State Taxation of Partnerships – Report to the Work Group

FEBUARY 15, 2023

GENERAL APPROACH

1. Identify and generally describe a comprehensive list of potential issues.
2. Note the important relationships between those issues.
3. Select a particular issue and develop generally recommended practices or positions.
4. Repeat step 3 until all major issues have been addressed and reconcile any differences.
5. Agree on overall set of recommended practices/ positions for all issues.
6. Begin creating draft models, etc., to carry out the recommended practices/positions.

LAST CALL

- Noted that we had just received ABA comments on the investment partnership model and would be looking at general sourcing in the meantime
- Reviewed changes to the Issue Outline
- Reviewed important general principles
- Discussed how these general principles apply to sourcing of partnership income
- Focused on the "default rule" – how partnership income will generally be sourced and what exceptions might be made to that default rule

SUMMARY OF CRITICAL FEDERAL AND STATE TAX PRINCIPLES

Federal

- Conduit principle –
  - Partnership items are valued and characterized based on the partnership's activities.
  - Items maintain character as they flow through upper tiers.
  - Federal sourcing (foreign/domestic) is also a characteristic determined based on partnership activities.
  - This means that partners (regardless of their role) treat items as if they were earned directly.

- Flexibility principle –
  - Partnerships have flexibility in allocating items provided allocations have substantial economic effect.
  - Flexibility has limits and cannot be used to artificially avoid federal tax.
  - Partners may receive different types of allocations:
    - Allocations made by agreement (IRC §704(b)
    - Allocations required by Subchapter K (IRC §704(c) and others)
    - Guaranteed payments (IRC §707(c)
    - Payments not as partners (IRC §707(a)

SUMMARY OF CRITICAL FEDERAL AND STATE TAX PRINCIPLES

Federal

- Domestic/foreign sourcing principles – (under IRC §§ 861-865 and federal rules) –
  - Federal rules determine sourcing for purposes of residents (computing the foreign tax credit that may be due) and nonresidents (computing the income subject to U.S. tax).
  - Specific items of income (interest, rents, royalties, services, sale of property, etc.) are sourced using rules applicable to those items.
  - The rules are applied to each item of income within the category depending on the activities giving rise to that item.
  - Expense associated with that income, as well as other general items for which there are no applicable rules, may be "allocated and apportioned."

SUMMARY OF CRITICAL FEDERAL AND STATE TAX PRINCIPLES

State

- Multistate sourcing principles –
  - Source net business/apportionable income using formulary apportionment based on certain factors
  - Source items of nonbusiness/nonapportionable income (net of related expense) using specific rules
- Unitary business principle –
  - A sufficient connection must exist between an item of income and the apportionment factors of the business
  - UDITPA – Sec. 1 defines "business" income based on the relationship between the transaction, activity, or property giving rise to the income and the taxpayer's [that is, the partnership's] business.
- Under MTC model regulations, if a corporate partner includes its share of partnership income in its apportionable income, then a share of the partnership factors is included in the apportionment formula ("blended sourcing").

POTENTIAL CONFLICT BETWEEN FEDERAL CONDUIT PRINCIPLE AND STATE SOURCING PRINCIPLES

- The question was raised – how can we reconcile the principle that partners treat partnership items as if they earned them directly with state sourcing principles that apply formulary apportionment to net business income.
  - Assume Partnership is doing business in States A and B and has a 50% apportionment factor in each.
  - Partnership has a business (apportionable) gain from the sale of real property located in State A?
  - How much of the gain should partners source to State A?
    - 50% (apportioned)?
    - 100% (as a separate transaction)?

RECONCILING THE CONDUIT PRINCIPLE APPLIED TO STATE SOURCING

RESTATEMENT OF THE "DEFAULT" – OR "PARTNERSHIP LEVEL SOURCING" RULE

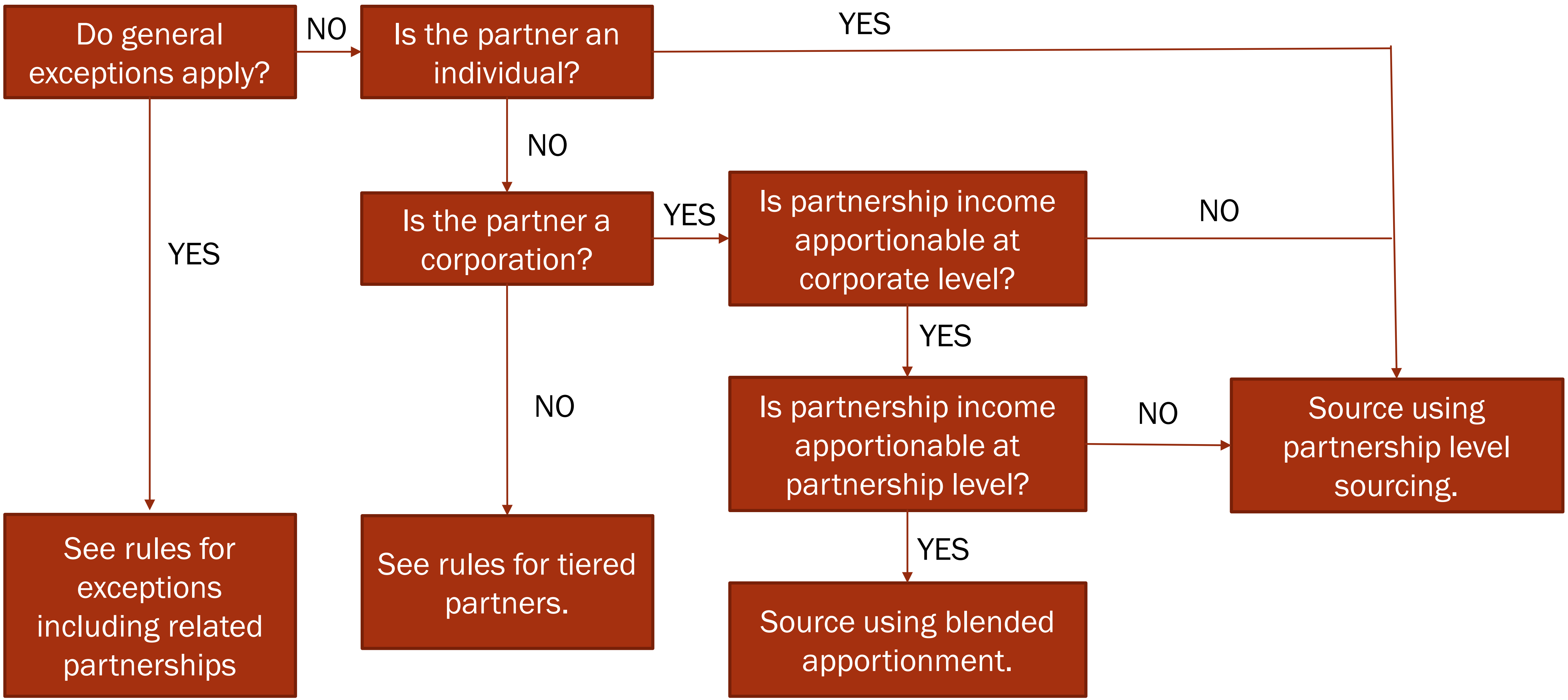
(FOR NON-INVESTMENT PARTNERSHIPS)

- Unless an exception applies:
  - Whether partnership items are business (apportionable) or nonbusiness (nonapportionable) will generally be determined applying state rules to the partnership's activities.
  - To the extent partnership items are business (apportionable), they will be apportioned using state rules—that is, formulary apportionment of net income using factors.
  - The partners will then source any partnership items included in that apportionable income as though they had earned the items directly ***while conducting the business of the partnership.*** (So the answer to the example above would be 50%.)
  - If a partnership item is nonbusiness (nonapportionable), it will be sourced applying state rules to the partnership's activity giving rise to the income.

POSSIBLE EXCEPTIONS TO THE DEFAULT RULE

- Guaranteed Payments: Are guaranteed payments for services done by partners sourced to the partner's location?
- Built-In Gain or Loss: Does the treatment of built-in gain/loss affect sourcing of related items?
- Loss Issues: Are any conflicts created by the federal treatment of losses and the state sourcing of partner-ship gain/loss as applied to individual and corporate partners?
- Special Allocations: Do special allocations of partnership income or items affect state souring?
- Related Partnerships: Can and should income of separate partnerships be combined for state sourcing purposes and if so, how?
- Tiered Partnerships: If state sourcing of income and items is generally determined at the partnership level, is that sourcing affected when the income and items pass through a tiered structure engaged in the same business, and if so, how?

DEFAULT RULE (INDIVIDUALS AND CORPORATIONS)



GUARANTEED PAYMENTS

- What is a guaranteed payment?
- They can generally only be understood in relation to two other concepts:
  - Distributive share (allocations of partnership items) – under IRC §704
  - Payments to a partner not acting in capacity as partner – under IRC §707(a)

GUARANTEED PAYMENTS

IRC 707(c) - Guaranteed payments

To the extent **determined without regard to the income of the partnership**, payments to a partner **for services or the use of capital** shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

GUARANTEED PAYMENTS

- Like all things in the partnership area – there are complications that the IRS has struggled to address.
- See, for example, Proposed Reg. 115452-14 (part of Internal Revenue Bulletin: 2015-32, August 10, 2015) - Disguised Payments for Services.
  - Summarizes the history of the treatment of guaranteed payments and difficulties distinguishing payments made for services not in the capacity of partners (IRC §707(a)) versus guaranteed payments made to partners acting as partners (IRC §707(c)).
  - This and similar IRS guidance highlights the need for anti-abuse rules to set boundaries that make the general rules work.

GUARANTEED PAYMENTS

- Federal Sourcing –
  - Unlike distributive share—where the character of the items and the partnership activities determine sourcing—guaranteed payments for services by partners are generally sourced to the location of the partner. Rev. Ruls. 81-300 and 81-301 and PLR 7939005.
  - 4 USC 114 – preempts any state other than the residency state from taxing retirement income including certain guaranteed payments made to a retired partner—including for termination of employment.

GUARANTEED PAYMENTS

- So – guaranteed payments are neither allocations of partnership items nor are they payments to partners not acting in the capacity of partners – but they are treated sometimes like one and sometimes like the other.
- Guaranteed payments are ordinary income for the partners—at least when paid for services.
- Guaranteed payments are deductible by the partnership—in determining the amount of partnership income.
- Guaranteed payments are not salary.
- Guaranteed payments may be sourced differently than distributive share for federal purposes.

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2022, or tax year beginning ______, 2022, ending ______, 20__.

Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123

2022

	Type or Print		
A Principal business activity		Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see instructions.	E Date business started
C Business code number		City or town, state or province, country, and ZIP or foreign postal code	F Total assets (see instructions) $

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return

H Check accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify): ______

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year: ______

J Check if Schedules C and M-3 are attached ☐

K Check if partnership: (1) ☐ Aggregated activities for section 465 at-risk purposes (2) ☐ Grouped activities for section 469 passive activity purposes

Caution: Include **only** trade or business income and expenses on lines 1a through 22 below. See instructions for more information.

Income	1a	Gross receipts or sales	1a		
	b	Returns and allowances	1b		
	c	Balance. Subtract line 1b from line 1a		1c	
	2	Cost of goods sold (attach Form 1125-A)		2	
	3	Gross profit. Subtract line 2 from line 1c		3	
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)		4	
	5	Net farm profit (loss) (attach Schedule F (Form 1040))		5	
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)		6	
	7	Other income (loss) (attach statement)		7	
	8	**Total income (loss).** Combine lines 3 through 7		8	
Deductions (see instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)		9	
	10	Guaranteed payments to partners		10	
	11	Repairs and maintenance		11	
	12	Bad debts		12	
	13	Rent		13	
	14	Taxes and licenses		14	
	15	Interest (see instructions)		15	
	16a	Depreciation (if required, attach Form 4562)	16a		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b	16c	
	17	Depletion **(Do not deduct oil and gas depletion.)**		17	
	18	Retirement plans, etc.		18	
	19	Employee benefit programs		19	
	20	Other deductions (attach statement)		20	
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20		21	
	22	**Ordinary business income (loss).** Subtract line 21 from line 8		22	
Tax and Payment	23	Interest due under the look-back method—completed long-term contracts (attach Form 8697)		23	
	24	Interest due under the look-back method—income forecast method (attach Form 8866)		24	
	25	BBA AAR imputed underpayment (see instructions)		25	
	26	Other taxes (see instructions)		26	
	27	**Total balance due.** Add lines 23 through 26		27	
	28	Payment (see instructions)		28	
	29	**Amount owed.** If line 28 is smaller than line 27, enter amount owed		29	
	30	**Overpayment.** If line 28 is larger than line 27, enter overpayment		30	

Sign Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than partner or limited liability company member) is based on all information of which preparer has any knowledge.

651121

☐ Final K-1 ☐ Amended K-1

OMB No. 1545-0123

Schedule K-1
(Form 1065)

Department of the Treasury
Internal Revenue Service

2022

For calendar year 2022, or tax year

beginning / / 2022 ending / /

Partner's Share of Income, Deductions, Credits, etc.

See separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS center where partnership filed return:

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.

G ☐ General partner or LLC ☐ Limited partner or other LLC

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	14	Self-employment earnings (loss)
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . . ☐
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses
6c	Dividend equivalents		
7	Royalties		
8	Net short-term capital gain (loss)	19	Distributions
9a	Net long-term capital gain (loss)		

QUESTIONS THAT DON'T ALWAYS HAVE CLEAR ANSWERS

- In some cases, it may not be clear when the payment is made to a partner not acting as a partner (and so is treated as a payment under IRC §707(a).
- Complex arrangements often raise the question of whether the payment to the partner is distributive share (allocation of partnership income) or a guaranteed payment.
- It is not clear whether some guaranteed payments are made for services or for capital contributed by the partnership.
- Federal rules sometimes, but not always, treat guaranteed payments for services similar to compensation.
- How do the states source guaranteed payments.

Summary

- We researched to find states with specific provisions on the sourcing of guaranteed payments for the performance of services.
- The states that address sourcing guaranteed payments take varying approaches including sourcing where the services are performed, sourcing the same as distributive share, or sourcing with a hybrid approach.
- However, we also found that many states do not have any specific provisions on the sourcing of guaranteed payments.
- If we have missed anything in our research, please contact Jenn Stosberg at jstosberg@mtc.gov

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

APPROACH 1 – SOURCE WHERE THE SERVICES ARE PERFORMED

- Colorado: GIL-20-001 (2/28/2020)

  Rule 39-22-109(3)(b)(xii) states that the source of a guaranteed payment for services is determined in accordance with the rules for sourcing wage income. Wage income is Colorado source income if it is paid for work performed in Colorado . . . guaranteed payments are not considered part of the partner's distributive share.

- Michigan: Michigan Revenue Administrative Bulletin 1988-31 (05/27/1988)

  A nonresident partner is taxed on a guaranteed payment to the extent the payment is includable in federal adjusted gross income and is for compensation received for personal services performed in this state. A guaranteed payment for the use of capital is allocated to the nonresident partner's state of domicile.

APPROACH 1 – SOURCE WHERE THE SERVICES ARE PERFORMED

- Montana: Mont. Admin. R. 42.9.303

  Guaranteed payments that result from the individual efforts of the partners are treated, both to the partnership and to the individual partner, as compensation for services and, like other compensation for services provided, sourced in the state where the services are performed. Guaranteed payments that are a priority allocation of capital are treated as a share of the profits from the partnership's business activities generally. This portion is apportioned according to the partnership's property, payroll, and sales factors. Guaranteed payments to a retired partner are sourced to domicile.

- New Mexico: N.M. Public Decision No. 12-12 (April 9, 2012); N.M. Code R. § 3.2.1.14

  For income tax, guaranteed payments for services are sourced as compensation. For gross receipts tax, a guaranteed payment for activities undertaken as a partner on behalf of the partnership is not a gross receipt.

- Virginia: PD 05-38 (March 16, 2005); PD 05-48 (April 7, 2005)

  Guaranteed payments for services are attributed to where the services are performed.

APPROACH 2 – SOURCE THE SAME AS DISTRIBUTIVE SHARE

- California: Cal. Rev. & Tax. Code § 17854, Cal. Code Regs. tit. 18, § 17951-4

  A guaranteed payment "shall be included in that computation as gross income from sources within this state in the same manner as if those payments were a distributive share of that partnership."

- Georgia: Ga. Comp. R. & Regs. 560-7-3-.08

  Payments made to a partner for services rendered or for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partner profits

- Illinois: Illinois General Information Letter IT 22-0006

  Nonresident partners apportion guaranteed payments to Illinois based on the apportionment factor of the partnership.

APPROACH 2 – SOURCE THE SAME AS DISTRIBUTIVE SHARE

- Maine: 36 M.R.S. § 5192

  In determining the sources of a nonresident partner's income, no effect shall be given to a provision in a partnership agreement which characterizes payments to the partner as being for services or for the use of capital.

- Massachusetts: 830 Mass. Code Regs. 62.5A.1; Form 3 Instructions

  Guaranteed payments made to nonresident partners are apportioned to Massachusetts as ordinary income of the partnership.

- Minnesota: Minn. R. 8002.0200, Form M3 Instructions

  Guaranteed payments to partners (including for services and use of capital) make up a portion of the partner's distributive share of partnership income. Accordingly, to determine the Minnesota portion of each partner's share of guaranteed payments, multiply the amount reported to the partner on Schedule K-1, line 4, to Minnesota using the same apportionment percentage or assignment ratio used to allocate the income from which the guaranteed payment was deducted federally.

APPROACH 2 – SOURCE THE SAME AS DISTRIBUTIVE SHARE

- Mississippi: Miss. Code R. § 35.III.9.01

  Payments made to a partner for services rendered and for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partner profits.

- Missouri: Mo. Rev. Stat. § 143.421

  In determining the sources of a nonresident partner's income, no effect shall be given to a provision in a partnership agreement which characterizes payments to the partner as being for services or for the use of capital.

- Nebraska: Neb. Rev. Stat. § 77-2729

  In determining the sources of a nonresident partner's income, no effect shall be given to a provision in a partnership agreement which characterizes payments to the partner as being for services or for the use of capital.

APPROACH 2 – SOURCE THE SAME AS DISTRIBUTIVE SHARE

- New Jersey: N.J. Admin. Code § 18:35-1.3

  Guaranteed payments shall be reported as distributive share of partnership income, except guaranteed payments received by a retired partner who is receiving such payments as a result of a period of service to the partnership pursuant to a retirement agreement or pension plan. Such guaranteed payments will be treated as pension income to retired partners and shall be reported by the partner as pension income.

- New York: N.Y. Tax Law § 632; New York TSB-A-06(9) (November 30, 2006)

  In determining the sources of a nonresident partner's income, no effect shall be given to a provision in a partnership agreement which characterizes payments to the partner as being for services or for the use of capital. Guaranteed payments are sourced as distributive share.

- North Carolina: N.C. Gen. Stat. § 105-154; Instructions to Form D-403

  Guaranteed payments received by a nonresident partner must be apportioned and allocated to North Carolina on the same basis as other partnership distributive income.

APPROACH 2 – SOURCE THE SAME AS DISTRIBUTIVE SHARE

- Oregon: Or. Admin. R. 150-316-0155

  Guaranteed payments paid to nonresident partners of a partnership that has business activity in the state of Oregon are treated as a distributive share of partnership income for Oregon tax purposes. In order to determine the income attributable to Oregon sources, each nonresident partner's entire distributive share, including the guaranteed payments, is then subject to the allocation and apportionment provisions of ORS 314.605 to 314.675

- Pennsylvania: Pennsylvania Personal Income Tax Guide; Ruling No. PIT-05- 019 (10/13/2005)

  For nonresidents a guaranteed payment for services in a partner capacity is allocable or apportionable to Pennsylvania to the same extent as the net profits are allocable or apportionable to Pennsylvania. For nonresidents a guaranteed payment for other services or for the use of capital is allocable to their state of residence.

APPROACH 2 – SOURCE THE SAME AS DISTRIBUTIVE SHARE

- Rhode Island: R.I. Gen. Laws § 44-30-34

  In determining the sources of a nonresident partner's income, no effect shall be given to a provision in a partnership agreement which characterizes payments to the partner as being for services or for the use of capital.

- Utah: Utah Advisory Opinion, No. 93-006, 03/22/1993

  Sources guaranteed payments the same as distributive share.

- Vermont: Instructions to Schedule BI-473

  Guaranteed payments are apportioned.

- West Virginia: W. Va. Code § 11-21-37

  In determining the sources of a nonresident partner's income, no effect shall be given to a provision in a partnership agreement which characterizes payments to the partner as being for services or for the use of capital.

APPROACH 3 – HYBRID APPROACH

- Idaho: Idaho Code § 63-3026A

Guaranteed payments are sourced to Idaho based upon the Idaho apportionment factor of the partnership; excluding:

1. Guaranteed payment to a retired partner per 4 U.S.C. section 114(b)(1)(I) that is sourced to the recipient's state of domicile;

2. Guaranteed payment to an individual partner up to two hundred fifty thousand dollars ($250,000) in any calendar year is sourced as compensation for services. The amount of the guaranteed payment in excess of two hundred fifty thousand dollars ($250,000) is sourced to Idaho based upon the partnership's Idaho apportionment factor. The two hundred fifty thousand dollar ($250,000) amount will be adjusted annually by multiplying the amount by the percentage (the consumer price index for the calendar year immediately preceding the calendar year to which the adjusted amount will apply divided by the consumer price index for calendar year 2013) as defined in section 63-3024, Idaho Code.

APPROACH 3 – HYBRID APPROACH

- North Dakota: N.D. Cent. Code § 57-38-08.1

Except as otherwise provided in this subdivision, guaranteed payments paid to nonresident partners of a partnership that has business activity in this state are treated as a distributive share of partnership income for state tax purposes. In the case of a professional service partnership, the portion of a guaranteed payment paid to a nonresident partner attributable to a reasonable salary may not be treated as a distributive share. The portion of the guaranteed payment not treated as a distributive share that is for services performed in this state must be assigned as provided under subsection 1 of section 57-38-04. For purposes of this subdivision, "professional service partnership" means a partnership that engages in the practice of law, accounting, medicine, and any other profession in which neither capital nor the services of employees are a material income-producing factor.

Approach 4 – No Provision on the Issue

We could not find any express provisions on the sourcing of guaranteed payments for the remainder of the states.

Potential Pros/Cons of Sourcing Where Services are Performed

Pros	Cons
Consistent with federal sourcing	Will there be complexity in determining where the services are performed?
Consistent with the Subchapter K principle that partners should be treated as if they conducted the activity directly	Will there be complexity in determining if a guaranteed payment is for services performed in a partner capacity (vs. a return of capital)?

Potential Pros/Cons of Sourcing the Same as Distributive Share

Pros	Cons
Easier to administer?	Inconsistent with federal sourcing
	May be inconsistent with the principle that partners should be treated as if they conducted the activity directly

Potential Problems with Multiple Approaches

- Double Taxation
- Nowhere Taxation
- Lack of Clarity

Additional Issues to Consider

- Whether guaranteed payments should be included in the payroll factor
- Pass-through entity tax provisions on guaranteed payments

POSSIBLE NEXT STEPS

- Examples – demonstrating the results under different rules and the problems that the lack of uniformity may create for multistate taxpayers.
- Exploring possible solutions – including credits for taxes paid to other states, reciprocal agreements, etc.

QUESTIONS - COMMENTS