



MULTISTATE TAX COMMISSION

Sourcing of Partnership Income

Combined Draft Model Provisions & Recommendations

Discussion Draft – April 15, 2025

This document is a revised version of the discussion draft circulated on March 15, 2025. It contains additional drafter's notes and certain clarifying changes. The general substance of the approach set out in these provisions has not been altered.

Important Background & Scope

This MTC project on taxing partnership income began with a detailed outline of issues. See the latest version, here: [Issue Outline](#). Those issues fall into several categories including jurisdictional issues, determining the state tax base, sourcing of partnership income, etc.

When it comes to sourcing, the project aims to clarify how the general state sourcing approaches should apply to income taxed under the pass-through system. The MTC has also worked to bring more uniformity to these general state sourcing approaches. (See our models here: [MTC Models](#).)

So far, the work group has focused on sourcing:

- Distributive share income of tiered and corporate partners.
- Guaranteed payments to individuals for services.
- Income of investment partnerships.

For each of these types of income, the work group has produced separate detailed white papers. These white papers demonstrate that sourcing of partnership income under the pass-through system needs to be generally consistent with:

- Subchapter K of the Internal Revenue Code (IRC), to which states conform.
- Common sourcing approaches states have long applied to corporations and nonresidents.
- Sourcing approaches used for partnership withholding, composite, and PTE taxes.

Purpose of Combining the Provisions

Using recommendations from the white papers, the work group drafted model provisions. The work group also decided these provisions should be reviewed together before finalizing them. To facilitate that review, this document combines the provisions and adds some information from the white papers. Changes to the latest versions of draft models include additional drafter's notes as well as some substantive changes to the provisions highlighted in yellow. Prior versions and other materials are on the MTC the project page, here: [Partnership Project Page](#).

Challenges in Drafting Model Provisions

Model state tax provisions are almost never “plug-and-play.” States adopting these models must often modify them to fit within their existing statutes and regulations. But models to apply state sourcing rules to partnership income raises additional challenges.

- The pass-through system is more complex than entity-level taxation.
- While states generally use similar sourcing approaches, the details vary.
- States may use different terminology for similar partnership or sourcing concepts.
- Existing partnership-specific sourcing rules may be worded generally or lack a clear basis.
- Partnership rules are typically embedded in individual and corporate tax sections.
- The rules may have developed over time and may not reflect changing precedents.

Despite the challenges, model provisions can still serve as a useful “proof of concept,” demonstrating that the general recommendations made in the white papers are workable and highlighting important elements that states should consider. They can also incorporate approaches that states are currently using effectively and can promote uniformity for specific issues.

Before Reviewing the Draft Provisions

These points (some of which are discussed in more detail in the white papers) are important to understand before reviewing the combined draft provisions in the following section:

The provisions address how state sourcing rules apply to partnership income.

As noted above, the project's focus is on applying the states' general income sourcing approaches to income taxed under the pass-through system.

Some unique partnership issues may call for uniform sourcing rules.

One example is the sourcing of guaranteed payments for services—where states take two different approaches, and which is addressed by draft provisions set out below.

Consistency in sourcing with entity level taxes is also key.

Whether taxing partnership income on a pass-through or entity-level basis (withholding, composite, or PTE taxes) the application of sourcing rules should achieve consistent results.

Tax treatment—including sourcing—depends on the tax character of items.

The tax treatment of items of income depends on the item's tax character. This is also true for sourcing treatment, whether done under federal or state rules. For example, state rules source non-apportionable income differently depending on whether it is from sales of tangible property, intangible property, interest, royalties, etc.

Partnerships determine the tax character of partnership items.

The tax character of a partnership's items of income that affect their substantive tax treatment is determined at the partnership level. (See IRS Form 1065.) This includes any tax character that depends on the activity from which the items are generated (e.g., business activity, investment, etc.).

The tax character of partnership items is attributed to the partners' shares.

Attribution is essential to the federal pass-through system. (See IRC § 702.) Attribution requires a partner—whether active or passive, general or limited, direct or indirect—to treat their share of the items recognized by a partnership as if the partner had realized or incurred them directly in the same manner from the same source as the partnership.

Attribution applies for state tax purposes, including when sourcing items.

States that conform to the federal pass-through system, conform to the attribution principle. So where state sourcing rules depend on the tax character of items—as determined by the activity generating those items—it is the partnership's own activities that matter.

Tax attributes of the partner have a limited effect on sourcing.

A partner's own tax attributes do not change the tax character of the partnership items. But they may have a limited effect on application of state sourcing rules. Two primary examples are:

- Where the partnership and the partner are both engaged in activities that are part of the same unitary business. In that case, states sometimes use “blended” apportionment.

- In rare cases where a partner's share of an item determined to be non-apportionable by the partnership is determined by the partner to be part of that partner's separate activities generating apportionable income.

Application of the unitary business principle to partnerships is unclear.

Because the U.S. Supreme Court has never applied the general criteria of the unitary business principle to a case involving the sourcing of partnership distributive share, it is not clear how those criteria would apply to partners and partnerships (which have different legal relationships than corporations and subsidiaries) is unclear. For example, some states have recognized that ownership, often used to determine control for corporate entities, does not determine control of partnerships—where minority partners often exercise control.

Anti-abuse rules and limits are essential.

The federal pass-through system relies heavily on rules and limitations designed to prevent abuse. States will need similar rules. But simply conforming to Subchapter K will not be enough. The federal rules often look to the effect on federal taxes, but partnerships can be used to alter general state tax treatment or shift income without otherwise affecting federal taxes. States should therefore specify that certain rules apply for state tax purposes and provide guidance for their application.

Additional regulations will be needed to implement the provisions here.

States may need to adopt more detailed regulations for the application of their sourcing rules to partnership income taxed on a pass-through basis. The provisions set out here are not intended to be a comprehensive package of regulations, but to provide a foundation for those regulations.

As with partnership taxation generally, information reporting is essential.

While the draft provisions do not address specifically how partnerships will report information, they provide tax agencies with the authority to require necessary information reporting.

Combined Draft Model Provisions & Recommendations

Prior versions of the draft model provisions for applying state sourcing rules to the income of tiered and corporate partners, guaranteed payments for services, and for income of investment partnerships are on the project page on the MTC website, here: [Partnership Project Page](#). Any substantive changes to the most recent drafts are highlighted. In addition, certain drafter's notes have been added or clarified.

Formatting Notes:

Drafter's notes or other comments or information not part of the draft model provisions themselves are set out in [blue](#). References within the draft provisions that depend on that state's own information are shown in brackets and capitalized—[CAPS].

SOURCING OF PARTNERSHIP INCOME BY TIERED & CORPORATE PARTNERS

Drafted in the Form of a Statute

General Drafter's Note:

[Provisions Drafted as Statutes](#)

The provisions in this Section are drafted in the form of statutes designed to provide a sufficient framework so that consistent regulations could be adopted for specific facts and circumstances. Some states may have existing statutory provisions that they view as sufficient—but may consider the provisions here for adoption in the form of general regulations.

[Making the Implicit Explicit](#)

States that conform to the federal pass-through system under IRC Subchapter K may believe that certain draft provisions below would be true for their state even if not explicitly stated. Where those concepts are essential, the draft includes them explicitly in order to avoid confusion or uncertainty.

[Inclusion of General Provisions](#)

While this Section is intended to address sourcing of partnership income for tiered and corporate partners, substantial parts of it might also be applied generally, including for distributive share income of individual partners and those taxed as nonresidents.

[References to State Sourcing Statutes](#)

Based on the research done as part of the related white paper, the states generally use the same sourcing methods for sourcing income of businesses whether those businesses are taxed directly (corporations and proprietorships) or on a pass-through basis. For nonbusiness income—as distinguished from general business income—states may have separate sets of rules for corporate and nonresident taxpayers—although the rules often lead to the same sourcing result. So, as part of the draft provisions below, the references may include references, as necessary, to both rules for corporations and nonresidents.

STATUTORY SECTION

Part I. Definitions of Terms:

Drafter's Note: The terms that are used to refer to partnership tax concepts can vary depending on the source. First, there are three general bodies of law that may use the same or similar terms—general state law governing partnerships, federal tax provisions, and general state tax provisions. This can create confusion and uncertainty. These draft provisions set out a number of definitions which states may need to use in their sourcing rules for partnership income. The definitions look to general state law and federal tax law, in order to achieve greater consistency. They may include terms that are not used in the other draft provisions below but could be used to the extent those provisions are expanded or for the purpose of drafting related regulations.

A. Certain terms used in this Section are defined as follows:

1. Allocate or allocation of distributive share income or items of income – A partnership's determination of a partner's share of partnership income or items of income under the partnership agreement as well as under any applicable state or federal tax law. See IRC § 704.
2. Apportionable income or items – Income or items that are included in net taxable income sourced using a particular apportionment formula related to that net income. See [REFERENCE(S) TO THE STATE'S STATUTORY PROVISIONS GOVERNING APPORTIONABLE OR "BUSINESS" INCOME].

Drafter's Note: The following provision 3 is important because it makes explicit that the tax character of items for state sourcing purposes is determined at the partnership level and attributed to the partners. See further rules under Part IV below.

3. Attribute (verb) or attribution of income or items – The way in which IRC Subchapter K and the pass-through system for partnerships which it creates assigns the tax character of partnership items, as determined by the partnership recognizing those items, to any direct or indirect partners who are allocated a share of those items. This includes the tax character of these items that may affect the sourcing of the items under [REFERENCE(S) TO THE STATE'S STATUTORY PROVISIONS FOR SOURCING INCOME OTHER THAN APPORTIONABLE INCOME]. See IRC §§ 702(b), 875, 897(c)(4)(B), and 958(a)(2).
4. Built-in gain (loss) – The amount of an asset's fair market value as compared to its tax basis at a particular point in time—including the point at which the item is contributed to or distributed from a partnership. See IRC § 704(c).
5. Tax character of an item – The nature and classification of items for tax purposes which may affect their tax treatment as determined by a partnership applying general substantive federal or state tax law based on the activity giving rise to the item. See IRC §§ 702(b) and 703(a) as well as [REFERENCE(S) TO STATE RULES CONFORMING OR DECOUPLING FROM FEDERAL TREATMENT AND STATE SOURCING RULES]. The tax character of an item may include:

- a. Type of receipts or expense – such as interest, royalties, dividends, gains (losses), etc.;
 - b. The type of transaction or activity giving rise to the income or expense – such as sales or purchases of property, leases of property, sales or purchases of services, depreciation of assets, borrowing of funds, etc.; and
 - c. The assets affected by the transaction or activity – such as real property, tangible or intangible property, inventory, etc.
6. Contribution – Cash or property transferred by a partner to a partnership in exchange for a partnership interest. See IRC § 721.
 7. Direct partner – A partner that owns an interest in a partnership directly and not through the partner’s ownership in an upper-tier partnership.
 8. Distribution – Cash or property transferred by a partnership to a partner that represent a return of the partner’s capital. See IRC § 731.
 9. Distributive share or distributive share of items or income – The percentage or amount of a partnership’s income (loss) or the percentage or amount of particular partnership items allocated to a partner in a given tax period. See IRC § 704.
 10. Indirect partner – With respect to a particular partnership, a partner owns an interest in an upper-tier partnership.
 11. Lower-tier partnership – A partnership in which another partnership holds an interest. See IRC § 706(d)(3).
 12. Non-apportionable partnership income or partnership items – Partnership income or partnership items that are assigned (or allocated) to particular states. See [REFERENCE(S) TO STATE STATUTORY PROVISIONS FOR DEFINING NON-APPORTIONABLE OR “NONBUSINESS” ITEMS OF INCOME.]
 13. Partner – A person [INCLUDE REFERENCE TO APPLICABLE STATE DEFINITION OF PERSON IF NECESSAR] treated as a partner under IRC Subchapter K, including direct and indirect partners. See IRC §§ 761(b) and 7701 and related regulations.
 14. Partnership – An entity treated as a partnership under federal tax law [WITH ANY EXCEPTIONS FOR STATE TAX PURPOSES] including general partnerships, limited partnerships, limited liability companies, etc. See IRC §§ 761(a) and 7701 and related regulations.
 15. Partnership agreement – The agreement between the partners generally or on particular partnership matters, regardless of form, as the term is used for federal tax purposes and consistent with general state partnership law. See IRC §761(c).
 16. Partnership income (loss) – A general reference to income (loss) determined and reported by the partnership under IRC Subchapter K. See IRC §703.

17. Partnership item – Any tax-significant result generated from a transaction, activity, or event including any item of income, expense, deduction, gain, loss, etc. that is recognized and given particular treatment under the general state or federal substantive tax law. See IRC §§ 702 & 704 (and IRS Form 1065, Schedule K-1).
 18. Partnership interest or partner’s ownership interest – Unless the context otherwise indicates, a partner’s ownership in a partnership or value of the partner’s partnership capital. See IRC §§ 704(e) and 864(c)(8).
 19. Specifically assign and rules of assignment – The method used to source or allocate corporate income to under [REFERENCE(S) TO STATE STATUTORY PROVISIONS FOR SOURCING NON-APPORTIONABLE OR “NONBUSINESS” ITEMS OF INCOME.]
 20. Sufficient unitary relationship – See Part VI.
 21. Taxpayer or partner attribute (noun) – An aspect of, or circumstance relating to a particular taxpayer that may affect the ultimate tax result for items recognized by or attributed to that taxpayer, which may include:
 - a. Whether the taxpayer or partner is a resident or nonresident individual or a corporation or other type of entity;
 - b. Whether the taxpayer or partner files a separate, joint, or combined/consolidated return;
 - c. The taxpayer’s marginal effective tax rate; and
 - d. The taxpayer’s participation or role in certain activities.
 22. Upper-tier partnership or tiered partner – A partnership that holds an interest in another partnership. See IRC § 706(d)(3).
- B. Other terms not defined above are interpreted consistently with the context and with applicable state and federal tax law.

Part II. Conformity to Federal Tax Rules, Including IRC Subchapter K

Drafter’s Note: As noted above, one challenge for drafting provisions to apply state sourcing rules to partnership income is that states generally have separate sections addressing income taxes imposed on corporations and individuals and may embed any partnership-related provisions, including references to sourcing rules and their application, in both. While the provisions in this Section are designed to be applicable to tiered and corporate partners (see Part IV.C below), the conformity provision in this Part II could be used in the context of tax on individuals as well (see the highlighted addition to the reference below).

- A. [STATE] conforms to the federal tax law, including IRC Subchapter K, as provided in [REFERENCE(S) TO STATE LAW THAT AFFECTS CONFORMITY FOR CORPORATE AND INDIVIDUAL TAXPAYERS]. In conforming to Subchapter K, [STATE] is also conforming to the principle that partnerships determine certain tax character of items of income and then attribute that character of the items to partners who receive a distributive share of those items. This tax character as determined by the partnership may affect the state tax treatment of the items under the state tax rules,

including the sourcing of those items under [REFERENCE(S) TO STATE LAW FOR SOURCING INCOME—INCLUDING CORPORATE AND INDIVIDUAL SOURCING RULES].

- B. In addition, [STATE] conforms to certain anti-abuse rules under IRC Subchapter K as described further in Part V of this Section.

Part III. Obligations of Partnerships to File Information Returns and Report Information

Drafter's Note: Again, while the provisions in this Section are designed to be applicable to tiered and corporate partners, the reporting provisions below could be used for individual partners as well (so the reference in C below includes individuals).

- A. A partnership shall provide to its direct partners the information necessary for its direct and indirect partners to properly compute and report their [STATE] tax. Necessary information includes any information as described or provided for in regulations, forms, and instructions issued by the [STATE TAX AGENCY]. This requirement to provide information applies to:
1. Any partnership doing business in [STATE];
 2. Any partnership that has a direct or indirect partner doing business in or resident in [STATE].
 3. Any partnership that has a direct or indirect interest in a partnership doing business in [STATE].
- B. A partnership shall provide to the [STATE TAX AGENCY] certain information as directed by the [STATE TAX AGENCY] necessary to verify the information required to be reported to partners under Subpart A, above and as provided in regulations, forms, and instructions issued by the [STATE TAX AGENCY].
- C. The type of information that may be required to be reported to partners or to [STATE TAX AGENCY] under this Part II includes:
1. Federal tax-related information, including the tax character of partnership income and items recognized by the partnership or allocated to the partnership from lower-tier partnerships;
 2. State tax-related information, including the tax character of partnership income and items recognized by the partnership or allocated to the partnership from lower-tier partnerships, as relevant to compliance with [REFERENCE TO STATE INCOME TAX RULES FOR CORPORATIONS AND INDIVIDUALS];
 3. Information necessary for direct or indirect partners to properly determine the source of partnership income and items, as described further in this Section;
 4. Information from lower-tier partnerships or business entities in which the partnership holds an interest that is necessary for that partnership's direct or indirect partners to properly determine the source of partnership income and items as described further in this Section; and

5. Any other information the partnership may have or obtain that is necessary for direct or indirect partners to properly report their state tax on partnership income and items.

Part IV. Sourcing of Partnership Income and Items

Drafter's Note: Again, while the provisions in this Section are designed to be applicable to tiered and corporate partners, the approach described in subparts A and B below would also be consistent with that generally used for individuals.

- A. A partnership required to report information as described in Part III, must apply the applicable [STATE] and federal tax rules as required by Part II in determining that information.
- B. Items Recognized Directly by a Partnership:

Drafter's Note: Partnership structures may include multiple tiers (partnership partners) through which distributive share will pass before being allocated to taxpaying partners. This provision is intended to make explicit the requirement that the partnership first recognizing the item of income, expense, gain, or loss determines its tax character for state tax treatment including sourcing.

Application of the rules for sourcing income under [REFERENCE TO STATE'S SOURCING RULES FOR INCOME OF BUSINESS ENTITIES, CORPORATIONS, OR NONRESIDENTS] to partnership income requires that a partnership determine the following with respect to the items of income, expense, gain, loss or other tax items that it recognizes directly from its activities:

1. Information as to the general tax character of those partnership items as it may be relevant to state tax treatment of the items, including:
 - a. The tax character of the items for purposes of determining their federal tax treatment to which the state conforms;
 - b. The tax character of the items for purposes of determining their state tax treatment, including any treatment that varies from the federal tax treatment; and
 - c. The tax character of the items for purposes of applying the sourcing rules in [REFERENCE TO STATE'S SOURCING RULES FOR INCOME OF BUSINESS ENTITIES, CORPORATIONS, OR NONRESIDENTS].
2. Information as to whether any partnerships items would be non-apportionable as that term is defined by this Section and the rules provided in [REFERENCES TO STATE'S SOURCING RULES—TREATMENT OF NON-APPORTIONABLE OR NONBUSINESS ITEMS FOR CORPORATIONS OR NONRESIDENTS] if those rules were applied based on:
 - a. The item's particular tax character as determined by the partnership; and
 - b. The relationship of the item to the business activity conducted by the partnership, alone or in conjunction with the activity conducted by one

or more entities in which the partnership holds a direct or indirect interest.

In determining this information, the partnership must determine whether its items of income have a sufficient unitary relationship to any business in which the partnership participates that also generates apportionable income, with the understanding that a partnership may engage in more than one unitary business.

3. Information necessary for sourcing all non-apportionable items determined under Paragraph 2 under [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF NON-APPORTIONABLE OR NONBUSINESS ITEMS FOR CORPORATIONS OR NONRESIDENTS].
4. Information on the net apportionable income of the partnership as determined under [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF APPORTIONABLE OR BUSINESS ITEMS FOR CORPORATIONS OR NONRESIDENTS] based on the particular business activities to which the items making up that net income have a sufficient unitary relationship, including business activity conducted by one or more entities in which the partnership holds a direct or indirect interest, with the understanding that a partnership may engage in more than one unitary business.
5. Information on the partnership's apportionment factor attributes related to the items determined to be part of net apportionable income under Paragraph 4, applying [REFERENCE TO STATE'S SOURCING RULES—APPORTIONMENT FACTORS] to enable determination of those apportionment factors.

C. Upper-Tier Partnership Treatment of Items Allocated from Lower-Tier Partnerships:

[Drafter's Note: As discussed at length in the related white paper, the majority of states that use blended apportionment to source apportionable income of a partnership that is also part of the partner's own apportionable income will determine the share of partnership factors to include by using the share of total partnership distributive share income allocated to that partner.](#)

[This approach is conceptually preferable for a number of reasons, but raises an issue when the partnership makes special allocations—since partners may receive more of some items of income, expense, gain, or loss and less of others. This means that in some cases the partner's share of net distributive share income will be negative whereas the partnership's total income is positive, or vice versa. The work group has therefore discussed the use of the absolute value method and has published different examples \(in Excel workbooks\) demonstrating the application of that method.](#)

[It has been suggested that this method would distort the share of factors a partner would include for using blended apportionment. But examples of that distortion have not been put forward nor has anyone suggested a workable alternative for the issue of special allocations. Nevertheless, paragraphs C \(here\) and D \(below\) now contain a note providing that the absolute value method may be used only when there are special allocations.](#)

Items of income, expense, gain, loss or other tax items that are allocated to an upper-tier partnership by a lower-tier partnership generally retain their tax character as determined in Subpart B. But the upper-tier partnership will also determine the following with respect to these items:

1. Whether items determined by the lower-tier partnership to be non-apportionable under Subpart B.2, or apportionable under Subpart B.4, have a sufficient unitary relationship to any business activity generating apportionable income in which the upper-tier partnership is engaged directly or in conjunction with any entity in which the partnership owns a direct or indirect interest.
2. If items determined to be non-apportionable by the lower-tier partnership are properly determined by the upper-tier partnership to have a sufficient unitary relationship to that partnership's own business activity generating apportionable income, then the upper-tier partnership would include these items in the net apportionable income from that upper-tier partnership's related business activities to be apportioned using the upper-tier partnership's related factors when reporting information to that upper-tier partnership's own partners.
3. If items determined to be apportionable by the lower-tier partnership are also determined to have sufficient unitary relationship to the upper-tier partnership's business activity generating apportionable income, the upper-tier partnership would include these items in the net apportionable income from that partnership's related business activity and would also include a share of the lower-tier partnership's in the upper-tier partnership's apportionment factors to create a "blended apportionment" approach when reporting information on those items and related factors to the upper-tier partnership's own partners.
4. The share of the lower-tier partnership factors to be included under Paragraph 3 is determined using the upper-tier partnership's total distributive share income from the lower-tier partnership as a percentage of that lower-tier partnership's total income using the absolute value of the items making up that distributive share. [Drafter's Note: States may decide to apply absolute value only when the partnership makes special allocations to partners.](#)
5. In determining the blended apportionment factors, any factors included representing transactions between the partner and partnership would be eliminated to the extent of the partner's share determined in Paragraph 4.

D. Corporate Partner Treatment of Items from Partnerships:

Items of income, expense, gain, loss or other tax items that are allocated to a corporate partner generally retain their tax character as determined in Subparts B and C. But the corporate partner will also determine the following with respect to these items:

1. Whether items determined by the partnership to be non-apportionable under Subparts B.2 or C.2 or apportionable under Subparts B.4 or C.3 of this Part VI have a sufficient unitary relationship to any business activity generating apportionable income in which the corporate partner is engaged directly or through related entities.

2. If items determined to be non-apportionable by the partnership are determined to have a sufficient unitary relationship with business activity of the corporate partner generating apportionable income, the corporate partner would include these items in the net apportionable income from that corporate partner's related business activity to be apportioned using the corporate partner's related factors.
3. If items determined to be apportionable by the partnership are determined to have a sufficient unitary relationship with the business activity generating apportionable income of the corporate partner, the corporate partner would include these items in the net apportionable income from that corporate partner's related business activity and would also include a share of the partnership's factors in the corporate partner's apportionment factors to create a "blended apportionment" approach.
4. The share of the partnership factors included under Paragraph 3 is determined using the corporate partner's total distributive share income from the partnership as a percentage of that partnership's total income using the absolute value of the items making up that distributive share. [Drafter's Note: States may decide to apply absolute value only when the partnership makes special allocations to partners.](#)
5. In determining the blended apportionment factors, any factors included representing transactions between the partner and partnership would be eliminated to the extent of the partner's share determined in Paragraph 4.

Part V. Application of Federal Tax Requirements, Limitations, and Anti-Abuse Rules

[Drafter's Note: These provisions should also be considered for adoption in taxing individual partners as well as for tiered and corporate partners. Note that these types of anti-abuse rules as used in the federal tax system are often accompanied by lengthy regulations explaining their application in different circumstances. A few states have also adopted more detailed rules focusing in particular on how these anti-abuse provisions apply in the state tax context, especially where state sourcing rules are affected even if federal tax is not. \(See the related white paper and sections discussing anti-abuse rules as well as the rules that New York has adopted.\)](#)

- A. Rules Setting Specific Requirements or Limitations: Various federal tax rules apply to determine the proper tax treatment of partnership income under the Internal Revenue Code. See, generally, Subchapter K, and the related federal regulations. To the extent these rules set specific requirements for or limitations on certain treatment of partnership items for federal tax purposes, those requirements or limitations also apply to any directly related state tax effects.
- B. Rules Based on Economic Effect or Substance: Other federal tax rules provide that the results of the federal tax treatment claimed must be consistent with the economic effect or substance of the activities or transactions undertaken or purported to be undertaken. Where the tax results are not consistent with the economic effect or substance, these rules may require modification of the tax treatment. To the extent

these rules limit certain treatment of partnership items for federal tax purposes, they also limit any directly related state tax effects.

In addition, these rules may also be applied in determining the proper treatment of partnership income where the effect is solely on the state tax result, including the application of sourcing rules under [REFERENCE TO STATE SOURCING RULES]. In applying these federal requirements to the state tax treatment of partnership income, the inquiry will not be limited to the effect on federal taxes or the tax result but will also consider whether the state tax results fairly represent the economic effect or substance of the activities or transactions.

In particular, the following federal requirements will be applied when determining the proper state tax treatment, including the sourcing of partnership income:.

1. The general federal tax economic substance rule set out in IRC § 7701(o)
 2. The general partnership anti-abuse rule set out in IRS Reg. § 1.701-2.
 3. The substantial economic effect requirements under IRC § 704(b) and related regulations.
 4. The rule for determining the effects of related-party transactions under IRC § 482.
 5. The consistency requirement of IRC § 6222.
- C. In the case of mandatory allocations of built-in gains (losses) to the contributing partner as required under Subchapter K, the source of those gains (losses) will be determined under the rules of Part V of this Section unless there is evidence that the property was contributed by the partner to the partnership in order to shift the sourcing of that gain (loss).

Part VI. Sufficient Unitary Relationship

[Drafter’s Note: The so-called “unitary business” principle is a concept created by the U.S. Supreme Court to limit the means by which states may assert the power to tax a portion of multistate income—in particular where formulary apportionment is used to apportion net income. Since its creation, the Court has applied this principle in less than 30 cases, all of which involve taxable entities or businesses (generally corporations). In no case has the Supreme Court applied the principle in the context of partnership taxation under the pass-through system where the income of the partnership is attributed to the partners.

Because the unitary business principle is a judicial creation, states have limited authority to issue binding regulations—and the application may be dependent upon specific facts and circumstances. As a result, states may have less in the way of specific statutory or regulatory provisions addressing the application of the principle than they would for other tax provisions, relying instead on litigation to address uncertain cases.

Nevertheless, it appears that there may be circumstances in which the application of apportionment to partnership income will require taking into account the activities and factors of partnerships and their partners in order to achieve fair apportionment. And since partnership structures are very flexible and can change, states that look only to the activities of a particular entity may all sourcing of income to be easily shifted.

To address this, states can provide for “blended apportionment” as provided in Part IV.(C) and (D) above. In order to do this, states will have to consider the application of the unitary business principle in this context. States may also want to consider other limitations on the use of blended apportionment, such as limits related to the amount of a partner’s distributive share.]

The term “sufficient unitary relationship” as used in this section refers to the necessary relationship between items of income and the apportionment factors used to source that income, especially in the pass-through tax system used to impose tax on partners for their shares of partnership income. The term takes into account all the facts and circumstances relevant to the sourcing treatment of particular items of income including:

- A. The relationship between the partnership that recognizes the income or items and the partners, including tiered partners, or other entities that are engaged in the related business activities generating other income or items, including:
 - 1. The extent of actual common control, direct or indirect, held or exercised over the business activities, regardless of the share of partnership capital held;
 - 2. The extent to which related activities are integrated or coordinated;
 - 3. The extent to which resources and costs are shared; and
 - 4. The extent of transactions or flows of value between the entities.
- B. The extent of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.
- C. The nature of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.

SOURCING OF GUARANTEED PAYMENTS FOR SERVICES AND ADDITIONAL CREDIT FOR TAXES PAID TO OTHER STATES

General Drafter's Note:

The draft provisions below include: (1) a general statute for sourcing and taxing guaranteed payments for services; (2) regulations implementing that general statute; and (3) a statute providing an additional credit for taxes paid to other states.

Federal tax rules generally source guaranteed payments for services to the location where the partner performs the services. See IRC § 911. But the majority of states that specifically address this issue do not follow this approach but instead require partners to source the guaranteed payments in the same manner as distributive share.

SOURCING STATUTORY SECTION #

Part I. State Sourcing and Taxation of Certain Guaranteed Payments

A. General Rule

Drafter's Note: The general rule here provides that guaranteed payments for services will be sourced by the state in the same way as distributive share.

Guaranteed payments recognized under Section 707(c) of the Internal Revenue Code by a direct, nonresident individual partner for the performance of services are sourced to this state as provided in [REFERENCE TO SECTION OF STATE LAW THAT GOVERNS THE SOURCING OF PARTNERSHIP DISTRIBUTIVE SHARE USING GENERAL ALLOCATION AND APPORTIONMENT RULES APPLIED AT THE PARTNERSHIP LEVEL.].

B. Guaranteed Payments Made to a Retired Partner

Drafter's Note: Under federal pension law, certain guaranteed payments to retired partners can only be sourced to their state of residence. Subsection (B) satisfies this requirement by sourcing such payments made to nonresidents outside of the state.

Guaranteed payments made to a retired nonresident partner are sourced outside of this state provided the payment is "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).

C. Guaranteed Payments Made to a Foreign Partners and Domestic Partners Performing Services Overseas

Drafter's Note: This decouples the state from the federal sourcing rules for guaranteed payments for services.

Notwithstanding any provision of federal law, including IRC § 911, guaranteed payments made to foreign partners and to domestic partners performing services in a foreign country are sourced using the general rule of subsection (a). [Note that state statutes that conform the state's law to federal taxable income or adjusted gross income may also need to be amended.]

SOURCING REGULATORY PROVISIONS

Sourcing of Certain Guaranteed Payments

Drafter's Note: The purpose of this regulation is to provide guidance on the imposition of state income tax on certain guaranteed payments for services and the sourcing of those payments.

Examples:

In examples 1 - 5, assume the following:

- Partnership X has a 20% apportionment factor in this state.
- Partnership X's Federal 1065 shows \$150,000 of gross receipts and \$50,000 of guaranteed payments and no other income or deductions.
- Smith is a nonresident partner that holds a 10% interest in Partnership X.
- Jones is a nonresident partner that holds a 90% interest in Partnership X.
- The Partnership X agreement provides that Smith will receive the \$50,000 in guaranteed payments and Smith and Jones will be allocated distributive share items according to their respective interests in the partnership.
- Neither Smith nor Jones has other income in this state.

Simple Example 1:

Partnership X will have \$100,000 (\$150,000 gross receipts - \$50,000 guaranteed payment) of ordinary business income that it will pass through to Jones and Smith. As a result, Smith's distributive share of partnership ordinary business income will be \$10,000, and Jones' distributive share will be \$90,000. Partnership X's apportionment factors will apply to the distributive shares so Smith will have an apportioned distributive share of \$2,000 in this state and Jones will have an apportioned distributive share of \$18,000 in this state.

Pursuant to subsection (b), Smith will also apportion 20% of her guaranteed payment (\$10,000) to this state. As a result, Smith's taxable income in this state will be \$12,000.

Example 2: Assume also that Smith is a retired partner, and the guaranteed payment meets the requirements of "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).

In this scenario, subsection (c) provides that the entire guaranteed payment will be sourced outside of this state. Other items of distributive share will be sourced according to [insert reference to model statutory provisions above]. As a result, Smith and Jones will have \$2,000 and \$18,000, respectively, of apportioned distributive share income in this state.

Example 3: Assume Smith receives the guaranteed payment for services performed outside of the United States.

Under [reference to the model act, subsection (c)], guaranteed payments made to foreign partners are sourced the same as guaranteed payments made to domestic nonresident partners. Therefore, the result will be the same as in example 1, above.

In examples 4 and 5, assume the following:

- Partnership X has offices and activities in this state.
- Partnership X has a 20% apportionment factor in this state.
- Partnership X's Federal 1065 shows \$40,000 of gross receipts and no other income.
- Partnership X's Federal 1065 shows a \$50,000 guaranteed payment and no other deductions.
- Smith is a nonresident partner that holds a 10% interest in Partnership X.
- Jones is a nonresident partner that holds a 90% interest in Partnership X.
- The Partnership X agreement provides that Smith and Jones will allocate distributive share items according to their respective interests in the partnership.
- Neither Smith nor Jones has other income.

Simple Example 4:

Partnership X will have \$10,000 of ordinary business loss (\$40,000 gross receipts - \$50,000 guaranteed payment). Smith and Jones will have \$1,000 and \$9,000, respectively of distributive share of this ordinary business loss. Partnership X's apportionment factors will apply to the distributive shares so Smith will have an apportioned distributive share loss of \$200 in this state and Jones will have an apportioned distributive share loss of \$1,800 in this state.

Pursuant to subsection (b), Smith will also apportion 20% of her guaranteed payment to this state. So, her apportioned guaranteed payment will be \$10,000, which gives Smith total apportioned income in this state of \$9,800.

Example 5: Smith is a retired partner, and the guaranteed payment meets the requirements of "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).

In this scenario, subsection (c) provides that the entire guaranteed payment will be sourced outside of this state. Other items of distributive share will be sourced according to [insert reference to state sourcing statutes and rules applicable to distributive share items]. As a result, Smith will have \$200 of apportioned distributive share loss in this state and Jones will have an apportioned distributive share loss of \$1,800 in this state.

CREDIT STATUTORY SECTION #

Drafter's Note: The additional credit below recognizes that a minority of states source guaranteed payments for services based on the location of the performance of the service. This credit is drafted as a statute to be adopted by residency states that source guaranteed payments in the same way as distributive share, and may wish to provide their residents with a credit if they would otherwise pay tax on the guaranteed payment sourced to the location of performance.

Part I. Additional Credit for Taxes Paid to Other States on Certain Guaranteed Payments

Drafter's Note – It may be that states already have a credit equivalent to this provision.

A. Additional Credit for Taxes Paid to Other States on Certain Guaranteed Payments

A resident in this state that receives a guaranteed payment for services under IRC § 707(c) performed for a partnership in which that resident owns a direct interest and where the services are performed in another state which imposes an income tax on the guaranteed payment based on the location of the service performed may claim an additional credit against the tax owed in this state, computed by multiplying the allowable effective tax rate times the allowable guaranteed payment.

B. Definitions

For purposes of this credit:

1. The allowable effective tax rate equals the lesser of:
 - a. The amount of the resident's tax on total net income properly reported in this state before the credit provided by this section divided by the amount of that total net income; or
 - b. The amount of the resident's tax paid on total net income properly reported in the other state, including any tax paid by the partnership on the resident's behalf, divided by the amount of that total net income.
2. The allowable guaranteed payment equals the lesser of:
 - a. The amount of the partner's guaranteed payment properly reported as taxable to the other state; or
 - b. The amount that results from subtracting the partner's distributive share of any related partnership net loss from the partner's total guaranteed payment for services [subject to other limits the state may impose], multiplied by the ratio of the number of partner working days spent in the state divided by the total partner working days in the tax year, where:
 - i. The partner's distributive share of any related partnership net loss is equal to the amount of the partner's distributive share of expense and loss in excess of the partner's distributive share of income and gain from the partnership that is allocated to the partner and properly reported in this state;
 - ii. Partner working days are the total days during the tax year in which the partner performed services for the partnership; and
 - iii. Partner working days spent in the state equals total days during which the time the partner spent performing services in that state exceeds the time spent working in any other state.

STATE TAX TREATMENT OF INVESTMENT PARTNERSHIPS

Drafted in the Form of Regulations

General Drafter's Note:

While states typically look to the activities of the partnership when sourcing the partnership's income, the majority of states provide that the partnership's activities (including its in-state property and payroll) will not determine the sourcing of income that is primarily from investment activities.

The model's approach is limited to those partners who are nonresident individuals (or taxed as nonresident individuals). In addition, the following requirements apply:

- The partner does not engage in managing the investment partnership.
- The partner is not a dealer in investments.
- The investment partnership interest is not held as part of the business of the partner.
- The partnership is not unitary with any other business.

SOURCING REGULATION PROVISIONS:

(a) General Rule.

Under the [REFERENCE TO STATE'S INDIVIDUAL INCOME TAX], a nonresident partner's distributive share of partnership income is generally allocated and apportioned to this state at the partnership level based on the partnership's business or other activities in this state. See [insert reference to applicable statutes and regulations, including UDITPA if applicable, and to IRC § 702]. But the investment related activities of a qualified investment partnership in this state do not affect how certain nonresident partners source their distributive share of that partnership's investment income. Rather, the sourcing rules for nonresidents apply to the items of income making up the partner's distributive share from the qualified investment partnership as though the partner earned (or incurred) the items directly. See [reference to applicable statutes and regulations governing sourcing of income for nonresidents].

(b) Applicability to Certain Nonresident Partners.

This rule, which provides that the investment related activities of a qualified investment partnership in this state will not affect the sourcing of distributive share income from that partnership, applies to the partners of the qualified investment partnership who are nonresident individuals [AND TRUSTS AND/OR ESTATES, IF APPLICABLE], and therefore pay tax on a source basis to the state, and who do not actively engage in the management of the qualified investment partnership, including recruiting investors, overseeing investments, performing administrative functions, and similar activities.

(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.

DRAFTER'S NOTE – The terms “materially participate” and “activities” are used under federal tax law to limit the ability to offset expenses/losses against income/gains in certain circumstances.

(d) Safe Harbor.

A partnership will be presumed to be a qualified investment partnership if, during the tax period in which the income is recognized, no less than 90 percent of the cost of the partnership's total assets consists of the following:

(1) Common stock of publicly traded corporations, including preferred or debt securities convertible into common stock; and preferred stock, including debt securities convertible into preferred stock;

(2) Bonds, debentures, and other debt securities such as certificates of deposit and collateralized securities available for sale or trade through public markets;

(3) Deposits and any other obligations of banks and other financial institutions regulated by the United States government, a state, or by any political subdivision or governmental agency thereof, 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.

DRAFTER'S NOTE: The state may wish to include other types of investments in this safe harbor provision to the extent their inclusion would be consistent with state sourcing rules generally.

The presumption provided here is intended to act as a safe harbor and does not limit the application of the general rule provided in Section (c) of this regulation. The presumption provided by this Section (d) can be rebutted if the [STATE TAX AGENCY] can show that the investment partnership lacks economic substance or was put into place to evade tax.

(e) 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.

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

- 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 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.

(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.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. As such, the activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, 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.

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 NONAPPORTIONABLE] income of X, then the gain would be allocated under [REFERENCE TO STATE'S RULES FOR SOURCING NONBUSINESS INCOME].

(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.

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 capital gain is sourced. Rather, 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.

(5) Partnership X is a Qualified Investment Partnership but Smith is a Dealer:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- Smith acts as a dealer in investments and has customers in this state.

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, Smith's investment in X would be considered part of the inventory of assets with respect to which Smith acts as a dealer. [INSERT REFERENCE TO STATUTES AND REGULATIONS.] Therefore, Smith's distributive share from X is sourced to this state as part of the income of Smith's business as a dealer in this state.

(6) Smith Uses Investment in Partnership X in Another Business:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- Smith operates Business Y, a sole proprietorship, in this state.

- Under state statutes and regulations, Smith’s investment in X would be considered part of the business income of Business Y. [Insert reference to statutes and regulations.]

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, the distributive share from X would be sourced to this state as part of the income of Business Y.

(7) Smith Participates in the Management of the Qualified Investment Partnership:

- Smith is a minority partner but participates in the management of X and receives a carried interest (profits interest) for the services Smith performs.
- X has dividends from corporate stock.

Because Smith is engaging in the management of X, Smith’s distributive share of income from X, including the share of dividends from corporate stock, is allocated and apportioned to this state based on the activities of X in this state.

(8) Smith Owns a Share of an S Corporation which Owns an Interest in Partnership X.

Because the partner in this case, the S corporation, does not meet the criteria of Section (b) of this regulation, this regulation does not apply. Instead sourcing rules under [REFERENCE TO SOURCING OF S CORPORATION INCOME] would apply.