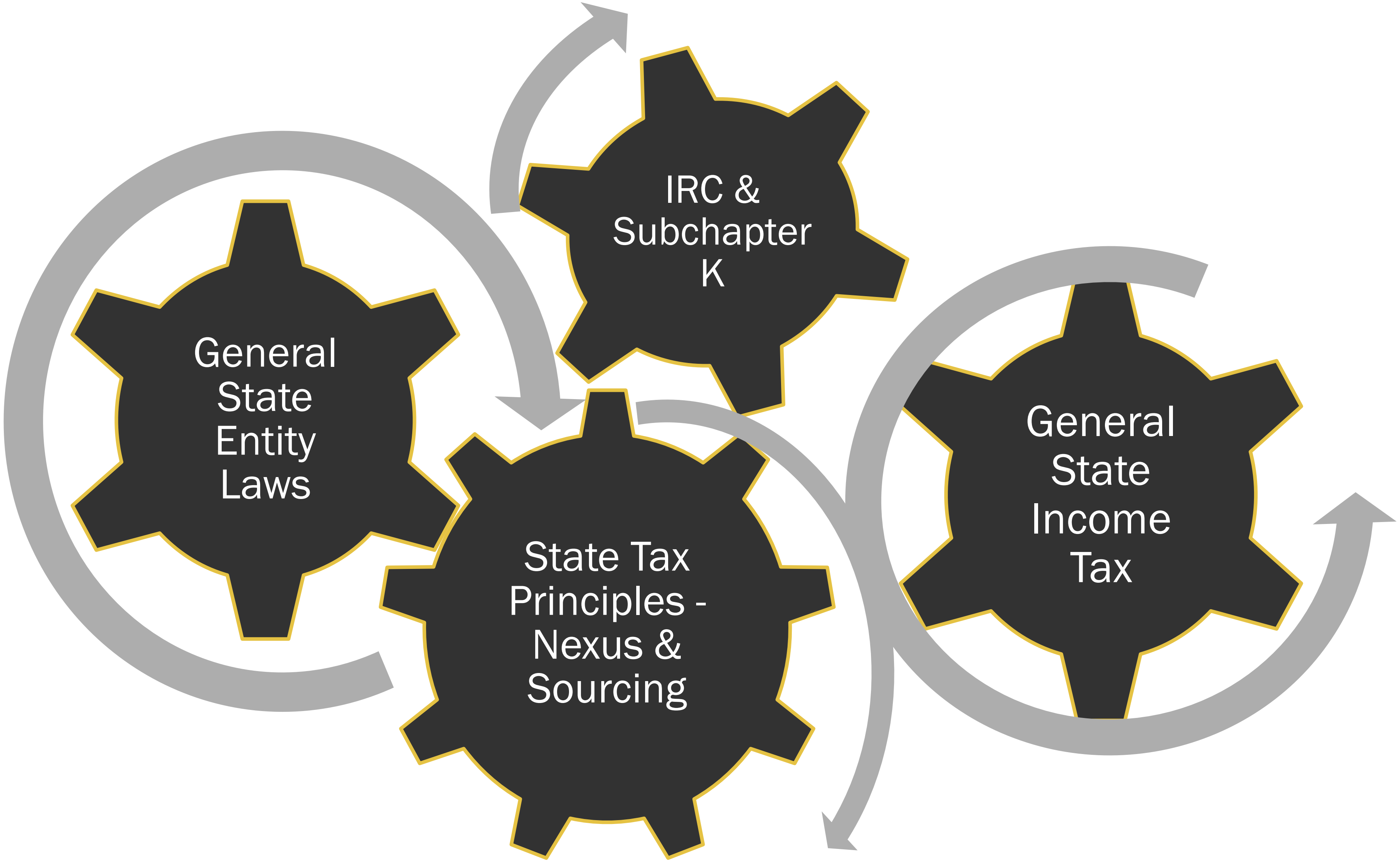

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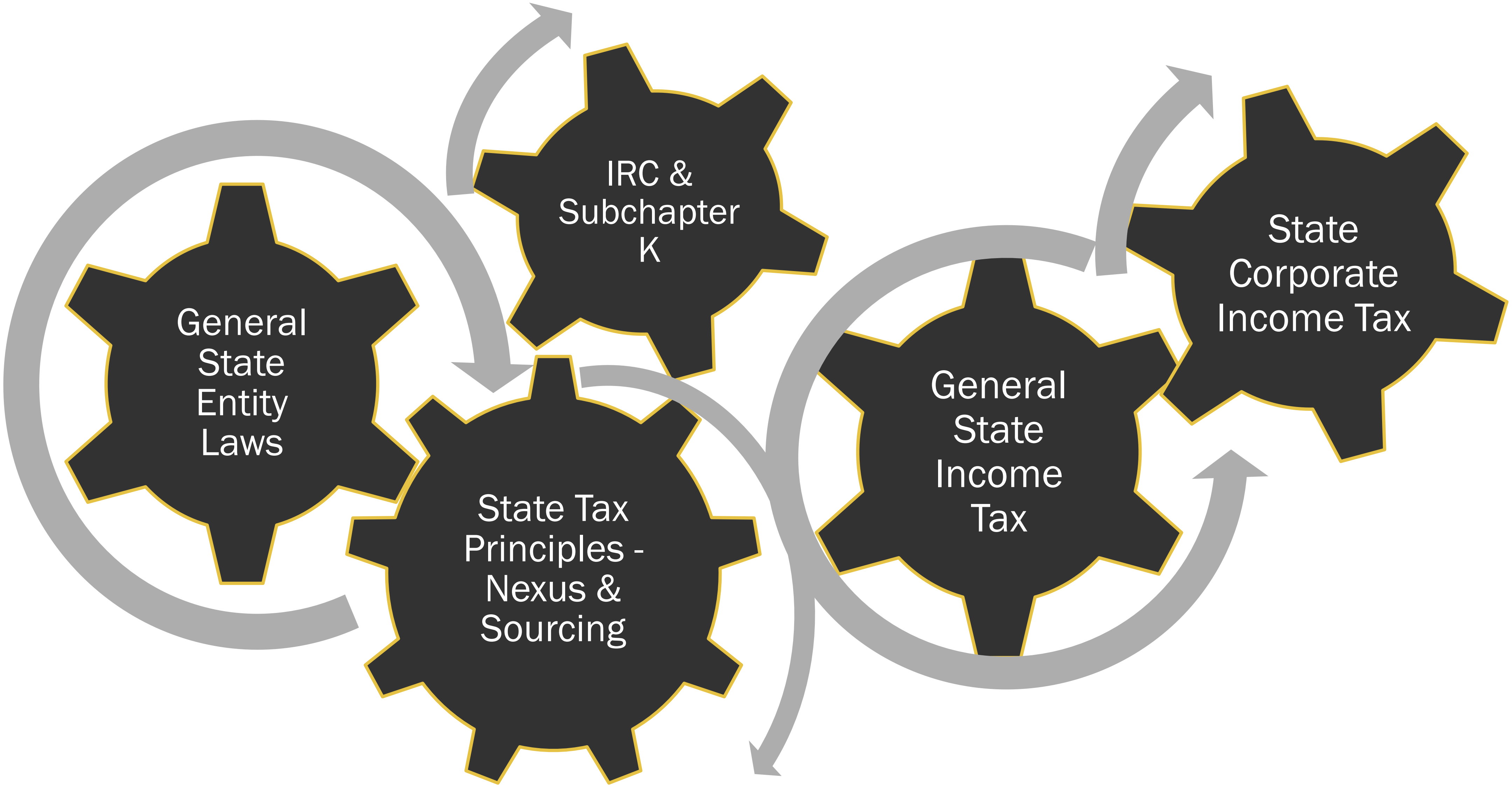

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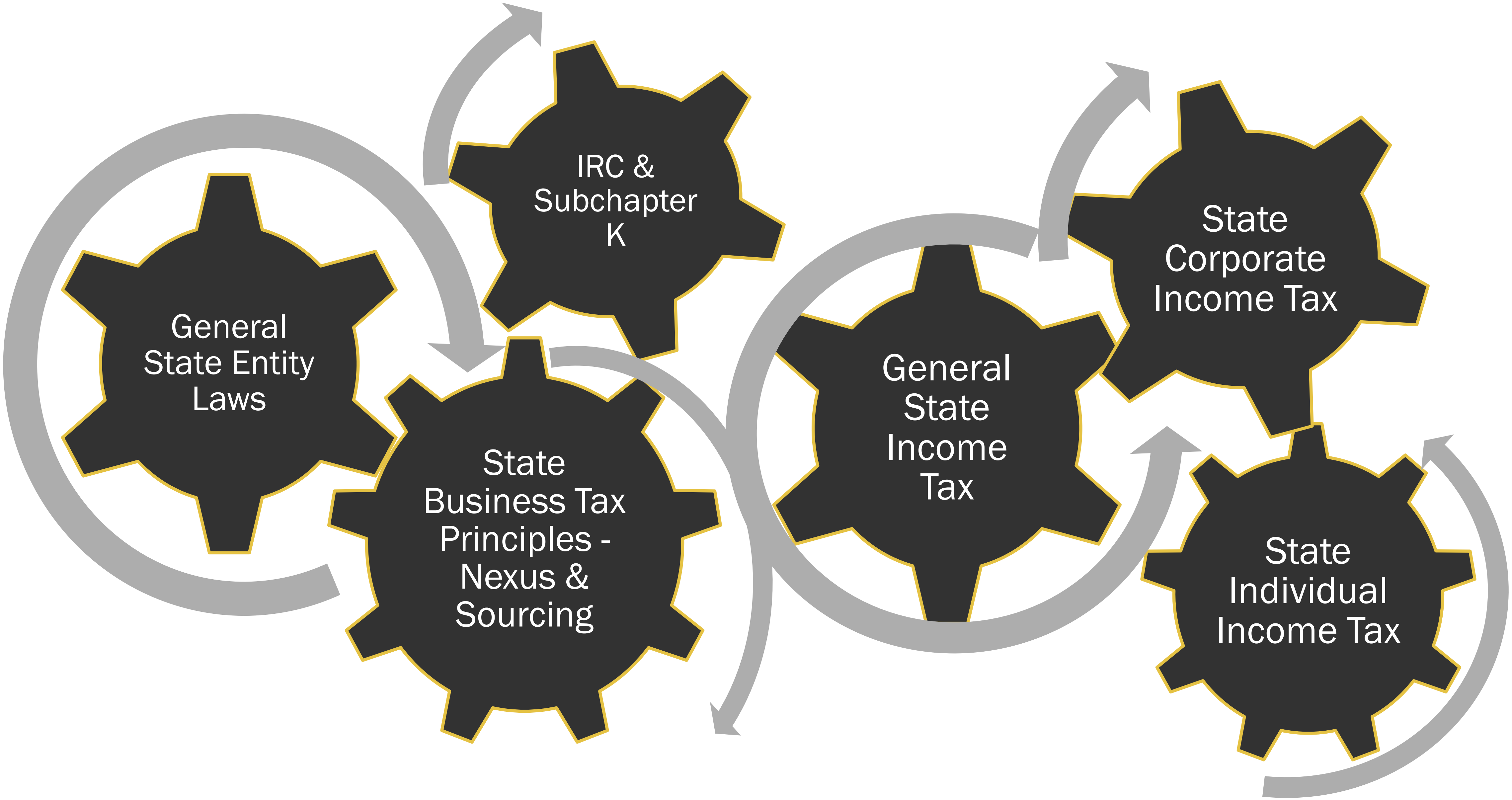

CATEGORIES OF TERMS & CONCEPTS

- State Entity Laws – ULC Models
- Internal Revenue Code & Subchapter K
- State Business Tax Principles
- General State Tax
- State Corporate Tax
- State Individual Tax

STATE ENTITY LAWS (ULC MODELS)

General state laws recognize and govern different types of partnership entities—creating rights and duties of partnerships and partners. These laws may also set out important terms that may apply in the context of taxation.

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1. Entity
2. General partnership
3. Limited partnership
4. Limited liability partnership
5. Limited liability company
6. General partner
7. Limited partner
8. Member
9. Managing member
10. Partnership Agreement
11. Partnership property
12. Agent of the partnership
13. Statement of authority
14. Liability of partners
15. Transferrable interest
16. Transfer
17. Dissociation
18. Dissolution
19. Jurisdiction of formation
20. Interest exchange

INTERNAL REVENUE CODE & SUBCHAPTER K

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1. Partnership
2. Partner
3. Indirect partner
4. Trade or business
5. At-risk
6. Active
7. Passive
8. Activity
9. Aggregation
10. Material participant
11. Distributive share
12. Partnership items
13. Character of items
14. Deductions not allowed partnership (703(a)(2))
15. Substantial Economic Effect
16. Inside basis
17. Outside basis
18. Partner capital account
19. Built-in gain (loss)
20. Partnership interest
21. Contribution
22. Distribution
23. Guaranteed payment
24. Contribution
25. Liquidating distribution
26. Profits interest
27. Partnership interest received in exchange for services
28. Hot assets
29. Allocation *
30. Tiered structure
31. Upper-tier partnership
32. Lower-tier partnership

STATE BUSINESS TAX PRINCIPLES

The application of certain state tax principles—especially nexus and sourcing—in the context of a pass-through tax system is complex and the terms when applied may need to be further defined or explained in order to make their specific application clear. In addition—this is where the entity and aggregate theories of partnerships may need to be considered and addressed.

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1. Entity theory
2. Aggregate theory
3. Jurisdiction – entity and partner
4. Nexus – entity and partner
5. Doing business
6. Attribution
7. Unitary business
8. Unitary asset
9. Apportionable (business) income
10. Non-apportionable (non-business) income

GENERAL STATE INCOME TAX TERMS & CONCEPTS

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1. Imposition of tax
2. General conformity to IRC
3. Authority to require information reporting
4. Authority to require withholding
5. Authority to audit

STATE CORPORATE INCOME TAX

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1. Affiliation or related entities
2. Separate filing
3. Combined filing
4. Joyce
5. Finnigan
6. Intercompany transactions
7. Blended apportionment

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1. Individual
2. Taxable trust
3. Taxable estate
4. Proprietorship
5. Resident
6. Nonresident
7. Credit for taxes paid

GENERAL CONSISTENCIES

- Apportioning business income – whether earned by a corporation, partnership, or proprietorship.
- Apportioning partnership business income using the factors of the entity.
- Using “blended” apportionment in certain situations – adding together the income and factors of tiered partnerships or corporate partners.

THINKING ABOUT NEXT STEPS

Reviewing the research to determine if there are un-addressed issues.

For this, it's necessary to review the essentials of the partnership tax system.

ESSENTIALS OF PARTNERSHIP TAXATION

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4. Two Kinds of Partner Interests –
   Partners can hold capital interests or profits interests (or both).

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8. <u>Special Allocations</u> –
   Partners can agree to share partnership items in any amounts—so long as the agreement has substantial economic effect.

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9. <u>Offsetting Income & Expense/Loss</u> –
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    There are a number of limitations and other anti-abuse rules that are essential to the partnership tax system.

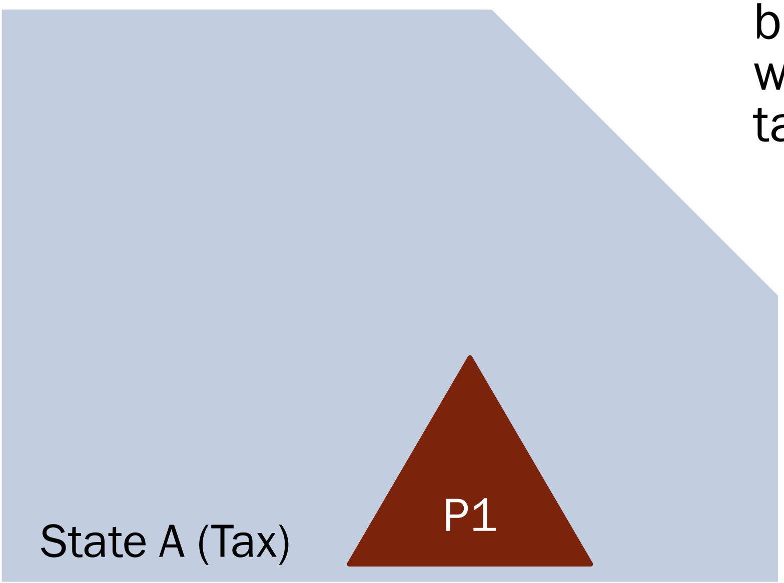
11. <u>Withholding</u> –
    Both the federal government and the states have found withholding essential to enforcement of tax on partnership income.

THINKING ABOUT NEXT STEPS

Reviewing the research to determine if there are un-addressed issues.

For this, it’s also necessary to use examples to illustrate the issues.

EXAMPLE 1:



Partnership 1 is doing business entirely in State A which imposes an income tax.

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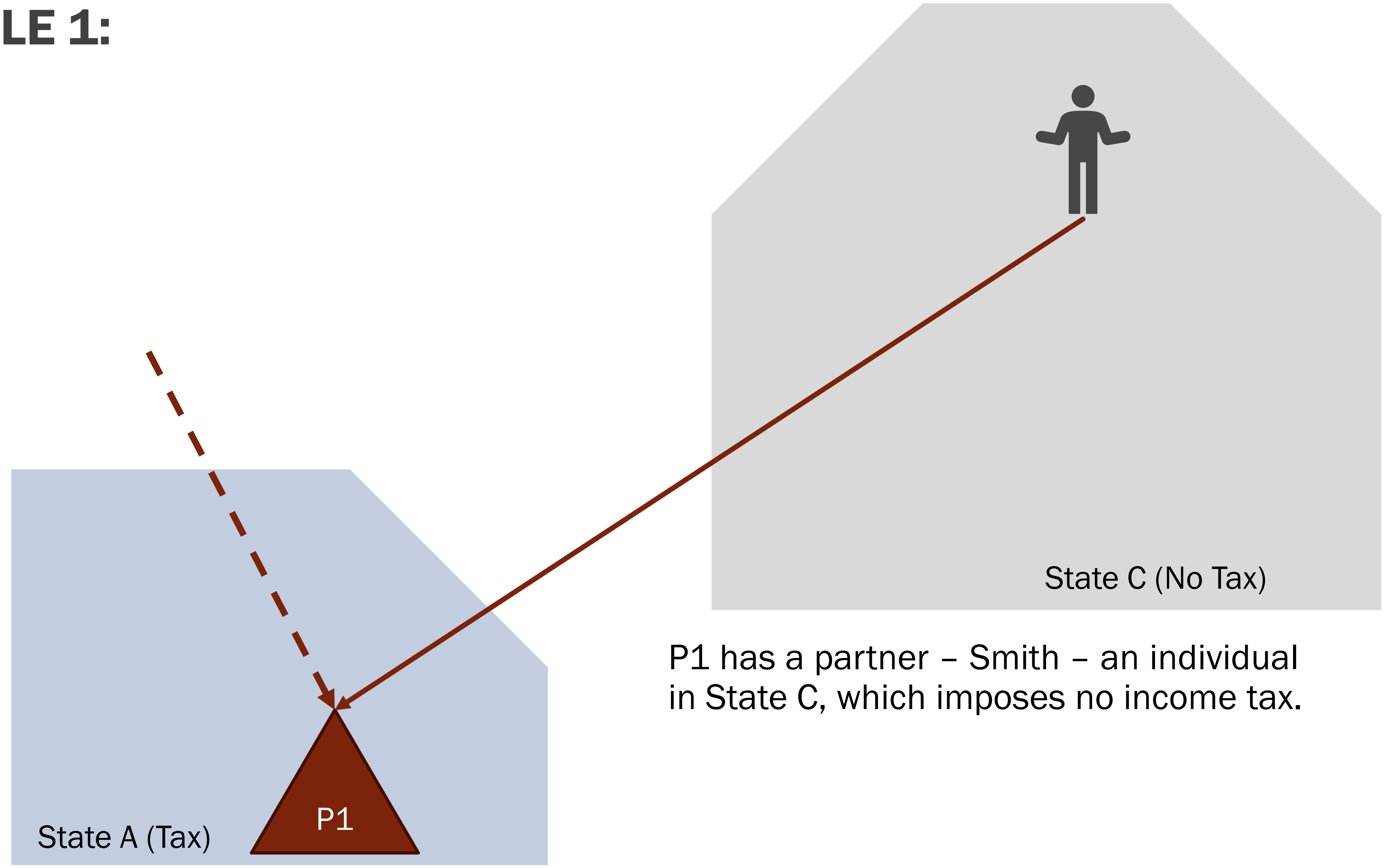
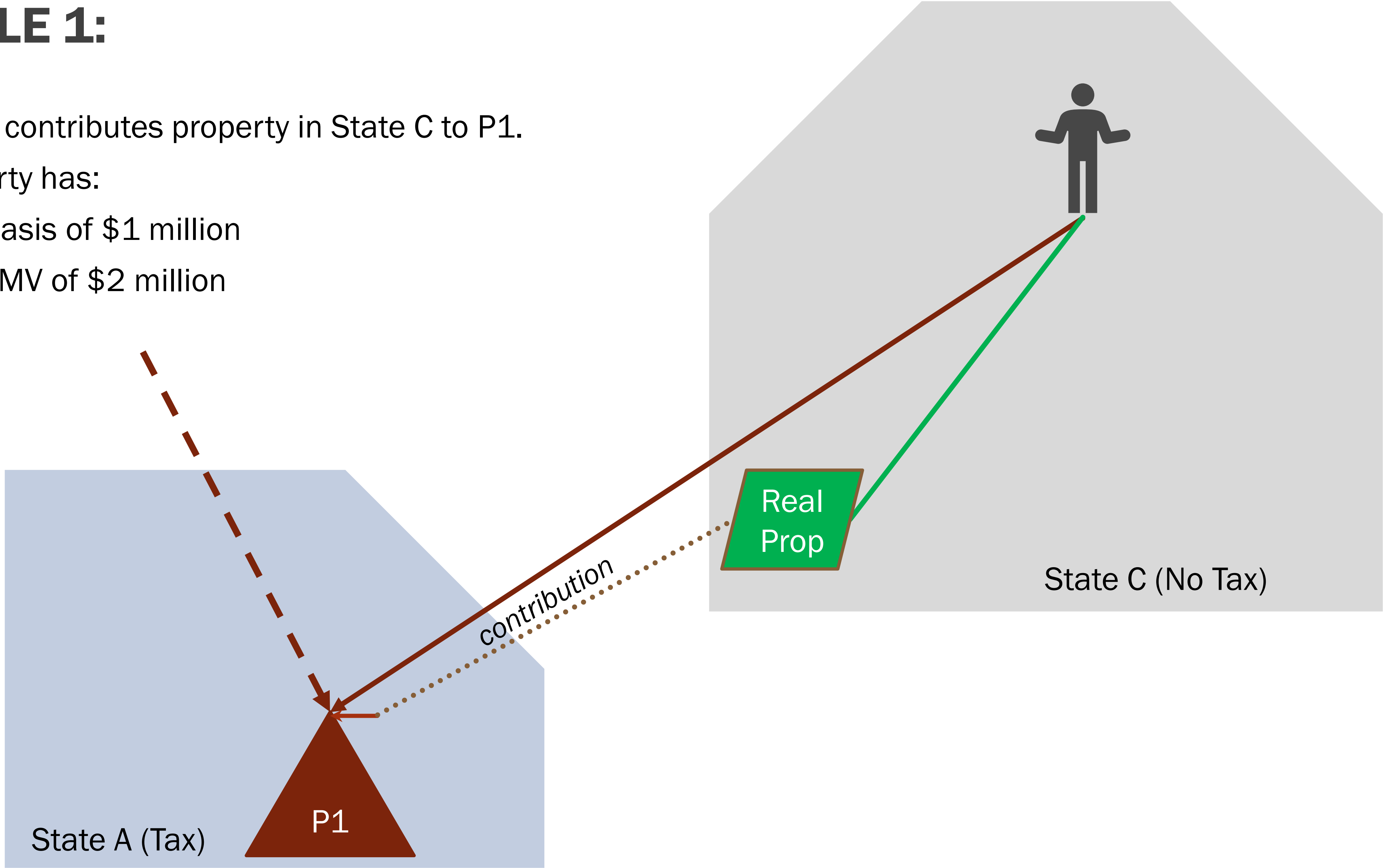


P1 has a partner – Smith – an individual in State C, which imposes no income tax.

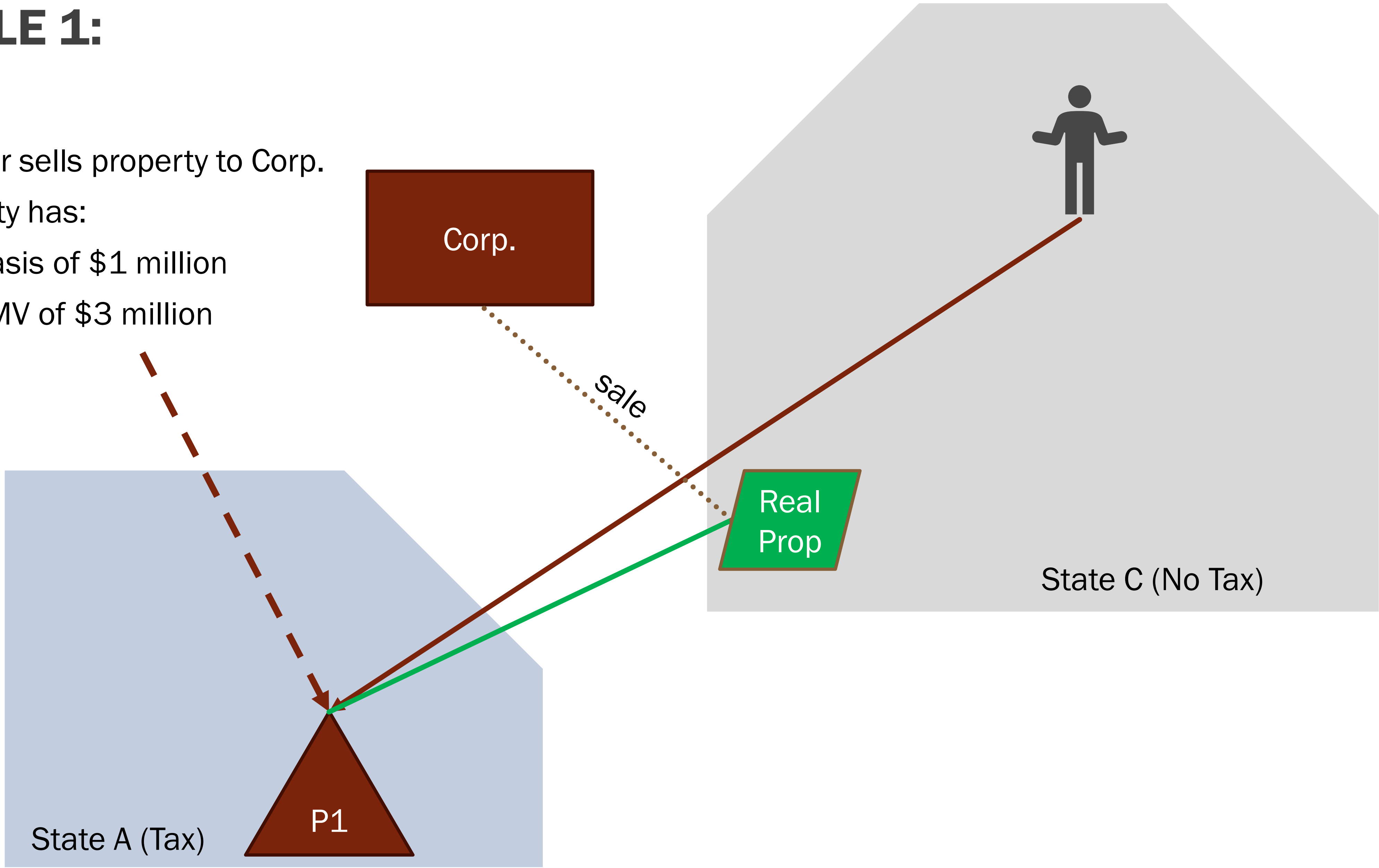
EXAMPLE 1:

- Smith contributes property in State C to P1.
- Property has:
  - Basis of $1 million
  - FMV of $2 million



EXAMPLE 1:

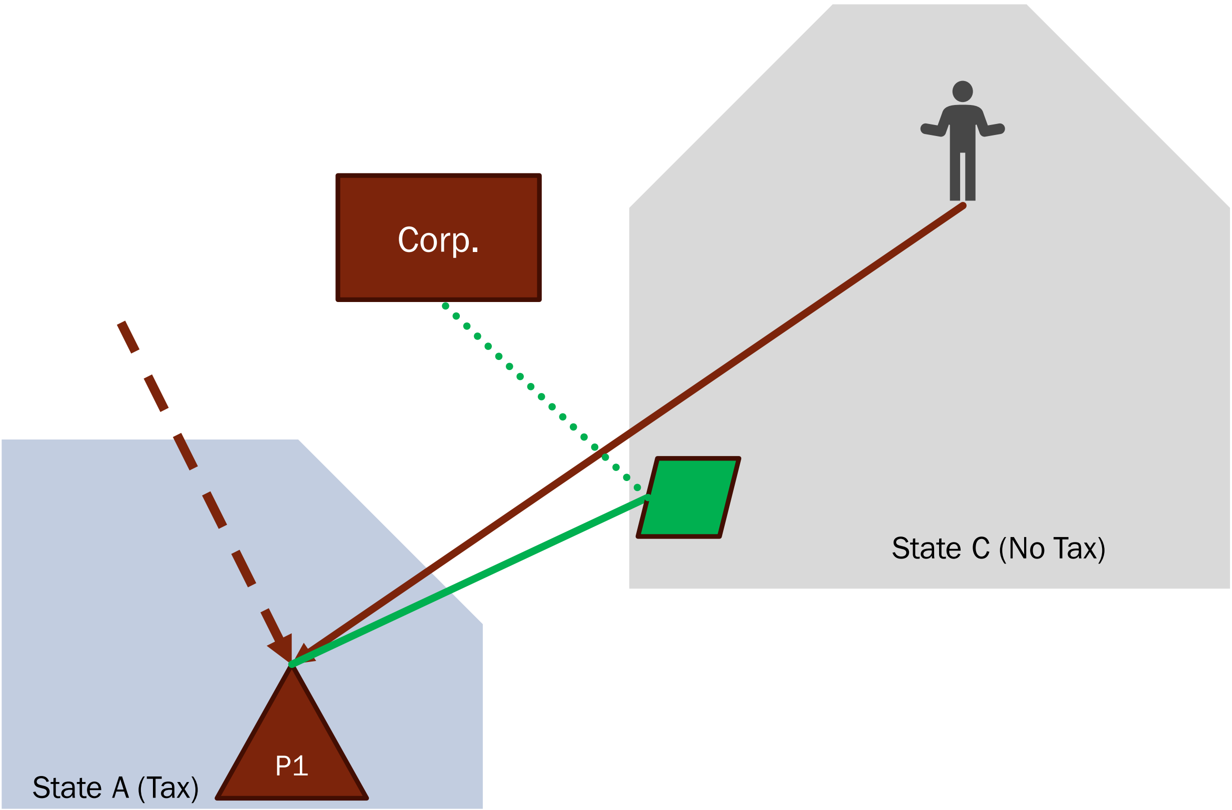
- P1 later sells property to Corp.
- Property has:
  - Basis of $1 million
  - FMV of $3 million



EXAMPLE 1:

Assume that under Subchapter K Smith is allocated:

- 100% of built-in gain = $1 million
- 20% of the later gain of $1 million = $200,000.



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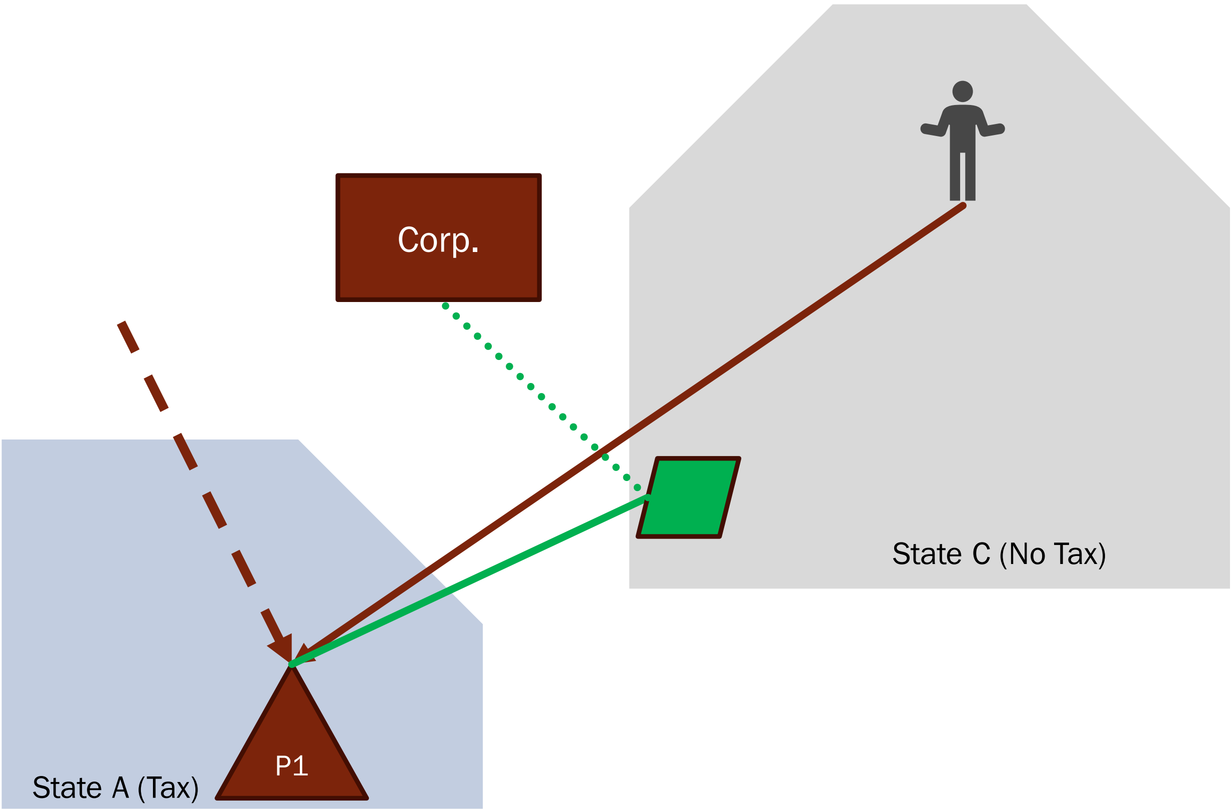

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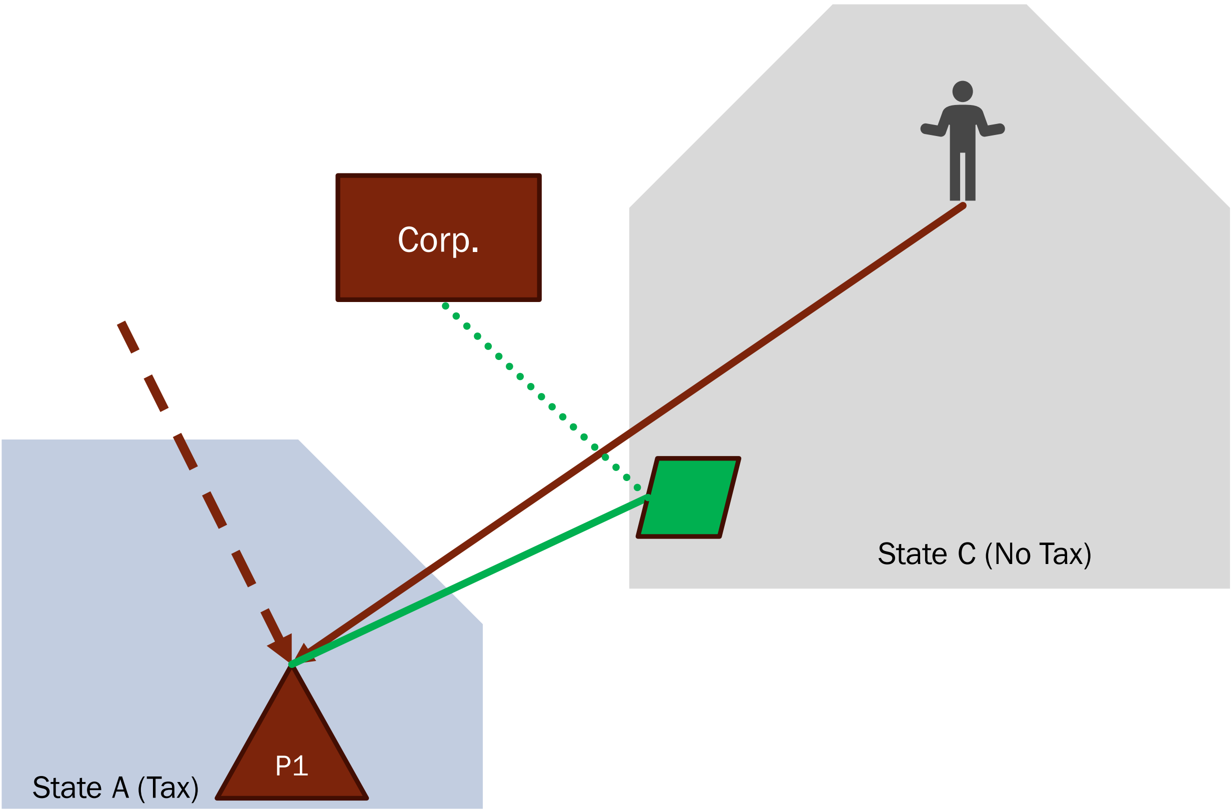

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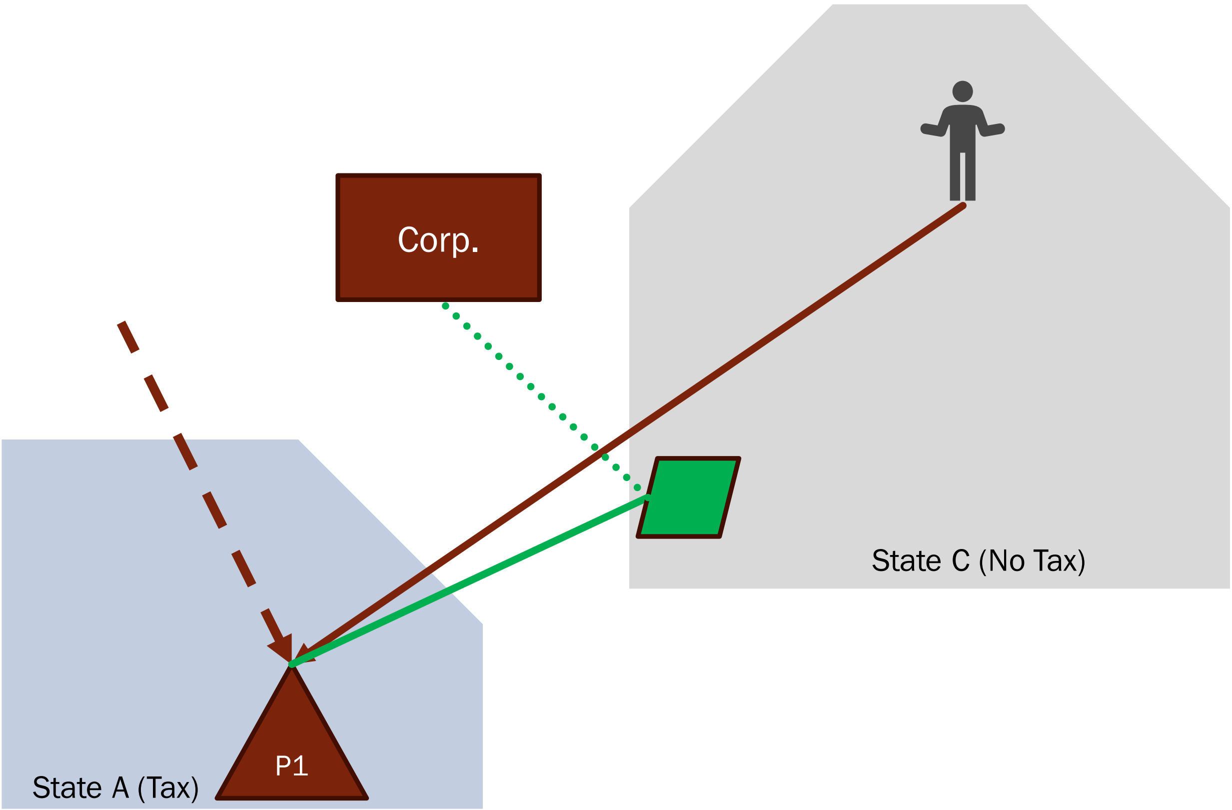

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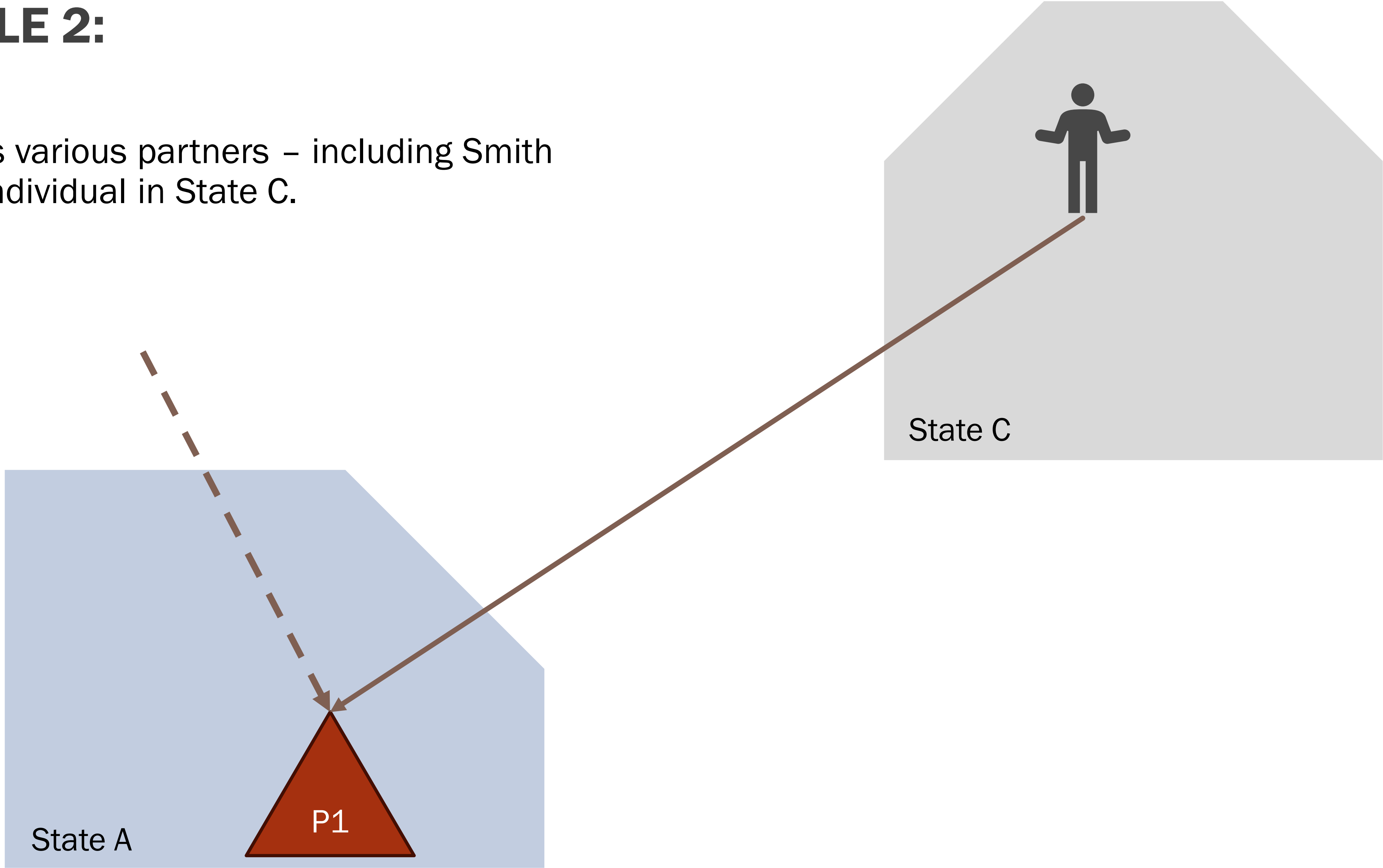
- As non-apportionable income of P1 –
  $1.2 M to State C.
- As apportionable income of P1 –
  $1.2 M divided between States A & C.
- Built-in gain to State C - $1 M
  and later gain as either apportionable or non-apportionable income of P1.

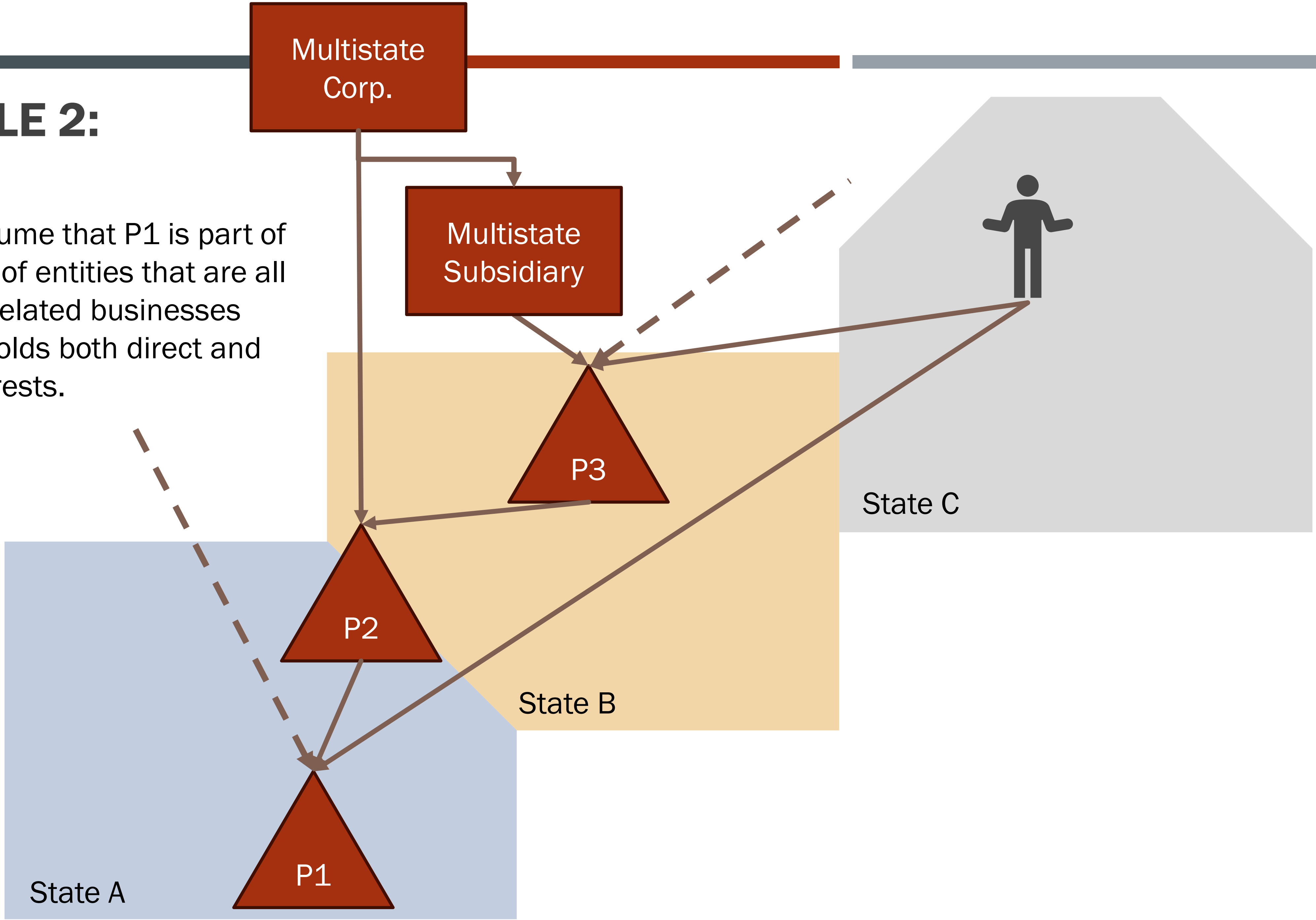
EXAMPLE 2:

P1 has various partners – including Smith – an individual in State C.



EXAMPLE 2:

But now assume that P1 is part of larger group of entities that are all engaged in related businesses and Smith holds both direct and indirect interests.



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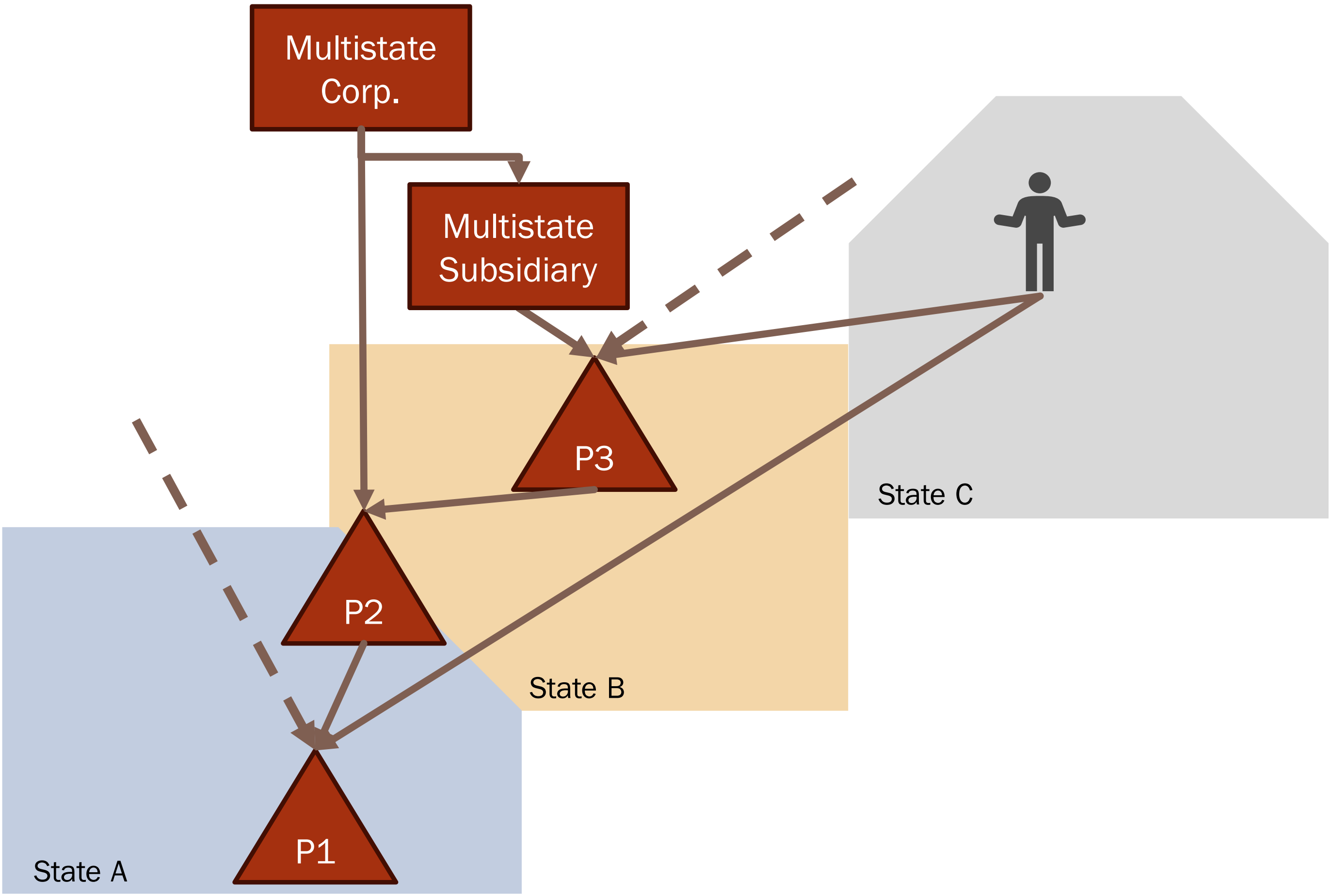

Questions:

- Should Smith source direct and indirect distributive share from P1 differently – using blended apportionment for the indirect share and using only P1's factors for the direct share?

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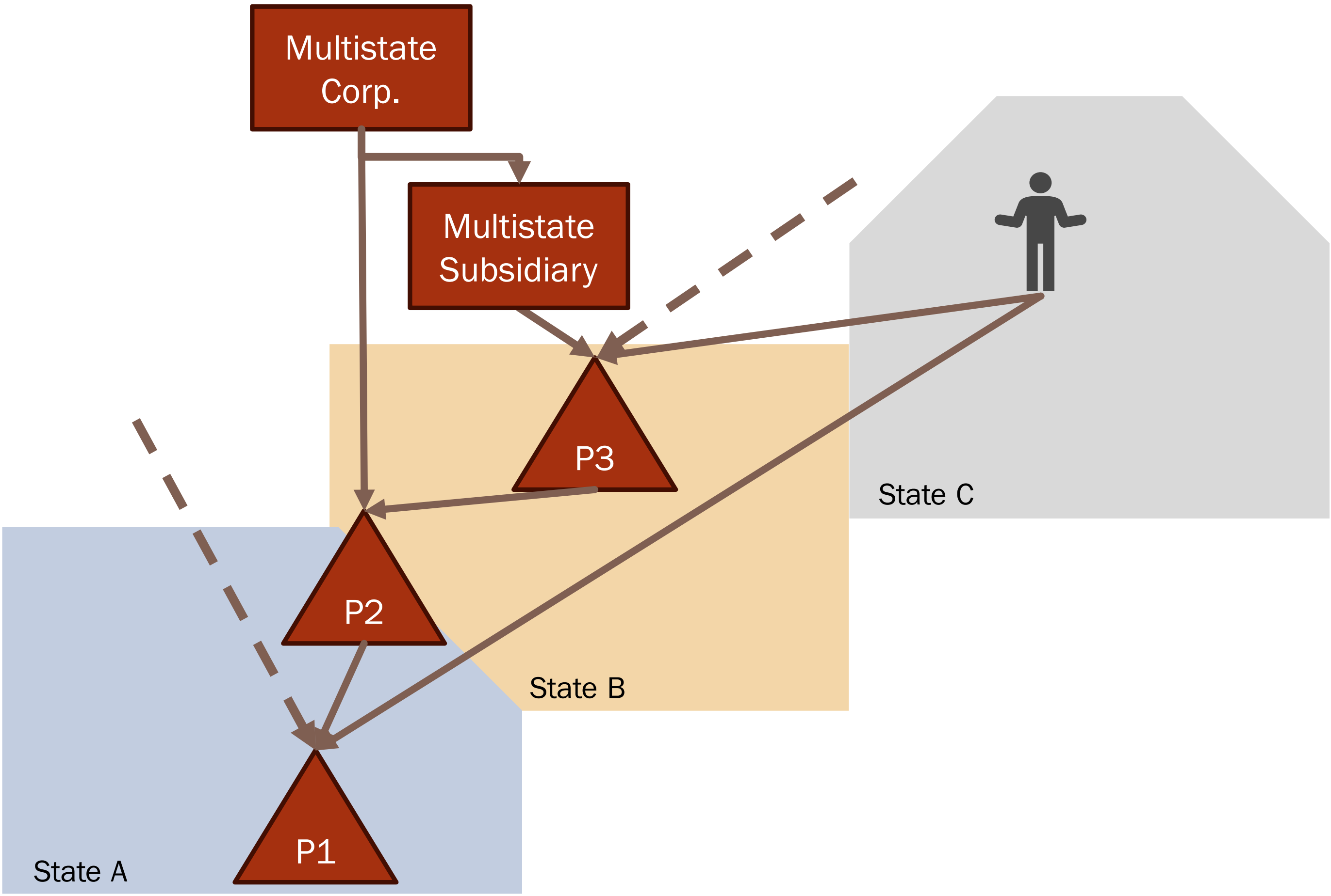


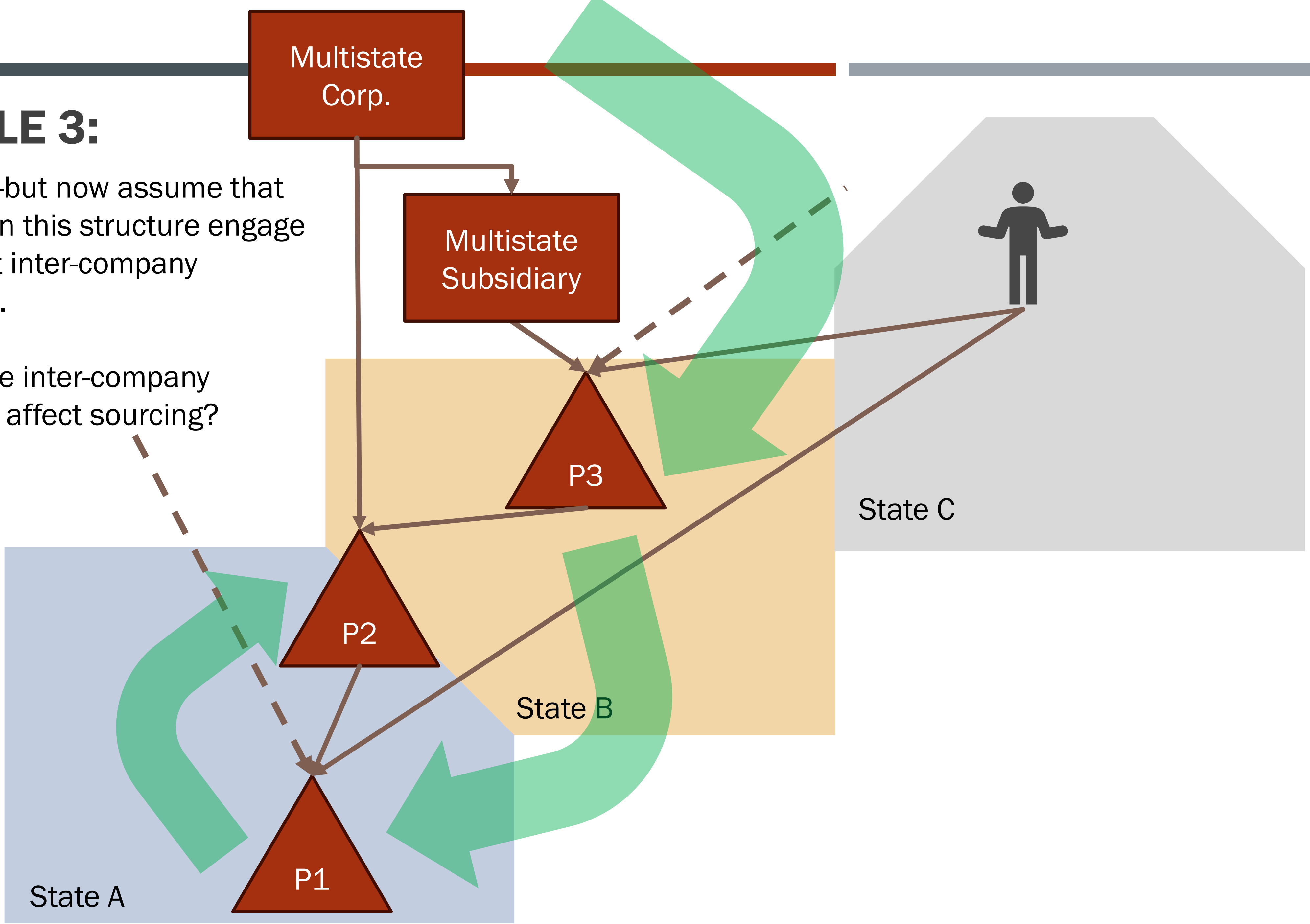
Questions:

- If blended apportionment is to be used—how should Multistate Corp. blend the factors of P2 and P3 in apportioning the income from P1.
    - Does it matter if Multistate Corp. and Multistate Subsidiary file separate or combined returns?
    - Does it matter whether any of the entities are "unitary"?

EXAMPLE 3:

Same facts—but now assume that the entities in this structure engage in significant inter-company transactions.

How do these inter-company transactions affect sourcing?



INEVITABLE QUESTIONS:

- To what degree should administrative simplicity effect the sourcing approach used?
- Are there jurisdictional or nexus issues that may affect the extent to which states can use particular sourcing approaches?
- Do states need anti-abuse provisions to address income-shifting in the partnership system?