

Combined Draft Model Provisions for Sourcing Partnership Income

Presented to the Uniformity Committee
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Key Points – Before Reviewing the Draft Provisions

The model provisions are based on work done by the MTC uniformity work group on taxation of partnerships project. Information on this project and the work done is on the MTC project page here: https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/.

The following points (some of which are discussed in much more detail in the white papers) are important to understand before reviewing the combined draft provisions.

1 **The provisions apply general state sourcing rules to partnership income.**	As noted above, the project's focus is on applying the states' established income sourcing approaches to the income of partnerships taxed under the pass-through system. This provides equitable treatment for business income regardless of the form of the business
2 **Some unique partnership issues may call for uniform sourcing rules.**	One example of the need for uniformity is the sourcing of guaranteed payments for services—where states take two distinctly different approaches that might lead to duplicative taxation, and which is addressed by draft provisions set out below.
3 **Sourcing on a pass-through basis must be consistent with entity-level taxes.**	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. Otherwise, inconsistency will lead to different partner-level and partnership-level tax results.
4 **Tax treatment, including sourcing—depends first on the tax character of items.**	The tax treatment of items of income is determined first by the item's tax character. This is also true for sourcing treatment, whether done under federal or state rules. For example, state rules for sourcing non-apportionable income depend on whether that income is from sales of tangible property, intangible property, interest, royalties, etc.
5 **Partnerships determine the tax character of partnership items.**	The tax character of a partnership's items of income that affects their substantive tax treatment is determined at the partnership level. IRC § 702(b). (See also IRS Form 1065 and Schedule K-1.) This includes any tax character derived from specific activities (e.g., business activity, investment, etc.).
6 **The tax character of partnership items is attributed to the partners' shares of those items.**	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.

7 **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.
8 **Tax attributes of the partner have a limited effect on sourcing partnership income.**	A partner's own tax attributes do not change the tax character of the partnership items. So, for example, the fact that the partner is not active in the business of the partnership does not change the character of the items. But a partner's attributes may have a limited effect on application of tax rules, including 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.
9 **How the unitary business principle applies to partnership income is unclear and the subject of some controversy.**	While some state courts have addressed the application of the unitary business principle and its criteria to the sourcing of partnership income, the U.S. Supreme Court has never done so. It is, therefore, not clear how those criteria apply to partners and partnerships—which have different legal relationships than corporations and shareholders or subsidiaries. For example, some states have recognized that ownership, often used to determine control for corporate entities, does not determine control of partnerships.
10 **Anti-abuse rules and limits are essential to the functioning of the pass-through system.**	The federal pass-through system relies heavily on rules and limitations to prevent abuse. States will need similar rules. But simply conforming to Subchapter K may not be enough. Some federal anti-abuse rules only look to the federal tax result, 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.
11 **Additional regulations will be needed to implement the statutory provisions here.**	Some of the provisions here are drafted as statutes. States may need to adopt detailed regulations for the application of these rules to partnership income taxed on a pass-through basis. The general provisions set out here are not intended to be a comprehensive package of regulations, but to provide a foundation for those regulations.
12 **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. This level of authority is very similar to the authority Congress has granted to the IRS.

Formatting Notes

- There are three sets of provisions:
    - Sourcing of Partnership Income Generally and Sourcing for Tiered & Corporate Partners
    - Sourcing of Guaranteed Payments for Services and Additional Credit For Taxes Paid to Other States
    - Sourcing of Income of Investment Partnerships
- The provisions will note whether they are drafted in the form of statutes or regulations.
- Drafter's notes 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 Generally and Sourcing for Tiered & Corporate Partners

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 can 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 apply to their state even if not explicitly stated. Where those concepts are essential, the draft includes them explicitly to avoid confusion or uncertainty.

Inclusion of General Provisions

This Section was initially drafted to address sourcing of partnership income for tiered and corporate partners. However, substantial parts of it also apply generally. Therefore, the scope has expanded to include all partners.

References to State Sourcing Statutes

The draft provisions below include bracketed references for the state sourcing rules for both corporations and nonresidents. Based on the research done as part of the related white paper, most states use the same sourcing methods for sourcing income of businesses, whether for individuals (proprietorships) or corporations. If a state has significant differences in the sourcing rules applied to business income of corporations and individuals, this complicates the sourcing of partnership income whether taxed on a pass-through basis or at the entity level.

Statutory Section

Part I. Definitions of Terms:

Drafter's Note: Terms that are used to refer to partnership tax concepts can vary depending on the body of law—state law governing partnerships, federal tax provisions, or state tax provisions. Differences in terminology can create confusion and uncertainty. These draft provisions set out definitions that states may need to use in their sourcing rules for partnership income. The definitions look to general state law and federal tax law to achieve greater consistency. They may include terms that are not incorporated into the draft provisions below but could be used to the extent those provisions are expanded or for the purpose of drafting related regulations.

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

1. Allocate or allocation of distributive share of 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.
   Note that the term "allocate" is used in Subchapter K as defined here. But it is also used in state sourcing rules, including the Uniform Division of Income for Tax Purposes Act (UDITPA) to mean the method of sourcing non-business or non-apportionable income using rules of assignment. This may cause confusion and states will need to consider how to reconcile the different use of the terms. Here, the term allocate is defined as noted in order to make sure that the draft provisions are clear.

2. Apportionable income or items – Income or items, including expenses, that are part of net income sourced using an apportionment formula related to that net income. See [REFERENCE(S) TO THE STATE'S STATUTORY PROVISIONS GOVERNING APPORTIONABLE OR "BUSINESS" INCOME].

3. Apportionment formula, factors, and factor components – The formula and factors used to apportion unitary apportionable income and amounts determined, included, and sourced based on the rules in [REFERENCE TO APPLICABLE STATE APPORTIONMENT LAW DETERMINING THE APPORTIONMENT FORMULA].

4. 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 partnership items, as determined by the partnership recognizing those items, to any direct or indirect partners who are allocated a share of those items, without altering their tax character. 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).
Drafter's Note: This provision 3 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.

5. Beneficial interest holder – A person with ownership rights or rights to income in an "other pass-through entity".

6. 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 by a partner to a partnership or distributed from a partnership to a partner. See IRC § 704(c).

7. Contribution – Cash or property transferred by a partner to a partnership in exchange for a partnership interest. See IRC § 721.

8. Direct partner – A partner that owns an interest in a partnership directly and not through the partner's ownership in an upper-tier partnership.

9. Distribution – Cash or property transferred by a partnership to a partner that represent, in whole or in part, a return of the partner's capital. See IRC § 731.

10. 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.

11. Indirect partner – With respect to a particular partnership, a partner that owns an interest in an upper-tier partnership.

12. Lower-tier partnership – A reference to a partnership in which another partnership or other pass-through entity holds an interest. See IRC § 706(d)(3).

13. Non-apportionable partnership income or partnership items – Partnership income or partnership items that are specifically assigned (or allocated) in whole or in part to [THIS STATE] rather than apportioned. See [REFERENCE(S) TO STATE STATUTORY PROVISIONS FOR DEFINING NON-APPORTIONABLE OR "NONBUSINESS" ITEMS OF INCOME.]

14. Other pass-through entity – An entity whose income is taxed on a pass-through basis to its direct or indirect beneficial interest holders under [State] law [SEE REFERENCE TO APPLICABLE STATE LAW WHICH MAY INCLUDE IRC SUBCHAPTER S CORPORATIONS AND CERTAIN TRUSTS].

15. Partner – A person [REFERENCE TO APPLICABLE STATE DEFINITION OF PERSON IF NECESSARY] treated as a partner for tax purposes under federal tax law, including IRC Subchapter K, which includes direct and indirect partners and members of LLCs. See IRC §§ 761(b) and 7701 and related regulations.

16. Partnership – An entity treated as a partnership under federal tax law, including IRC Subchapter K [WITH ANY EXCEPTIONS FOR STATE TAX PURPOSES], which includes general partnerships, limited partnerships, limited liability companies, etc. See IRC §§ 761(a) and 7701 and related regulations.

17. Partnership agreement – The agreement between the partners generally or on particular partnership matters, regardless of form, as the term is used for federal income tax purposes and consistent with state partnership law [REFERENCE TO THE STATES LAWS FOR GENERAL PARTNERSHIPS, LIMITED PARTNERSHIPS, LLC'S, ETC.]. See IRC §761(c).

18. Partnership income (loss) – A general reference to income (loss) determined and reported by the partnership under IRC Subchapter K. See IRC §703 (and IRS Form 1065).

19. 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 federal tax law or the tax laws of this state. See IRC §§ 702 & 704 (and IRS Form 1065, Schedule K-1).

20. Partnership interest or partner's ownership interest – Unless the context otherwise indicates, a partner's legal ownership rights in a partnership or value of the partner's partnership capital. See IRC §§ 704(e) and 864(c)(8).

21. Specifically assign and rules of assignment – The method used to source or allocate income or items of income under [REFERENCE(S) TO STATE STATUTORY PROVISIONS FOR SOURCING NON-APPORTIONABLE OR "NONBUSINESS" ITEMS OF INCOME.]
See the drafter's note for the definition of "allocate," above.

22. Sufficient unitary relationship – See Part VI.

23. Tax character of an item – The nature and classification of items for tax purposes which may affect their income 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. The nature 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.

24. Taxpayer or partner attribute (noun) – An aspect of, or circumstance relating to a particular taxpayer or partner that may affect the ultimate tax result for items recognized by or attributed to that taxpayer or partner, 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 or partner's marginal effective tax rate; and

    d. The taxpayer's participation or role in certain activities.

25. Upper-tier partnership or tiered partner – A partnership that holds an interest in another partnership. See IRC § 706(d)(3).

Part I. B. Other terms not defined above are to be interpreted consistently with the context and with [REFERENCE TO LAWS OF THIS STATE] and federal income tax law.

Part II. Conformity to Federal Income 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 partnership-related provisions, including references to sourcing rules and their application, in both sections. While these model provisions are designed to be applicable to tiered and corporate partners (see Part IV.C below), the conformity provisions in this Part II could be used in the context of tax on individuals as well.

Part II. A. [STATE] conforms to the federal income tax law, including IRC Subchapter K, as provided in [REFERENCE(S) TO STATE LAWS THAT AFFECT CONFORMITY FOR CORPORATE AND INDIVIDUAL TAXPAYERS]. In conforming to Subchapter K, [STATE] also conforms to the principle that the tax character of items of income and loss is determined at the partnership level and then attributed to the partners who receive a distributive share of those items. This character as determined at the partnership level may affect the state income tax treatment of the items under the state income tax rules, including the sourcing of those items under [REFERENCE(S) TO STATE LAW FOR SOURCING INCOME - INCLUDING CORPORATE AND INDIVIDUAL SOURCING RULES].

Part II. 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: 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.

Part III. A. A partnership shall provide to its direct partners the information necessary for its direct and indirect partners or beneficial interest holders 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 partner or an indirect partner or beneficial interest holder doing business in or resident in [STATE].

3. Any partnership that has a direct or indirect interest in a partnership or other pass-through entity doing business in [STATE].

Part III. 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].

Part III. 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 III. D. To the beneficial interest holders of another pass-through entity are taxed on partnership income flowing through that entity, the entity may also be required to report information described in this Part III.

Part III. E. A partnership or other pass-through entity is presumed to have knowledge that an indirect partner or beneficial interest holder is doing business or resident in this state for purposes of this Part III if that information is otherwise known to that partnership or if the partnership has received a notification from a partner, indirect partner, or beneficial interest holder. If, under the circumstances, a partnership or other pass-through entity is not presumed to have this knowledge, the failure to provide information to its partners that is necessary for indirect partners or beneficial interest holders to properly compute and report their [STATE] tax will not be subject to any penalties.

Part IV. Sourcing of Partnership Income and Items

Drafter's Note: These provisions are designed to for tiered and corporate partners and to address the use of blending. But the approach described in Subparts A and B is consistent with state sourcing of income of individual partners as well. Therefore, this Part IV also includes provisions for sourcing income where blending is not used, including for individual partners.

And while the rules below provide references to both a state's corporate and individual state tax and sourcing rules, this is because those rules are often contained in separate sections of state law. But we assume that the rules would generally be the same whether sourcing the income from business activities of individuals or corporations. If this is not the case for a particular state, it will complicate the application of both the pass-through tax system and any entity-level taxes applied to partnerships.

Finally, to the extent a state has adopted Section 18 authority, that authority may also apply to partnership income, subject to the specific language and requirements of the state's provision.

Part IV. A. In applying the sourcing rules below, a partnership required to report information as described in Part III, must properly apply the applicable [STATE] and federal tax rules as required by Part II in determining that information.

Part IV. B. Items Recognized Directly by a Partnership:

Drafter's Note: Partnership structures may include multiple tiers, partners that are other partnerships or other pass-through entities, through which a lower-tier partnership's distributive share income and items pass before being allocated by the upper-tier entities to taxpaying partners or beneficial interest holders. Under IRC Subchapter K, an item's character is determined by the partnership recognizing the item and does not change.

Paragraph B is intended to make explicit the requirement that the partnership first recognizing the item of income, expense, gain, or loss must also determine 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 and items 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 and to guaranteed payments made to partners:

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 are 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] applying those rules 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 also 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 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 apportionable 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. Guaranteed payments to partners for services are presumed to be part of the partnership's apportionable income.

5. Information on the partnership's apportionment factor attributes related to the items determined to be part of apportionable income under Paragraph 4, applying [REFERENCE TO STATE'S SOURCING RULES—APPORTIONMENT FACTORS] to enable determination of those apportionment factors.

Part IV. C. Upper-Tier Partnership and Other Pass-Through Entity Treatment of Items Allocated from Lower-Tier Partnerships:

Drafter's Note: As discussed at length in the related white paper, a majority of states use blended apportionment to source partnership income for tiered and corporate partners. Of those that specify how to determine the share of partnership apportionment factors to include in the partner's formula, most refer to the use of a ratio based on the partner's distributive share of profit and loss.

This approach is conceptually preferable to other possible approaches for a number of reasons, but raises an issue when the partnership makes dis-proportionate special allocations of items, guaranteed payments, or mandatory or remedial allocations to tiered or corporate partners. In some cases, the partner's distributive share will be negative whereas the partnership's total distributive share income including guaranteed payments is positive, or vice versa. But even when this is not the case, the share of the partnership's apportionment factors will be affected if the partner that uses blending receives relatively higher or lower shares of any expense/loss items versus income/gain items or has significant guaranteed payments.

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. This absolute value method is necessary to ensure that the partner who blends the partnership's apportionment factors with its own includes a share of those factors that represents the effect on that partner's income of its share of the partnership items—whether that effect is positive or negative.

Note that the absolute value method is used as the default rule. However, when all the items of income and deductions composing the distributive shares of all partners are allocated in the same proportion for each partner, and there are no guaranteed payments or notional allocations, the absolute value method yields the same result as if it was not used.

Guaranteed payments and items of income, expense, gain, loss or other tax items that are allocated to an upper-tier partnership or other pass-through entity by a lower-tier partnership retain their tax character as determined in Subpart B regardless of whether the allocations are made in accordance with the partner's partnership interest, or are special, mandatory, or remedial allocations. But the upper-tier partnership or other pass-through entity will also determine the following with respect to these guaranteed payments and allocated items when reporting information to that upper-tier partnership's partners or the entity's beneficial interest holders:

1. Whether guaranteed payments or 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 or other pass-through entity is engaged directly or in conjunction with any entity in which the partnership owns a direct or indirect interest.

2. If any guaranteed payments or items determined to be non-apportionable by the lower-tier partnership are properly determined by the upper-tier partnership or other pass-through entity to have a sufficient unitary relationship to that partnership's or entity's own business activity generating apportionable income, then the upper-tier partnership or other pass-through entity will include these guaranteed payments and items in the apportionable income from that partnership's or entity's related business activities to be apportioned using the upper-tier partnership's or other pass-through entity's apportionment factors.

3. If any guaranteed payments or items determined to be apportionable by the lower-tier partnership are properly determined to have a sufficient unitary relationship to the upper-tier partnership's or other pass-through entity's business activity generating apportionable income, the upper-tier partnership or other pass-through entity will include these guaranteed payments and items in the apportionable income from that partnership's or entity's related business activity.

   When sourcing this unitary apportionable income, the upper-tier partnership or other pass-through entity will include a share of the lower-tier partnership's apportionment factors from the related unitary business activity in the upper-tier partnership's or other pass-through entity's apportionment factors, aggregating the factor components. This inclusion of a share of lower-tier partnership factors with the partner's own factors will be referred to as the blending of apportionment factors. Under this calculation, the partner adds its share of the lower-tier partnership's factor components to its own factor components, and the partner's apportionment factors are recalculated based on the resulting aggregations.

4. The share of the lower-tier partnership's apportionment factors to be included when blending apportionment factors under Paragraph 3 of this subpart is determined using a ratio which is the partner's total unitary guaranteed payments and distributive shares of items computed using the absolute value of those items, divided by the total of all the unitary guaranteed payments and distributive shares of items to all partners of the lower-tier partnership computed using the absolute value of those items.
In determining the blended receipts factor, any receipts representing transactions between the partner and partnership will be eliminated from that blended factor to the extent of the partner's distributive share of the partnership items (receipts or expenses) associated with those transactions.

5. If any guaranteed payments or items allocated to the upper-tier partnership or other pass-through entity by the lower-tier partnership are properly determined not to have a sufficient unitary relationship to the upper-tier partnership's or other pass-through entity's business activity generating apportionable income, the upper-tier partnership or other pass-through entity will source these guaranteed payments or items as stated in the information from the lower-tier partnership as provided by Subpart B.

6. Upper-tier partnerships and other pass-through entities must provide sufficient sourcing information for their partners or beneficial interest holders to properly source their guaranteed payments or distributive share income in accordance with these provisions.

Part IV. D. Corporate Partner Treatment of Items from Partnerships:

See the Drafter's Note for Subpart C above.

Guaranteed payments and items of income, expense, gain, loss or other tax items that are allocated to a corporate partner retain their tax character as determined in Subparts B and C regardless if the allocations are made in accordance with the partner's partnership interest, or are special, mandatory, or remedial allocations. But the corporate partner will also determine the following with respect to these guaranteed payments and allocated items:

1. Whether guaranteed payments or 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 IV 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 any guaranteed payments or items determined to be non-apportionable by the partnership have a sufficient unitary relationship with business activity of the corporate partner generating apportionable income, the corporate partner will include these items in the apportionable income from that corporate partner's related business activity to be apportioned using the corporate partner's apportionment factors.

3. If any guaranteed payments or items determined to be apportionable by the partnership have a sufficient unitary relationship with the business activity generating apportionable income of the corporate partner, the corporate partner will include these items in the apportionable income from that corporate partner's related business activity.

   In addition, the corporate partner and will include the related share of the partnership's apportionment factors in the corporate partner's apportionment factors. This inclusion of a share of partnership factors with the partner's own factors will be referred to as the blending of apportionment factors. Under this calculation, the corporate partner adds its share of the partnership's factor components to its own factor components, and the corporate partner's apportionment factors are recalculated based on the resulting aggregations.

4. The share of the partnership's apportionment factors to be included when blending apportionment factors under Paragraph 3 of this subpart is determined using a ratio which is the partner's total unitary guaranteed payments and distributive shares of items computed using the absolute value of those items divided by the total of all the unitary guaranteed payments and distributive shares of items to all partners of the lower-tier partnership computed using the absolute value of those items.

   In determining the blended receipts factor, any receipts representing transactions between the partner and partnership will be eliminated from that blended factor to the extent of the partner's distributive share of the items (receipts or expenses) associated with those transactions.

5. If guaranteed payments or items allocated to the corporate partner are properly determined not to have a sufficient unitary relationship to the partner's business activity generating apportionable income, the corporate partner will source these items as stated in information from the lower-tier partnership as provided by Subpart B.

Part IV. E. All Other Partners Treatment of Items from Partnerships

Items allocated to other partners will be sourced using information from the partnership as provided in Subpart B, unless other provisions of [STATE] law provide for different sourcing treatment.

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 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.)

Part V. 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.

Part V. 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.

Part V.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 "unitary business" principle is a concept created by the U.S. Supreme Court to limit how 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). To date, the Supreme Court has never applied the principle in the context of partnership taxation under the pass-through system where the income of the partnership is attributed to its partners.

Because the unitary business principle is a judicial creation, states have limited authority to issue binding regulations—and its 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 from year to year, states that look only to the activities of a single entity may find that the sourcing of income can 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:

Part VI.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.

Part VI. B. The extent of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.

Part VI. 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 and 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

Part I.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.

Also note that this provision is for taxes applied to income of entities on a pass-through basis. Comments on this provision noted that some states may not have addressed the potential double-counting of guaranteed payments that may result where there is an entity-level tax so that the payments are included in the partnership's apportionable business income and again as separately sourced income to the partner.

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.].

Part I.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).

Part I.C. Guaranteed Payments Made to 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. Note that state statutes that conform the state's law to federal taxable income or adjusted gross income may also need to be amended.

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).

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 [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 [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.

Part I.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.

Part I.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

General Drafter's Note:

This model is drafted in the form of regulations.

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 to this exception is limited to those partners who are nonresident individuals (or taxed as nonresident individuals) and sources income as if the nonresident partner held the corresponding assets directly. 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:

Sourcing of Investment Partnership Income

(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 term "materially participate" is a term used under federal tax law, IRC § 469, to limit the ability to offset expenses/losses against income/gains in certain circumstances. The term "actively engage" allows states to expand on this concept where they determine that activities constitute business activities.

(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 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.

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. [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. [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. [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. [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. [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. [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.