State Taxation of Partnerships – Status Report and Request for Guidance

MULTISTATE TAX COMMISSION

APRIL 17, 2024

RECAP OF RECENT WORK

- We have been discussing the sourcing of partnership income—and especially how state sourcing rules may apply in tiered partnership structures.
- States generally use formulary apportionment to source the business income of partnerships.
- A number of states have explicit rules for "blended" apportionment of the income and factors of the partnership and certain types of partners.
- The research on state rules for sourcing income in tiered partnership structures is on our website – here: Research Summary – State Sourcing in Tiered Structures

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
What are special allocations?	Well, first – they're not that special.
Why do you say that??	IRC – Sec. 704(a) provides that: "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the *partnership agreement*."
So, why are they called "special."	They're "special" to the extent we look at allocations as primarily determined by a partner's share of partnership capital.

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
What are “items”?	Items are amounts of specific transactions or categories of transactions that go into the determination of net income (including, BTW, exempt income and non-deductible expenses).
So, not just income.	Right - See IRC Sec. 702 (a) General rule In determining his income tax, each partner shall take into account separately his distributive share of the partnership’s— . . . (7) . . . items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, . . .

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
So, partners can simply agree to share any items in any way they want and this will be allowed for tax purposes?	Well, there are limits. The first is “substantial economic effect.” See IRC Sec. 704(b)(2), which provides that the agreement will not determine the amounts of items allocated to the partners if: “the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.”
Is this just economic substance?	Sort of, but it’s a bit more complicated than that.

SPECIAL ALLOCATIONS – A DIALOGUE

Question	Answer:
Go on . . . ???	Suffice it to say – see IRS Reg. Sec. 1.704-1(b)(2). Economic effect is met if the partners also agree that: (1) the partnership will maintain capital accounts in accordance with Subchapter K and applicable regulations; (2) liquidating distributions will be based on these capital accounts; and (3) if any partner's capital account is negative, that deficit will be made up either by a contribution by or an offsetting allocation to that partner.

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
So that's "economic effect"? What about "substantial?"	Ah yes – good question. Regs say that to be "substantial" there must be: "a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, *independent of tax consequences*." This prevents two things: • Using allocations of items with different tax character to alter the partner's tax results. • Altering allocations over time (while maintaining the overall economic effect) in response to partners' individual tax attributes, such as offsetting losses from other sources or changes in effective tax rates.

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
So – what if the allocations don't have substantial economic effect?	Then, pursuant to IRC Sec. 704(b) – "A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) . . . "
And THAT'S where allocating based on a partner's share of capital comes in, right?	NO. Not exactly. The "partner's interest in the partnership" is more complicated than that.
Of course it is.	Right.

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
SIGH Go on . . .	Under IRS Regulation § 1.704-1(b)(3)(ii) the factors that are considered include: • The partners' relative contributions to the partnership, • The interests of the partners in economic profits and losses (if different than that in taxable income or loss), • The interests of the partners in cash flow and other non-liquidating distributions, and • The rights of the partners to distributions of capital upon liquidation.
And does this really work.	Impossible to know since the IRS partnership audit rate is around .03%.

SPECIAL ALLOCATIONS – A DIALOGUE

Question:	Answer:
OK – so – anything else I should know?	Yes. (Many things.) There are certain mandatory allocations required under Subchapter K. For example, IRC Sec. 704(c) addresses situations in which a partner contributes an asset to a partnership that has a built-in gain or loss and provides how any eventual gain or loss recognized by the partnership—as well as related deductions like depreciation—will be allocated. This is to keep people from using partnerships to shift gain or loss that has already accrued, but hasn't been recognized, to someone else.
Anything else.	Yes – there are special rules for allocating so-called non-recourse deductions. But that's probably enough for now.

DO SPECIAL ALLOCATIONS AFFECT STATE SOURCING?

Short answer:

It’s unclear.

Assuming states generally source business income of partnerships by apportioning it at the entity level (or by using blended apportionment)—it’s not clear if or when special allocations should affect this.

SIMPLE EXAMPLE 1

- X and Y form Partnership XY which operates in two states – State A and State B.
- X is a resident of State A and Y is a resident of State B.
- X oversees operations of the business in State A and Y oversees operations of the business in State B.
- X and Y agree to allocate the income of Partnership XY so that the income from the operations in State A is allocated to X and the income of the operations from State B is allocated to Y, (Assume this has substantial economic effect.)

SIMPLE EXAMPLE 1 (CONT'D)

- If the income (and all items) of Partnership XY were apportioned using the rules of States A and B applied at the entity level, that income (and items) would be sourced 30% to State A and 70% to State B.
- How should X and Y source their income?
  - Each 30% to State A and 70% to State B? OR
  - Each to the State from which they say the income is derived from XY's operations?

SIMPLE EXAMPLE 2

- X and Y form Partnership XY which operates in two states – State A and State B.
- X is a resident of State A and Y is a resident of State B.
- X has real property that has a built-in gain of $1 million which X contributes to XY.
- Also assume that the property was used as a business asset by Partnership XY in its unitary business.

SIMPLE EXAMPLE 2 (CONT'D)

- Later, X sells the property and recognizes a gain of $1 million.
- Assume Subchapter K requires the $1 million gain to be allocated entirely to X (see IRC Sec. 704(c)).
- If the built-in gain is apportioned using XY's factors, it will be sourced 50/50 to States A and B.
- So, only $500,000 of that gain will be sourced to State B—whereas if the gain had been recognized at the time of contribution--$1 million would be source to State B.

SIMPLE EXAMPLE 3

- X and Y form Partnership XY which operates in two states – State A and State B.
- X is a resident of State A and Y is a resident of State B.
- In Year 1, XY has income, expense, gain, and loss adding up to $1 million in net income.
- But because of how X and Y agree to share items, – X is allocated items that amount to a net loss of $2 million and Y is allocated items that amount to a net gain of $3 million.

SHOULD WE BE WORRIED THAT SPECIAL ALLOCATIONS CAN BE USED TO SHIFT OR AVOID STATE TAX?

Short Answer:

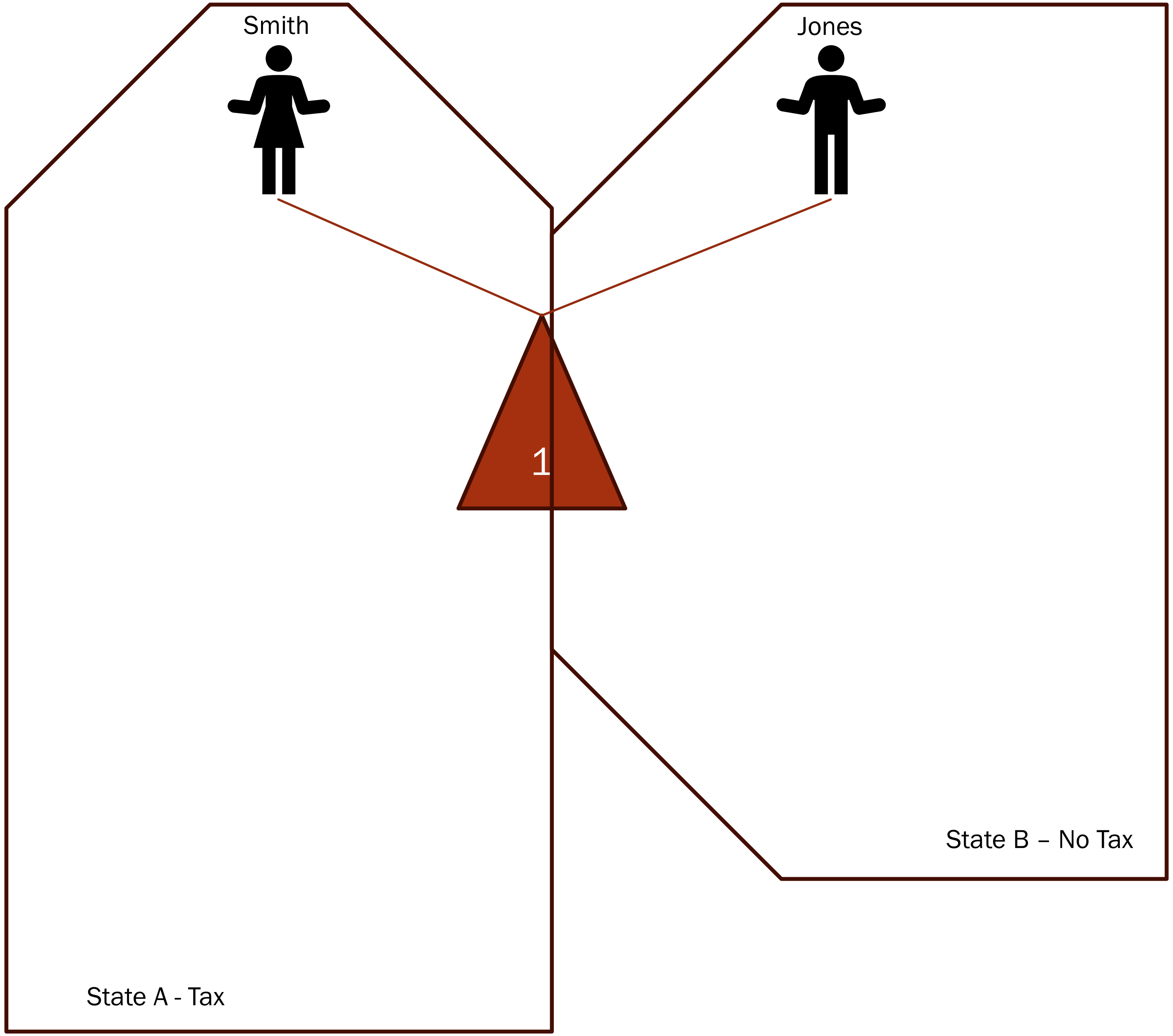
Yes

Longer Answer:

The extent to which this can happen may depend on the particular sourcing rules that states use in tiered structures, and whether they have any state-specific anti-abuse rules.

SIMPLE EXAMPLE

- Partner Smith is a resident of State A which has an income tax.
- Partner Jones is a resident of State B which does not have an income tax.
- Partnership 1 has business operations in States A and B that are equally profitable.
- Partnership 1 forms two lower-tier partnerships (in which Davis also invests a small amount as a passive minority partner).
- Lower-tier Partnership 2 takes over operations in State A and Lower-tier Partnership 3 takes over operations in State B.

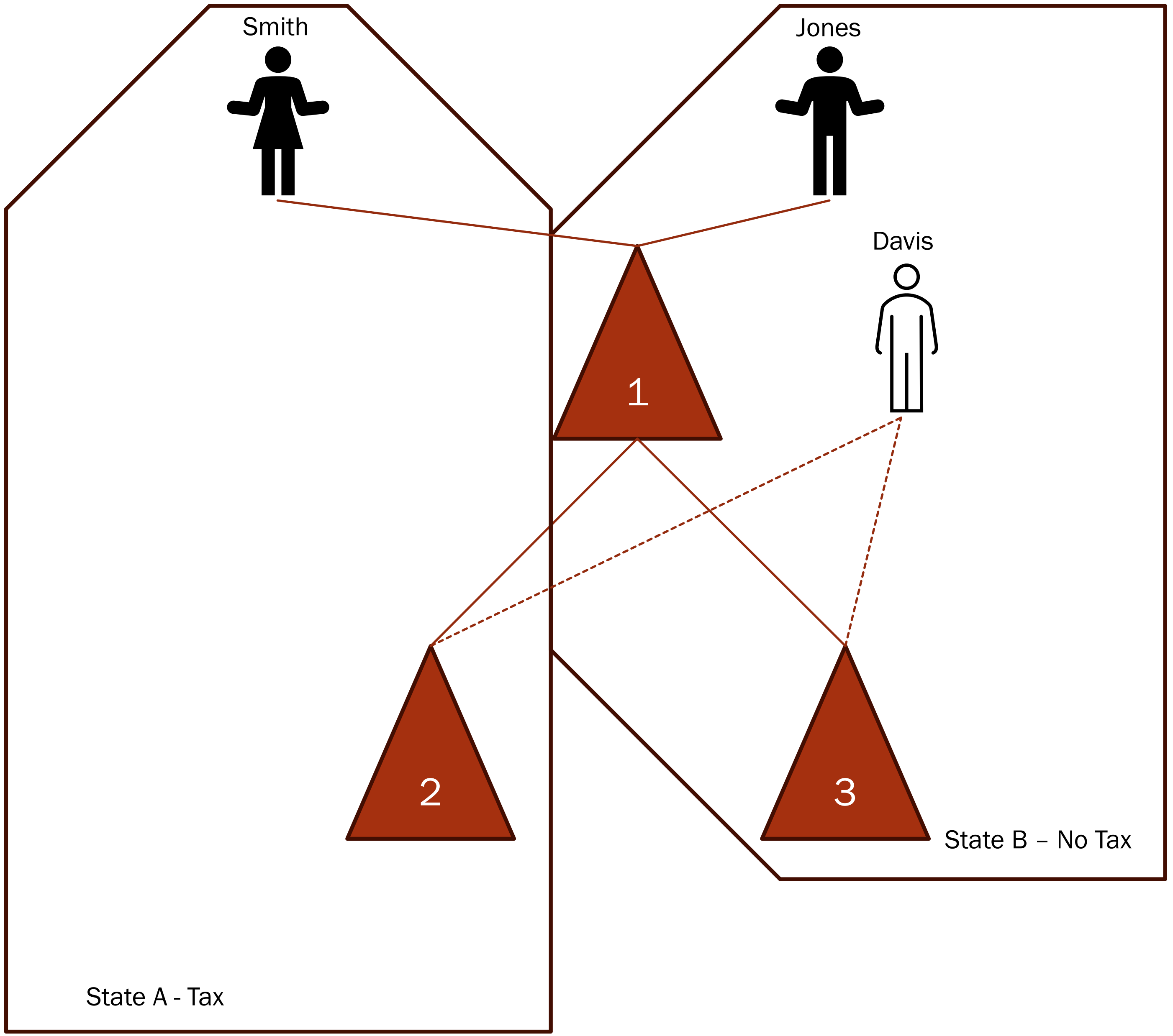


Assume that before the restructuring:

- P1 has $1 million in income .
- The income is apportionable 50% to State A and 50% to State B.
- Smith and Jones share the income 50/50.

Tax result:

- State A will tax Smith on 100% of Smith's $500,000 (because she is a resident and receives no credit – since State B has no tax).
- State A will tax Jones on a total of $250,000 – because only $250,000 of his share is sourced to State A.
- Total amount taxed in State A = $750,000.



Assume that after the restructuring:

- P2 has $500,000 which State A would say is sourced entirely to State A.
- P3 has $500,000 in income which State A would say $0 is sourced to State A.
- Now Smith and Jones agree that Smith will be allocated all the income of P2 and Jones will be allocated all the income of P3. (Davis is allocated a di minimis portion of both.)
- P1 is a holding company with no other income.

Tax result:

- State A will tax Smith on $500,000. (Same as before.)
- State A will tax Jones on $0.
- Total amount taxed in State A = $500,000.

WHAT HAVE STATES DONE?

New York:

(c) Whether the principal purpose of a special allocation of an item is the avoidance or evasion of New York State personal income tax depends on all the surrounding facts and circumstances. Among the relevant circumstances to be considered are the following: whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has “substantial economic effect,” that is, whether the allocation may actually effect the dollar amount of the partners’ shares of the total partnership income or loss independently of New York State personal income tax consequences; whether related items of income, gain, loss or deduction from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall New York State personal income tax consequences of the allocation.

NY State Tax Regulations, PART 117. RESIDENT PARTNERS

WHAT HAVE STATES DONE?

West Virginia:

17.4. West Virginia Tax Avoidance Or Evasion Through Partnership Form Of Business.

17.4.2. . . . a provision for special allocation does not have as its principal purpose the avoidance or evasion of federal income tax, but has as its principal purpose the avoidance or evasion of West Virginia income tax. In such an instance, any such provision shall be disregarded and each partner's share of the pertinent item of partnership-income, gain, loss or deduction shall be determined in accordance with his share of the partnership's ordinary income or loss.

17.4.3. Whether the principal purpose of a special allocation of an item is the avoidance or evasion of West Virginia income tax depends upon all surrounding facts and circumstances . . . and any other factors from Treasury Regulation 1.704-1.

West Virginia Code of State Rules 2019, W. Va. C.S.R. § 110-21-17[2019], Resident Partners

SPECIAL ALLOCATIONS: WHAT DO THE EXPERTS SAY?

- “The allocation rules are complex, burdensome, and prone to abuse.”
- “This article joins the chorus of those who have argued that special allocations generally should be disallowed.”

Hasen, David (2023) "Partnership Special Allocations Revisited," Florida Tax Review: Vol. 13, Article 8. Available at: https://scholarship.law.ufl.edu/ftr/vol13/iss1/8

SPECIAL ALLOCATIONS: WHAT DO THE EXPERTS SAY?

- The immensely complicated tax rules governing partnership allocations—the notorious section 704(b) regulations—have been the subject of criticism ever since their promulgation nearly 30 years ago. Yet, one particular problem with those rules has thus far escaped significant scrutiny. The problem involves partnership allocations that are shared by partners who are related to one another. Because the section 704(b) regulations are premised on the assumption that partners deal with each other at arm's length, they are ill-suited to deal with related-partner allocations. As a result, these regulations can easily be abused by related partners.

Cauble, Emily and Polsky, Gregg D. (2023) "The Problem of Abusive Related-Partner Allocations," Florida Tax Review: Vol. 16, Article 9. Available at: https://scholarship.law.ufl.edu/ftr/vol16/iss1/9

SPECIAL ALLOCATIONS: WHAT DO THE EXPERTS SAY?

- Special allocations shouldn't be permitted, and section 704(b) should be amended to say so. All allocations should be made based on the proportionate capital interests of the partners in the partnership. An exception to this proportionate capital treatment could be allocations related to preferred interests in the partnership. This is because the preferred interest would be given priority regarding distributions under the partnership agreement and local nontax law. As a corollary rule, all partnership allocations in form to service partners should be treated as the payment of compensation by the partnership to the partners for all federal income tax purposes,[23] including for employment tax purposes. Appropriate transition rules should be provided.

Monte A. Jackel, "Special Report: Is It (Finally) Time? Reforming Subchapter K," Tax Notes, Mar. 29, 2021, https://www.taxnotes.com/special-reports/partnerships-and-other-passthrough-entities/it-finally-time-reforming-subchapter-k/2021/03/26/3k6c2

QUESTION -

- Do we need to do more work on special allocations and their possible effect on sourcing –
- OR – given that the two things are somewhat connected – shall we tackle both. (Should be easy . . .)