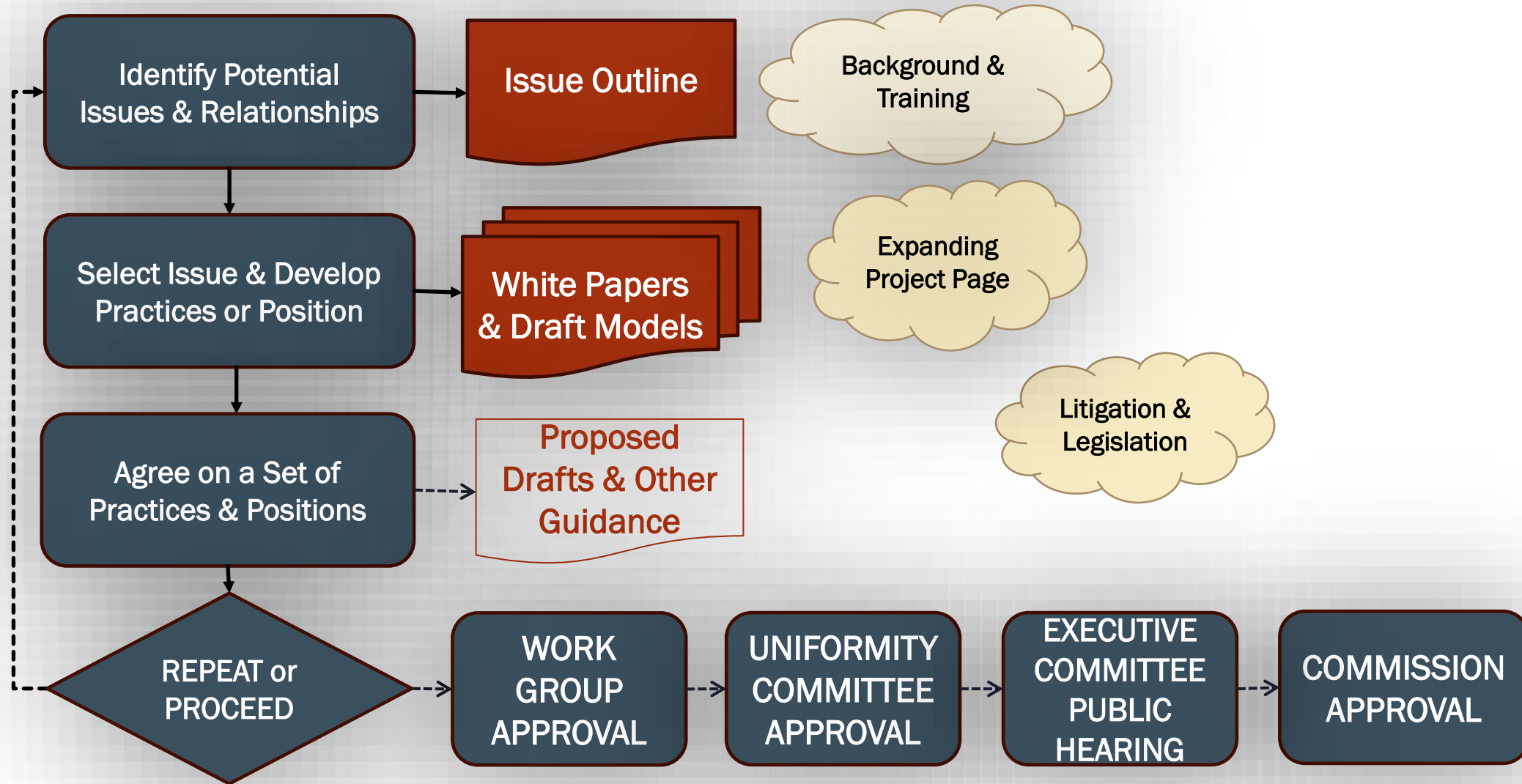




# State Taxation of Partnerships – Status Report and Plan for 2024

JUNE 20, 2024

# General Work Group Process



# STATUS - OVERVIEW

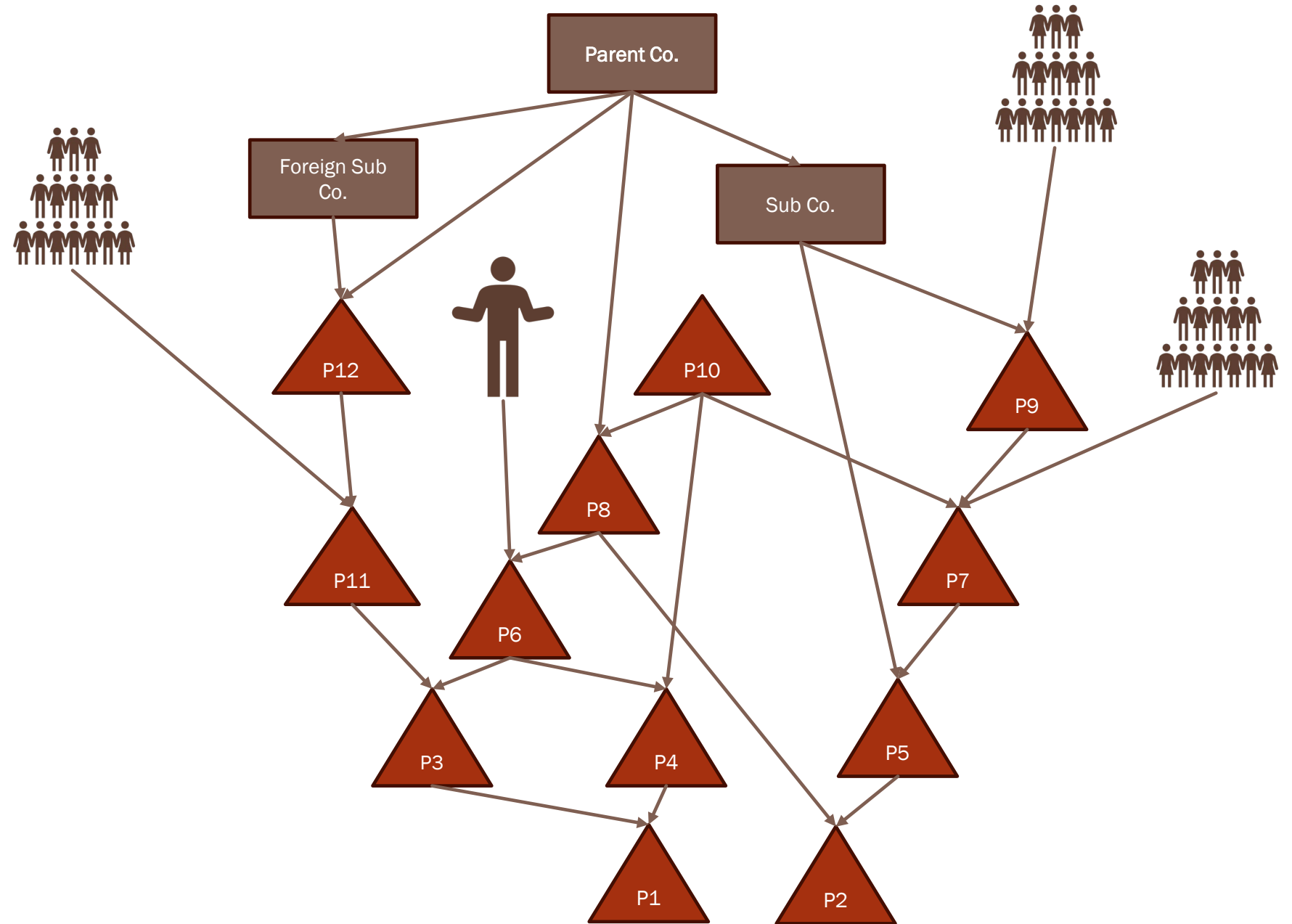
	Initial Discussion	State and Other Research	Define Issues & Scope	Analyze Alternatives – White Paper	Draft Models or Recommendations	Refer Recommendations to Uniformity Committee
Investment Partnerships	✓	✓	✓	✓	✓	
Guaranteed Payments for Services	✓	✓	✓	✓	✓	
Sourcing in Complex Partnership Structures	✓	✓				

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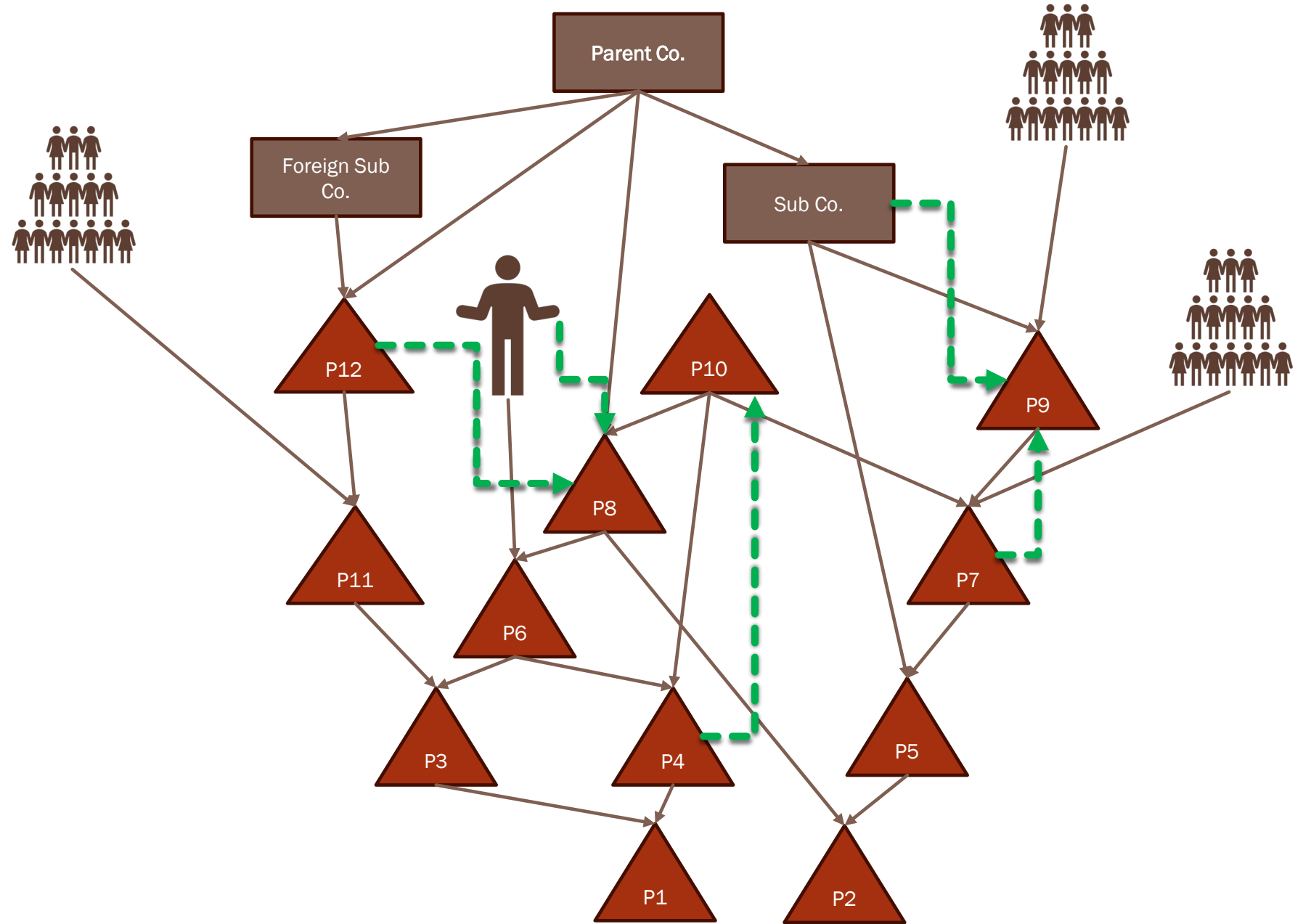
## **POSSIBLE SCOPE & ISSUES FOR WHITE PAPER:**

- How is sourcing affected by:
  - Tiered Partnerships
  - Intercompany Transactions
  - Special Allocations

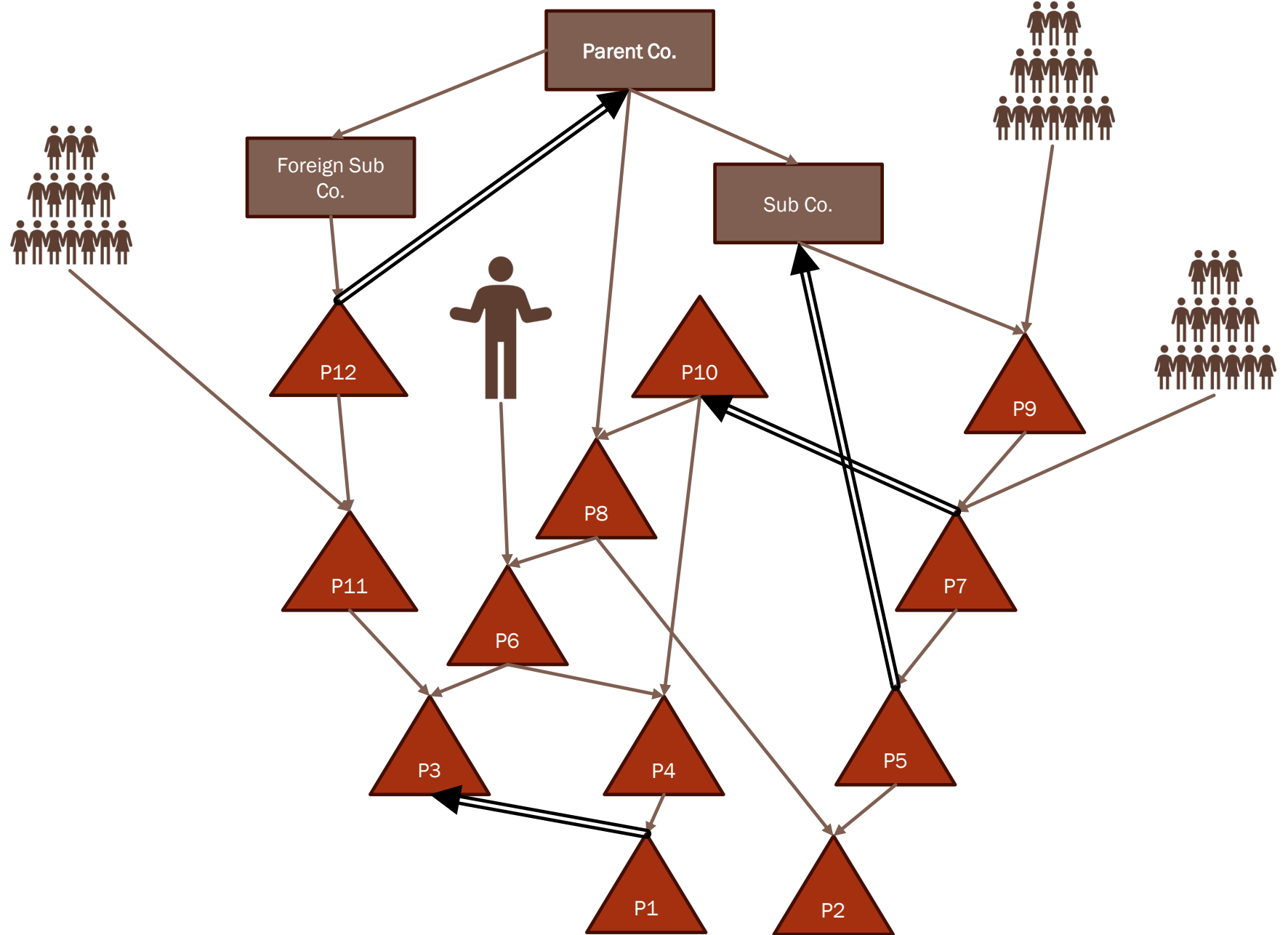
# TIERED PARTNERSHIP STRUCTURES



# INTERCOMPANY TRANSACTIONS



# SPECIAL ALLOCATIONS OF PARTNERSHIP ITEMS





## RESEARCH ON RELATED STATE RULES

- Focused on tiered partnership structures in particular.  
(The current version of the research is posted on the agenda.)
- Most states do not have anything like Subchapter K – a section of law entirely devoted to partnership taxation.
- States also may not have specific statutory guidance for a number of issues.
- So what is the basis for state partnership tax rules?



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Existing Corporate  
and Personal  
Income Tax Rules



State  
Partnership  
Taxation

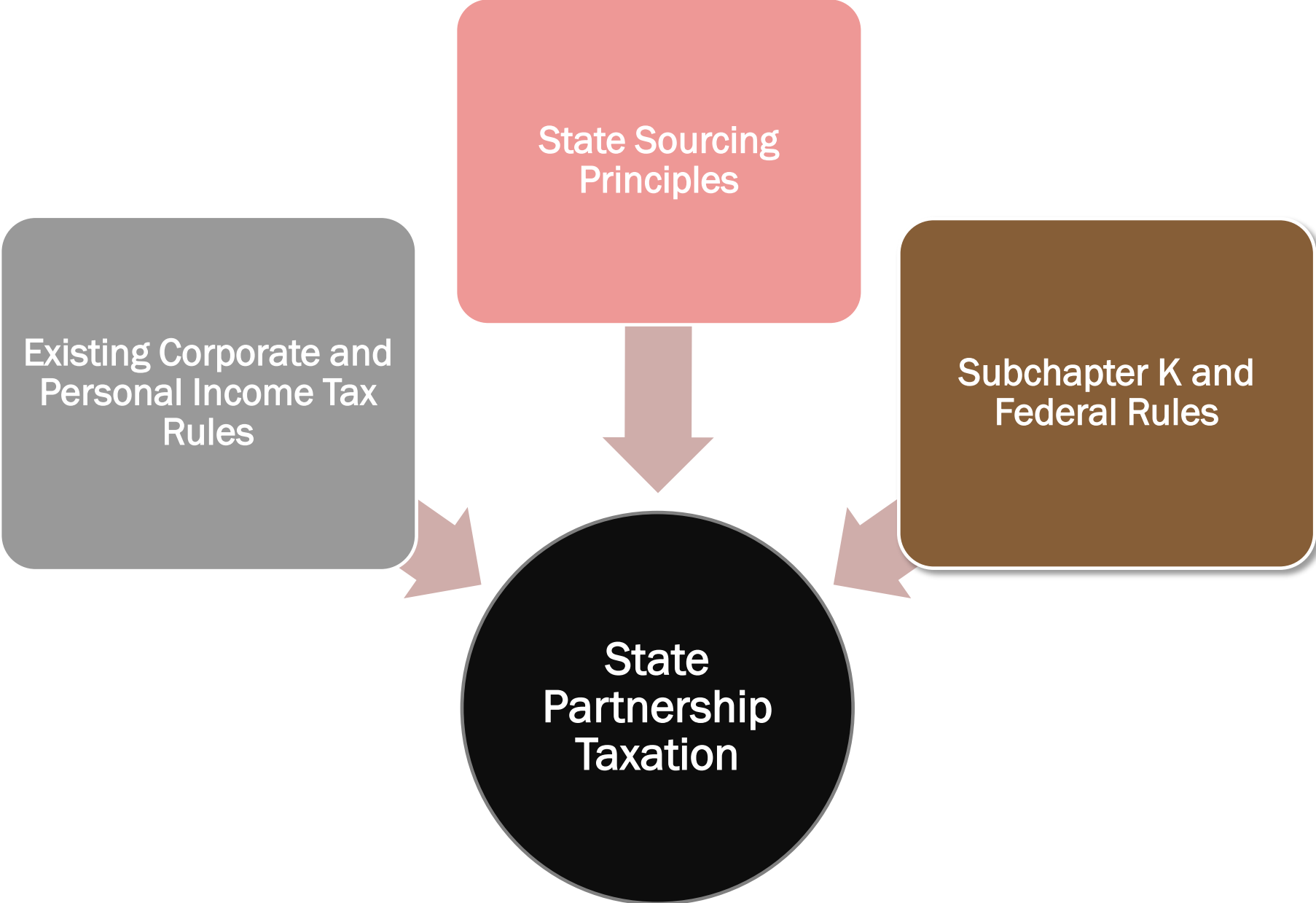
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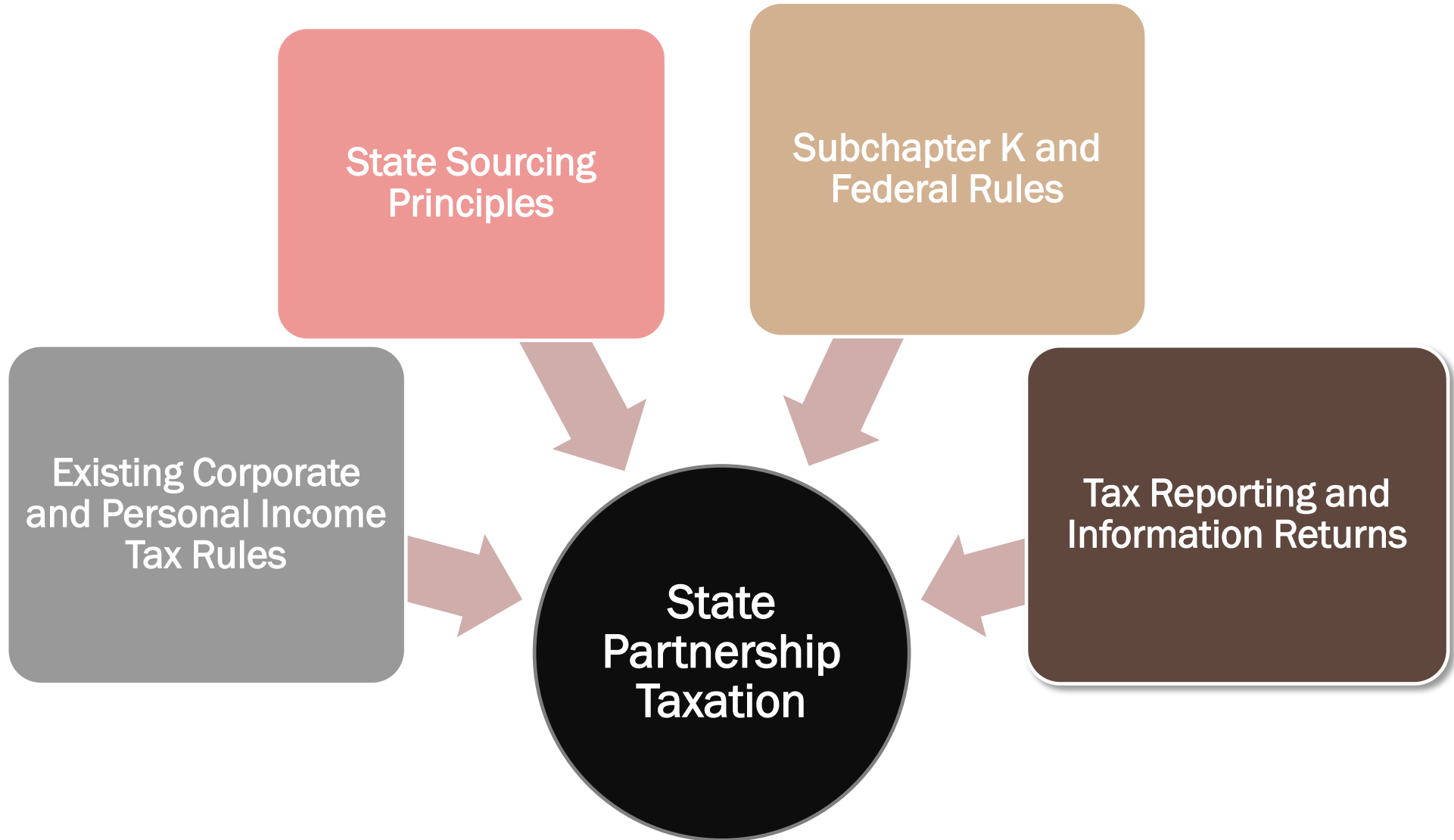
Existing Corporate and  
Personal Income Tax  
Rules

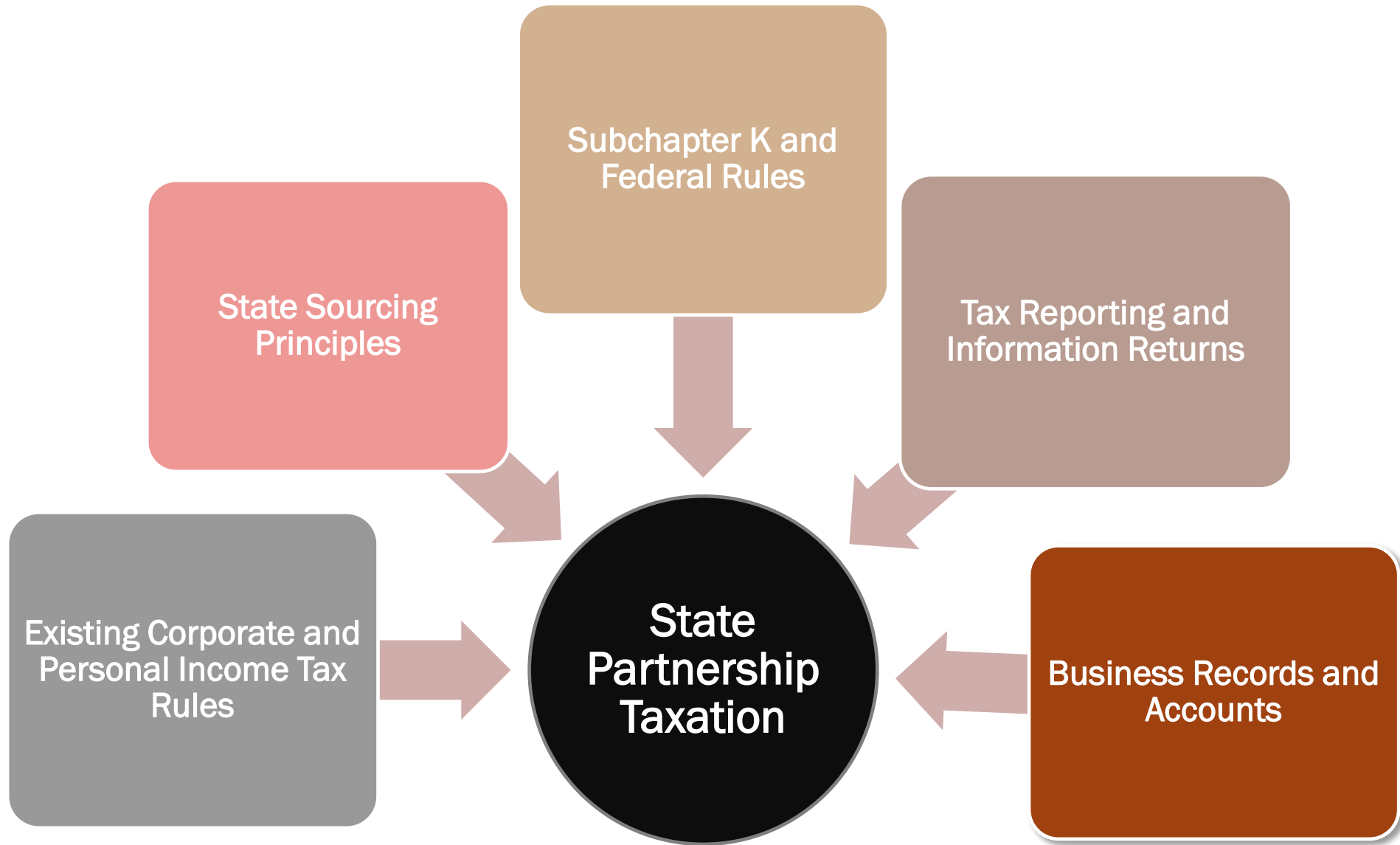
State Sourcing  
Principles

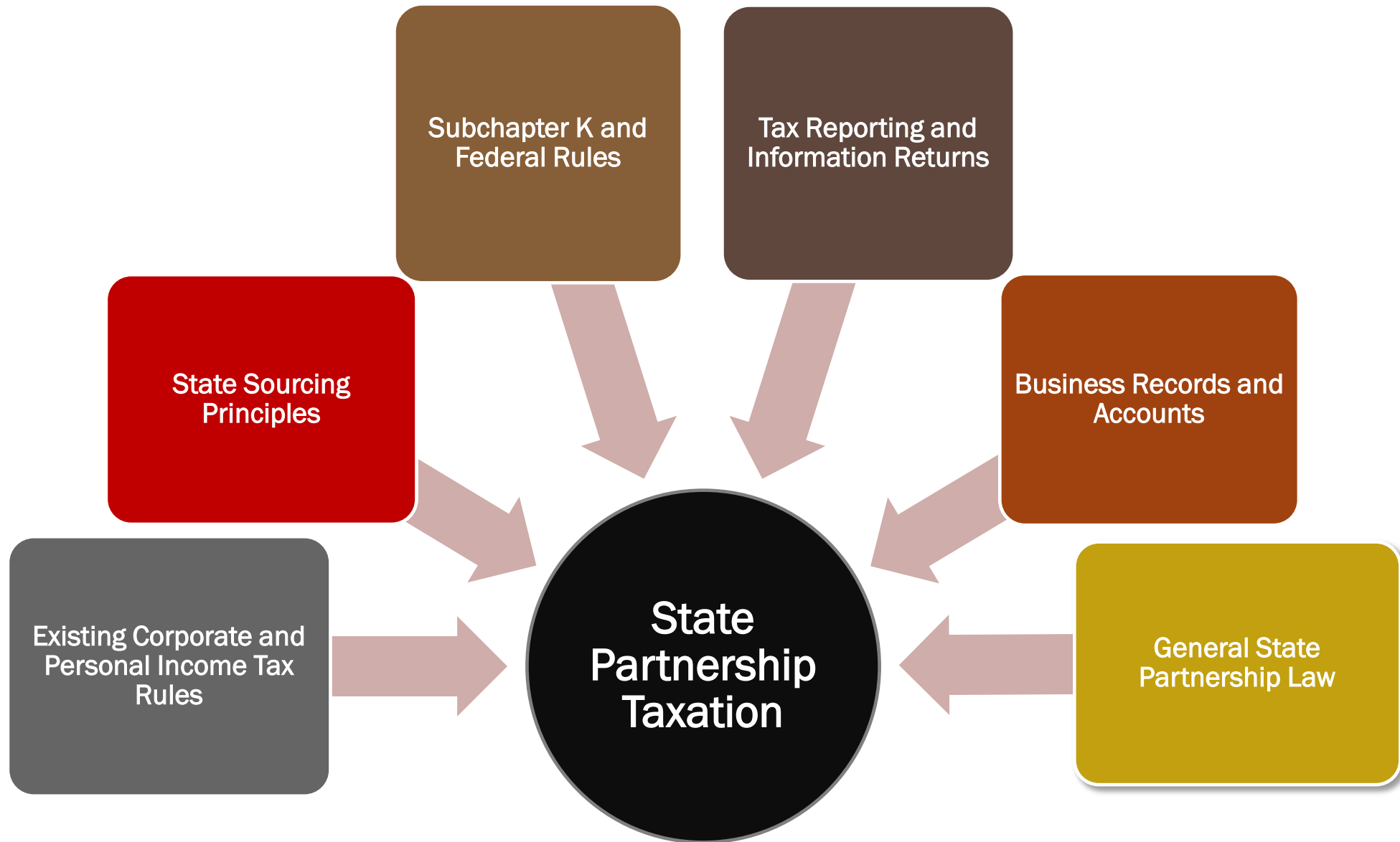
State  
Partnership  
Taxation

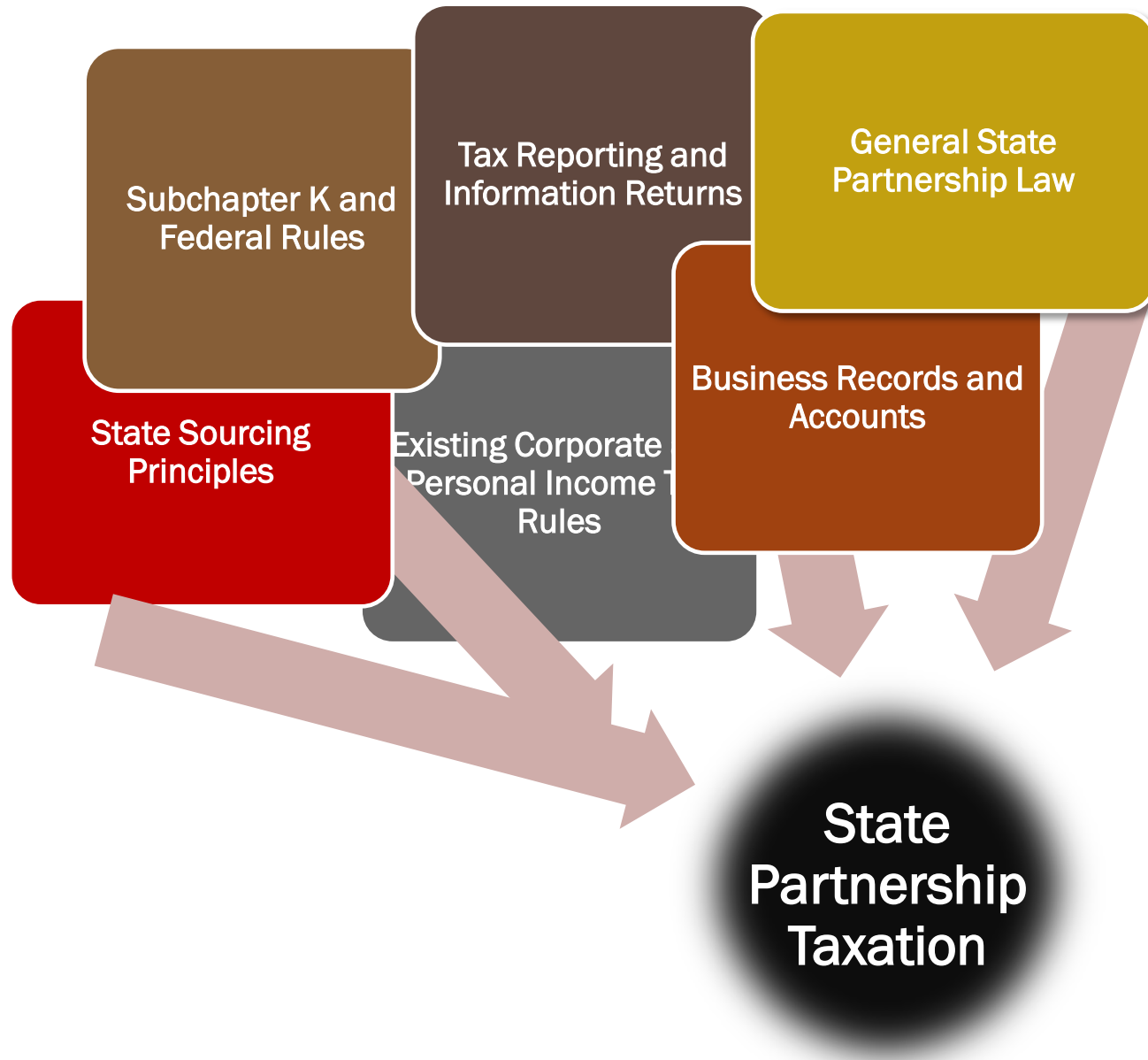














General State  
Partnership  
Law

## Aggregate Versus Entity

**Does state law  
treatment of  
partnerships  
determine the tax  
result?**

- **Maybe YES –**

The Texas Supreme Court ruled that tax on partnership income was not an unconstitutional tax on the partners' income by looking to the general state law of partnerships saying:

“Although it has not always been so, **Texas adheres to the entity theory.** In **1961** the Legislature adopted the **Texas Uniform Partnership Act (TUPA)**, TEX. CIV. STAT. ANN. art. 6132(b) which “lean[ed] heavily toward the entity idea.”

*In re Allcat Claims Serv., LP*, 356 S.W.3d 455 (Tex. 2011).



General State  
Partnership  
Law

## Aggregate Versus Entity

**Does state law  
treatment of  
partnerships  
determine the tax  
result?**

- **Maybe NO–**

The D.C. Circuit noted that after the Tax Court's decision that the aggregate theory did not apply to treatment of gains from the sale of a partnership interest, **Congress enacted legislation establishing that the aggregate theory (rather than the entity theory) governs the disposition of a partnership interest.**

*See Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner, 926 F.3d 819, 823 (D.C. Cir. 2019).*



Sourcing  
Principles

## Apportionment Versus Item-Sourcing

**Does the role of the partner determine applicable sourcing rules?**

- Maybe YES –
  - A few states indicate that minority, limited, passive, or indirect partners may treat partnership income as sourced using general allocation or item-based rules, including sourcing certain income to the partner's residence.



Sourcing  
Principles

## Apportionment Versus Item-Sourcing

**Does the role of the partner determine applicable sourcing rules?**

- Maybe NO –
  - Other states indicate that under the “conduit” or “attribution” principles, the source of partnership income is determined by the activities of the entity (as though the partner engaged in those activities directly). This, in turn, is a recognition of this foundational principle of Subchapter K – see IRC 702.

1950

CHANGES OVER TIME

2024

Aggregate Theory

State Partnership Law

Entity Theory

Physical Presence

State Tax Jurisdiction

Economic Presence

Separate Accounting

Sourcing of Business Income

Formulary Apportionment

2000

MORE RECENT TRENDS

2024

COP Based Sourcing

State Apportionment Rules

Market-Based Sourcing

Three-Factor Formula

State Apportionment Rules

Single Sales-Factor

Separate Filing

Treatment of Related Entities

Combination & Add-Back



## SO – HOW MIGHT WE PROCEED?

- We need to at least informally agree on a framework to eliminate some of the details and the complexity that would otherwise have to be addressed.
- We can look to current state rules as well as what works and what doesn't in developing that framework.
- What's left—the gaps or uncertainties—may represent problems with the framework, or may simply require rules to fill those gaps.
- That framework was drafted back in late 2023.



## **PROPOSED FRAMEWORK – OCT. 2023**

Purpose – an agreed-upon baseline that can serve to help focus the scope of our work, and evaluate the issues and potential solutions.

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# Proposed Framework

## General

1. State law governs the formation of different types of partnerships and the basic rights of partners . . .
2. States allow entities formed in other jurisdictions to operate in the state, provided they comply with state regulatory requirements.
3. State income taxes generally conform to applicable federal substantive tax provisions for computing and characterizing items of income for individuals and corporations, and follow the IRS interpretation of those provisions.



# Proposed Framework

## General (Cont'd)

4. State pass-through tax systems generally conform to the provisions of IRC Subchapter K . . . :
  - a. Partnership income is taxed when earned (IRC § 702 & 703).
  - b. Partners are required to report and pay tax . . . regardless of whether they receive any actual distribution (IRC § 704).
  - c. Distributions are not taxable to the extent they represent contributions by or income already recognized by the partner (IRC § 731).
  - d. Partners may agree to vary their shares of partnership items and change those shares over time and the tax result will reflect their agreement . . . (IRC § 704(b)).

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# Proposed Framework

## General (Cont'd)

5. The IRS has adopted certain anti-abuse rules deemed essential for the federal pass-through system to function properly but the application at the state level may be unclear.
6. Both general state law and Subchapter K allow partnerships to have partners that are corporations (whether taxed as C corporations or S corporations), individuals, trusts, and other partnerships.
7. Most states that impose tax on partnership income on a pass-through basis have also adopted elective pass-through entity taxes . . . .

# Proposed Framework

## General Regulatory Jurisdiction

8. Over the Entity: If a partnership has assets or activities with a sufficient connection to a state, the state may exercise general regulatory jurisdiction over that partnership, including . . .
9. Over the Partners: If a state has general regulatory jurisdiction over the partnership, that jurisdiction generally extends to the partners in matters involving activities of the partnership, although there remains some uncertainty as to whether it extends to passive or indirect partners in all cases.

# Proposed Framework

## Constitutional Tax Nexus and State Doing Business Standards

10. A business's choice of entity—sole proprietorship, partnership, corporation, etc.—does not affect constitutional limits on the state taxation of the business's income.
11. States have due process nexus to impose tax on the income of a business, including a partnership, to the extent there is a sufficient connection between the assets or activities giving rise to that income and the state.
12. States have commerce clause nexus to impose tax on the income of a business, including a partnership, to the extent the income or a share of it is fairly sourced (or “apportioned,” as that term is used generally in Supreme Court precedent), the tax does not discriminate against interstate commerce, and the tax does not impose an undue burden on interstate commerce.

# Proposed Framework

## Constitutional Tax Nexus and State Doing Business Standards (Cont'd)

13. States that have due process and commerce clause nexus over the income of a partnership taxed on a pass-through basis also have due process and commerce clause nexus to apply the tax to partners generally. And while there have been some conflicting opinions in the past, this nexus extends to both direct and indirect partners and applies regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership, provided the state takes reasonable steps so as not to burden interstate commerce.

# Proposed Framework

## Constitutional Tax Nexus and State Doing Business Standards (Cont'd)

14. States' doing business or tax imposition statutes, as applied to partnerships, should be consistent with other businesses and may apply a factor-presence nexus standard or threshold at the entity level.
15. As with nexus, if a partnership exceeds any doing business standard or threshold, then states should make clear that the standard or threshold is also met by any direct or indirect partner, regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership.

# Proposed Framework

## Sourcing

16. States generally conform to the federal rules for domestic sourcing of multinational income, but do not apply these federal rules to the sourcing of domestic income between the states.
17. States generally apply formulary apportionment and specific rules of assignment to source income of multistate businesses.
18. Under the dormant commerce clause, apportionable income is limited to income that has a sufficient connection to the apportionment formula and factors in the state, and it may include income that is part of a unitary business to which the factors relate.

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# Proposed Framework

## Sourcing (Cont'd)

19. Nonapportionable income can be sourced using state rules of assignment provided there is a sufficient connection between the basis for the rule and the income to be sourced.
20. Formulary apportionment and state rules of assignment can be properly applied to the partnership income or items at the entity level, based on the activities and assets of the partnership.



# Proposed Framework

## Sourcing (Cont'd)

21. The sourcing of partnership income or items at the entity level can be attributed to any direct or indirect partner that receives a share of that income or items, regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership, unless the partner is separately engaged in a business and –
- a. That business is unitary with the business conducted by the partnership, or
  - b. That partnership interest held by the partner serves a unitary purpose in that business.

In that case, the factors related to the partner's business may also be taken into account in sourcing the partner's share of the partnership income or items.

# Proposed Framework

## Withholding/Composite/PTE Tax

22. States that tax partnership income on a pass-through basis may impose a requirement on partnerships to withhold tax on their partners distributive shares of that income, regardless of whether the partners receive any distributions.
23. States that allow partnerships to file a composite or PTE return and pay tax attributable to the shares of income or items of partners, and that also exempt partners with no other income in the state from requirements to file and report tax on that partnership income or items, have sufficiently reduced the burden that the tax might otherwise impose on interstate commerce.



## WHITE PAPER

- States are in general agreement that business or operational income of partnerships is sourced using formulary apportionment at the entity level and this sourcing information flows through to the partners.
- Exceptions may be where there are:
  - Tiered partnership structures
  - Intercompany transactions
  - Special allocations
- Question—to what extent should these issues affect sourcing—for example, through the use of blended apportionment or other sourcing options or through anti-abuse rules.

## EXAMPLES OF SPECIFIC QUESTIONS TO BE ADDRESSED

- Tiered structures or corporate partners, intercompany transactions, and blended apportionment –
  - Should the unitary business principle apply and if so, how?
    - Since minority partners can control the partnership—does ownership matter?
  - Given the inability to have partnerships file combined returns—should there be a limits on when blended apportionment is used?
  - In applying blended apportionment, how should the partner’s “share” of factors be determined?
  - Should there be elimination of intercompany sales from the factors? What about income?
- Are there any type of special allocations that should be sourced differently?
- What types of anti-abuse rules might states need to avoid income shifting?



## QUESTION:

- Does this basic white paper scope and the issues to be covered make sense?



## **OTHER – PARTNERSHIP TRAINING**

- Still have the basics of partnership taxation for state tax administrators available on the MTC LMS.
- 2023 – had the in-person summit to identify issues for additional training.
- Looking to do in-person training for states in January 2025.
- Prior to that - will work on remote training modules for the LMS.



## **NEXT WORK GROUP CALL AND UNIFORMITY MEETING**

- July 17, 2024
- MTC Uniformity Meeting – part of the MTC Annual Meetings – in Denver, Colorado – July 30, 2024 (open to remote participation)