State Taxation of Partnerships Proposed White Paper Outline Sourcing in Complex Structures

MULTISTATE TAX COMMISSION

JULY 17, 2024

NOTE:

THESE SLIDES SUMMARIZE AN OUTLINE AND SUMMARY OF CERTAIN ISSUES FOR USE IN PREPARING A WHITE PAPER ON BEHALF OF THE MTC TAXATION OF PARTNERSHIPS WORK GROUP. INFORMATION IN THESE SLIDES IS FOR DISCUSSION PURPOSES ONLY.

SCOPE & ISSUES

- Sourcing partnership income where:
  - Partner is a corporation
  - Partnership structure has –
    - Tiers
    - Intercompany transactions
    - Special allocations

DRAWING ON MULTI-STATE RESEARCH

- States source partnership income using formulary apportionment.
- A number use blended apportionment in some cases.
- Blended apportionment raises issues not fully addressed.
- Special allocations and intercompany transactions also raise issues.
- Additional research may need to be done.

OUTLINE

I. **Scope**

The white paper would address sourcing where the partner is a corporation, the partnership is a tiered structure, or situations where there are intercompany transactions or special allocations. It would exclude investment partnerships but include guaranteed payments (sourced in the same way as distributive share).

II. **Essential Terms**

(See slides below.)

III. **Importance of the Attribution Principle**

(See slides below.)

OUTLINE (CONT'D)

IV. **Sourcing Non-Apportionable Partnership Income - Generally**

A. Determination of non-apportionable income (see slides below)

B. Sourcing non-apportionable income (see slides below)

V. **Sourcing Apportionable Partnership Income**

A. Corporate and tiered partners – need for blended apportionment

B. How blended apportionment may be applied

1) Share of partnership factors

2) Effects of special allocations

3) Effects of intercompany transactions

C. When blended apportionment may be applied and legal and other limitations

OUTLINE (CONT'D)

VII. Anti-Abuse Rules

A. Special allocations and substantial economic effect
B. Other – including equitable apportionment rules

VIII. Administrative Issues

A. How information is reported by partnerships and partners
B. How withholding may be affected
C. How composite returns or PTE taxes may be affected

IX. Summary of State Research

A. Treatment of corporate and tiered partnerships
B. Treatment of special allocations
C. Anti-abuse rules

Why Focus on "How" First?

- Understanding how may help to shed light on the when.
- It's necessary to test workability of theoretical approaches.
- Some issues may be better addressed through anti-abuse rules, which will be clearer after considering some of the "how" issues.

ESSENTIAL TERMS – FOR THE “HOW” SECTION

Basic Tax Terms	
Partnership	An entity properly treated as a partnership under Subchapter K.
Partner	A person properly treated as a partner under Subchapter K.

Basic Tax Terms (cont’d)	
Income	Used generically to describe both receipts and receipts net of related expenses. The precise meaning may depend on the context.
Receipts	Proceeds from a particular transaction or activity.
Net Income (Loss)	An amount made up of netting various items of income, expense, gain, and/or loss, as determined under applicable tax rules. (See federal Form 1065 for partnerships.)
Substantive Tax Rules	IRC rules that determine the treatment of particular items.

Basic Tax Terms (cont'd)	
Item	Income, expense, gain, or loss from a particular transaction or activity.

Examples: Assume the partnership owns and leases real property.

- Rents are items of receipts (or "income").
- Renovation expenses are an item of expense—or may be capitalized and depreciated.
- Depreciation of the real property is an item of expense or deduction.
- The proceeds from sale of the real property is an item of receipts (or "income").
- Gain or loss from the sale (proceeds less basis) is also an item.

Basic Tax Terms (cont'd)	
Character or Tax Character	Information about a particular tax item that determines its treatment for tax purposes under the substantive tax rules.

Examples:

- Income may be taxable or exempt, recognizable or deferred, etc.
- Expense may be deductible, capitalizable, or non-deductible
- NOLs may be subject to limitations on use
- Gains or losses may be capital or ordinary, short-term, long-term, deferred, etc. and loss may be subject to limitations

Basic Tax Terms (cont'd)	
Attribute (Noun)	An "attribute" is information that is used in determining the character or tax treatment of something.
Item Attribute	An "item attribute " is information about an item that is used in determining its character for tax purposes.
Partner Attribute	A "partner attribute" is information about a partner that would have an effect on the tax the partner would owe on partnership items.

Examples:

- Whether property sold has been held more than a year is an item attribute.
- The taxpaying partner's marginal or effective tax rate is a partner attribute.

Basic Tax Terms (cont'd)	
Attribute (Verb) or Attribution	The requirement that taxpaying partners must recognize their share of partnership items *and their character* in determining the tax owed.

Examples:

- IRC §702(b) – "The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."
- Congress has the authority to either tax the entity itself or attribute the undistributed income to the owners and tax those owners. *Moore v. United States,* 602 U.S. __ (2024).

NOTE: Attribution would also be a separate section of the white paper.

Basic Partnership Concepts	
Consistent with Subchapter K:	
Partnership Item	An item recognized or incurred by a partnership.
Allocate or Allocation	A partners' distributive shares of the partnership's income or items. (See the federal Schedule K-1.)
Distribution	Payment of money or assets by a partnership to a partner.
Distributive Share	A partner's share of partnership items, consistent with IRC § 704, including special allocations.
Guaranteed Payment	A payment made to a partner, acting as a partner, which is not dependent on the partnership's income, consistent with IRC § 707(c).
Interest in the Partnership	A term used under Subchapter K to determine substantial economic effect of special allocations. (See §704(b).)
Partnership Capital	The capital (assets minus liabilities) of a partnership.
Partner Capital	The partner's share of partnership capital.

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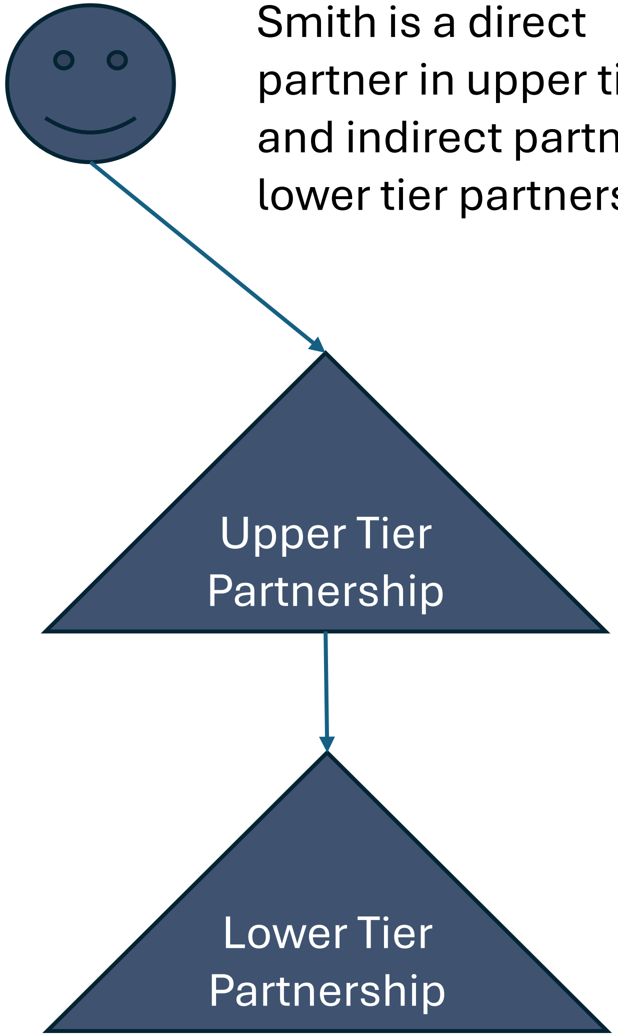
Types of Partners and Partnerships	
Corporate Partner	A partner that is a corporation.
Individual Partner	A partner that is an individual person.
Tiered Partner	A partnership that holds interests in other partnerships.

Types of Partners and Partnerships (cont'd)	
Tiered Partnership	A partnership structure that includes tiered partners.
Lower-Tier Partnership	A partnership that has a partnership as a direct or indirect partner.
Upper Tier Partnership	A partnership that is a direct or indirect partner in another partnership.
Direct Partner	A partner that holds an interest in a partnership.
Indirect Partner	A partner of a tiered partnership, with respect to a lower-tier partnership.

Smith is a direct partner in upper tier and indirect partner in lower tier partnership.



Sourcing Terms	
Source or Sourcing	Terms referring to how amounts of net income or items of income, expense, gain, or loss from multistate activities are attributed to a particular state.
Apportionable Income	Net income made up of items of income, expense, gain, or loss to which formulary apportionment is properly applied (sometimes referred to in other sources as "business income").
Non-Apportionable Income or Items	Items of income, expense, gain, or loss to which specific rules of assignment are properly applied (sometimes referred to in other sources as "nonbusiness income").
Formulary Apportionment	The use of a formula or ratio consisting of factors representing activity in the state (e.g., receipts, property, and/or payroll) which is generally applied to an amount of net income from that activity.
Assign and Rules of Assignment	Sourcing items (using rules of assignment) including sourcing to a particular state or the division of items between multiple states.

IMPORTANCE OF THE ATTRIBUTION PRINCIPLE

Attribution Principle

- Partnership structures generally convey a tax benefit – a single level of tax – paid by the partners.
- Why impose the tax at the partner level? Because partner attributes (e.g., marginal tax rates) matter.
- But in order to apply the various substantive tax rules—the nature of items of income, expense, gain, and loss ("character") must flow through to the partners.
- This means partners reflect these items on their own return as though they engaged in the related activities directly. (IRC §702(b))

Attribution Principle

If there were no attribution principle:

- Partners would get no tax benefit from items based on their character—e.g., capital gains or losses.
- Special allocations—permitted by Subchapter K—would often have no effect.
- It would be possible to use partnerships to avoid the effects of substantive tax rules—such as limits on use of certain expenses or losses.

Attribution Principle

Sourcing –

- Attribution applies to sourcing as well. That is, under the federal rules, the source of the income is determined on a by-item basis at the partnership level and flows through to the partners. (See IRC §§702(b) and 861-865)
- States do not conform to the particular federal sourcing rules—but unless they provide otherwise, the attribution principle would apply to state sourcing of partnership income or items as well.
- As with attribution generally, the role of the partner does not matter.

SOURCING NON-APPORTIONABLE INCOME - GENERALLY

Determination

- First - non-apportionable income must be distinguished from apportionable income derived from separate lines of business where separate apportionment formulas might be used.

- States generally apply the same rules applicable to corporations and businesses generally.

Determination

- Step 1 – Entity-Level Non-Apportionable Income –
  - Determine whether any partnership items are non-apportionable to the entity that recognized or incurred the items.
  - If so—they are sourced at the entity level and that sourcing information flows through to direct and indirect partners.

Determination

- Step 2 – Partner-Level Non-Apportionable Income –
  - If the answer to Step 1 is no—that is, the income or items are apportionable income to the partnership, then determine the partner's distributive share would, itself, be non-apportionable income to the partner.
  - If so, then the income or items are apportioned at the partnership level and that sourcing information flows through to direct and indirect partners.

Sourcing

- <u>Entity-Level Non-Apportionable Income</u> –
  - Apply state rules of assignment to the income or items at the partnership level.
  - Attribute that sourcing information to the partners.
  - Example – if rents from real property are non-apportionable, they would be sourced to the location of the property and the partner's distributive share of those rents would also be sourced to the location of the property.

Sourcing

- Partnership Level Apportionable - Partner-Level Non-Apportionable Income –
  - For income or items that are NOT determined to be non-apportionable at the partnership level—but the distributive share to the partner is non-apportionable –
    - Source using formulary apportionment at the entity level.
    - Attribute that sourcing information to the partner.

3 Possible Outcomes

Income or Items Are:		Source:
Non-Apportionable to the Partnership	√	Apply general rules of assignment. Source is then attributed to the partner.
NOTE: - The income is also non-apportionable to the partner.		
Non-Apportionable to the Partnership		Apply formulary apportionment. Source is then attributed to the partner.
Apportionable to the Partnership	√	
Non-Apportionable to the Partner	√	
Non-Apportionable to the Partnership		This is the subject of the section on apportionable income.
Apportionable to the Partnership	√	
Non-Apportionable to the Partner		
Apportionable to the Partner	√	

SOURCING APPORTIONABLE INCOME

GENERALLY

- States use formulary apportionment.
- Default Rule – Use the factors of the entity recognizing the income.
- Blended Apportionment – Some states require a combination of the taxpaying partner factors with a share or the partnership factors for:
  - Corporate partners
  - Tiered structures

EXAMPLES: CORPORATE PARTNER RULES

- Maine (18-125 Me. Code R. 801 § .07
- 830 Mass. Code Regs. 63.38.1 (12)(f)
- Or. Admin. R. 150-314-0385
- 61 Pa. Code § 153.29

MTC COMBINED FILING MODEL

"...The [property, payroll, and sales] of a partnership shall be included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group in accordance with Section 3.C.ii.(c). and the denominator of which is the amount of the partnership's total unitary income."

IS BLENDED APPORTIONMENT NECESSARY?

- Simple Example - Assume –
  - Corporation C forms Partnership X with another entity.
  - C owns 50% and receives a 50% allocation X's income.
  - X performs important functions for C's business.
  - As separate entities:
    - C has $2 million of income and $20 million in receipts—but no receipts in State 1.
    - X has $1 million of income and all of its receipts--$20 million—are in State 1.

IS BLENDED APPORTIONMENT NECESSARY?

Partner-Level Apportionment

C includes its distributive share of X's income in its apportionable income—but does not include any share of X's factors. So it has no income apportioned to State 1 because it has no receipts of its own in State 1.

RESULTS: $0 sourced to State 1.

IS BLENDED APPORTIONMENT NECESSARY?

Partnership-Level Apportionment -

Partnership X sources its income at the entity level to State 1 and that sourcing result is attributed to C. Since all of X's receipts are in State 1—all of X's income is, and C's share of that income, is sourced to State 1.

RESULT: All of C's distributive share - $500,000 is sourced to State 1.

IS BLENDED APPORTIONMENT NECESSARY?

Blended Apportionment -

C combines its own factors with its share of X's factors and uses that combined formula to apportion all of its income.

	State 1	Total
C Corp Receipts	$	$ 20,000,000
C Corp's Share of X's Receipts	$ 10,000,000	$ 10,000,000
Total	$ 10,000,000	$ 30,000,000
C's Blended Receipts Factor	33%	
C Corp Income Including Distributive Share	$ 2,500,000	
C Corp Income in State 1	$ 833,333	

IS BLENDED APPORTIONMENT NECESSARY?

- Comparison:
  - Partner Apportionment - $0
  - Partnership Apportionment - $500,000
  - Blended Apportionment - $833,333

Some “How” Questions

- How do partners determine share of partnership factors to include?
  - Partner’s “interest in the partnership”?
  - Partner’s share of capital?
  - Partner’s share of partnership income (distributive share)?

Some “How” Questions

- If share of income is used – how is this affected by –
  - Guaranteed payments the partner may receive?
  - Special allocations or similar allocations of items?
- Do partner-partnership or other intercompany transactions affect sourcing or use of blended apportionment?
  - Should intercompany receipts be eliminated?
  - How are guaranteed payments treated?

QUESTIONS???

AND FEEL FREE TO REACH OUT

UPCOMING MEETINGS AND CALLS

THE COMMITTEE'S IN-PERSON MEETING IS TUESDAY, JULY 30, 2024 IN DENVER

THE NEXT WORK GROUP MEETING WILL BE WEDNESDAY, AUGUST 21, 2024

PARTNERSHIP TRAINING – WEEK OF JANUARY 13, 2025 IN NEW ORLEANS